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ROMANIA

# Dealmaking in Romania: lessons for foreign acquirers

BY SONIA KALSI

M&A activity in Romania has surged in the last few years primarily due to strong foreign direct investment. Economic growth and increased consumer spending power, accession to the EU and favourable prospects for the future viability of the market are just some of the factors that make Romania an attractive choice. Although all sectors have witnessed activity, financial services, pharmaceutical, energy, insurance, telecoms and more recently real estate, have stood out in terms of the size and scale of transactions. Foreign investors including private equity funds are flocking to the region but should exercise caution. Romania is still an emerging market and with investment in such a region comes a degree of risk. Local regulatory requirements, culture and practices must be clearly understood and careful due diligence procedures implemented in order to achieve long term success.

**An attractive investor proposition**

Noticeable growth in the Romanian market began between 1996 and 1998. Since then the country has gradually restructured itself in order to arrive at the thriving business position it is in today partially assisted by foreign investors. Nokia, one such investor, was recently at the heart of one of the biggest single cross-continent employment moves to eastern Europe. The world's largest producer of mobile handsets closed its German based factory and moved 2,500 employees to Romania in January 2008, throwing Romania's sharp economic growth, favourable business tax regime and low cost labour into the limelight.

Still largely untapped, Romanian opportunities for regional players and foreign investors are in abundance. A notable group of private equity firms have been drawn to the area. "We have seen increased interest not only from established regional players but also from pan-European funds such as 3i, Oaktree and CVCI says Hein van Dam, partner in charge with the financial advisory services at Deloitte Consultanta S.R.L. "In terms of infrastructure, there are pockets of expertise in the market able to service larger more demanding private equity clients. The degree of familiarity with private equity in the areas of structuring and acquisition finance are obviously not at western European levels, but I expect this to change rapidly." Indeed, western law firms have started to open local offices to service the large amount of work undertaken by their clients, particularly in M&A, real estate and private equity.

Supported by an increasingly stable regulatory environment, private equity interest in a vast range of Romanian businesses is on the up. Dragos Mihail Vilau, a partner at Vilau & Mitel SCA describes the favourable environment for private equity in Romania. "The applicable regulations have evolved in time and currently provide a rather stable environment where rights of a private equity investor are recognised and protected to a much larger extent than in the past five years, if only to mention the introduction of the dual structure for managing the company, the conflicts of interest as well as restricted transactions between directors and the company," he says. There are still aspects of the infrastructure that need to be implemented such as the statutory protection for whistleblowers and a definition for the role of the general counsel in the company's board – both of which will improve investor security.

**Due diligence in an emerging market**

To bridge international expectations with the reality of the Romanian business environment, keen investors should examine local structures and culture in any due diligence process. They should also be thorough with basic technical aspects such as due incorporation and operations of the target, employment, financing, material agreements, assets and litigation. As the European environmental agenda climbs further up the political ladder, environmental areas of due diligence are also having a much larger impact on due diligence processes.

To assist the due diligence process, a buyer has to obtain quality business information, particularly in respect of smaller privately held companies. Although the public database containing information on a specific sector or even regarding individual companies is fast improving and rapidly expanding, it is still inadequate as the main source of information for a due diligence exercise. "Limited information may be obtained from the Ministry of Finance or the Trade Registry Office, but the nature of this information is determined by minimum statutory compliance and therefore not necessarily very useful or reliable from an investment perspective. The extent and quality of public disclosure and hence research resources will naturally improve over time. As a result, there is substantial client benefit in drawing on the sector or industry experience of advisory firms with relevant credentials," says Mr van Dam. In addition to seeking external local expertise, target companies in Romania are becoming more willing to disclose busi-

ness information for a prospective investor.

When it comes to owner-managed businesses, special attention should be given to internal management processes and company policies for conducting business. In the last few years, a trend has emerged in Romania where many of the small to medium sized enterprises acquired have been tightly managed by owners who started with a brilliant business idea but failed to develop operations with a skilled management team in place. In such an instance, an investor should consider identification of non-core assets and their value, normalised EBITDA and the potential legal, compliance and tax related liabilities. A thorough evaluation of operational practice on company authorisations, permits and licenses and transactions with the company's key employees or other companies owned by the same owner or part of the same group should also be sought. "When dealing with owner-managed businesses, negotiations are more complex and difficult as the owner has been personally involved," says Mr Vilau. "To this end, negotiations can become quite 'sensible' when addressing issues such as due compliance with applicable laws but also when addressing matters like future of the employees. However, a lack of M&A know-how and experience from similar deals means slower progress in transactions, unless an owner chooses to seek external expertise from business lawyers, investment bankers and auditors on such matters – a fast growing trend in Romania."

On a broad level, foreign acquirers could mitigate risk in Romanian M&A transactions, by ensuring due diligence processes include a budget for pre-investment costs covering legal, financial, investments, technical and transactional structure creation due diligence, according to Mr Vilau. "During negotiations, the investor should also obtain agreement on clear rights as shareholder of the target, including blocking rights, full access to and continuation of the current management and the owner's role in management for a period of at least three years and place part of the remaining purchase price into an escrow account for a period of at least six months to secure sellers representation and warranties," he says. "Following acquisition, the target company should perform an extensive due diligence exercise to confirm the findings of the pre-transaction due diligence and determine whether the representation and warranties given at the time of the transaction were indeed true, accurate and not misleading." Investors should, however, be mindful that every transaction is different, and besides seeking professional advice, should have a contingency plan for economic trends such as the skills shortage currently being experienced in Romania in many industries. Succession planning, key personnel retention and cultural awareness are essential to post acquisition success.

**Opportunities in 2008 and beyond**

Romania is a thriving market, albeit a new market, and offers a wealth of opportunity for savvy foreign investors who have a thorough due diligence process that considers local issues. The rest of the year and beyond will see key issues underpinning M&A transactions in Romania coming to the fore. "There will be slower but still substantial foreign direct investment, a greater focus on shareholder value and balance sheet efficiency which will drive increased restructuring, disposal of non-core businesses and assets, domestic consolidation by leading Romanian companies and Romanian companies of scale seeking to grow by acquisition within the region and beyond," says Mr van Dam.

In terms of sector attraction, banking and the financial services arena are set to grow, as are the real estate, construction, FMCG and pharmaceutical sectors. As the political EU agenda is focusing more resources on environmental issues and the Romanian authorities are actively integrating and adapting environmental issues to the EU requirements, waste management and environmentally driven businesses will become more attractive to investors. There will also be a growing interest in farming, agriculture and wine production sectors that are currently being developed with local and EU funds.

The Romanian market is bursting with opportunities with many sectors boasting accelerated growth due to market demands and EU requirements. For foreign investors to effectively compete with regional players, they need to be fully aware of local customs and practices. The local infrastructure is improving and in addition to legal guidelines already implemented, further proposals on whistleblowing and corporate governance are in the pipeline to increase investor security. However, Romania is still a new market. When investing, the acquirer should consider key market weaknesses such as the skills shortage, and implement careful due diligence practices to accommodate such flaws. By seeking the advice of local professional expertise where necessary, foreign investors should implement effective due diligence procedures covering the entire transactional spectrum from pre-investment costs through to post acquisition strategies in order to increase the chances of success and long term value. Only then will foreign investors reap the full rewards that Romania has to offer. ■

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Dragos has a significant experience in advising clients in investing and growing their business in Romania, being involved in sound transactions on the Romanian market during the last thirteen years. Dragos has published various articles and spoke at several international conferences on investments, privatizations, intellectual property and tax.

Examples of recent significant mandates include: Acquisition of the Romanian tractor factory; Acquisition of an almost 100% interest in one of the largest refineries in Romania and negotiations with the Romanian Government on the acquisition of their receivable; Pan-European merger of two European banking and financial groups; World's largest manufacturer of tractors in connection with several trade mark and trade name infringement cases and Global pharmaceutical company in connection with a land mark Romanian case concerning one of their registered trademark.