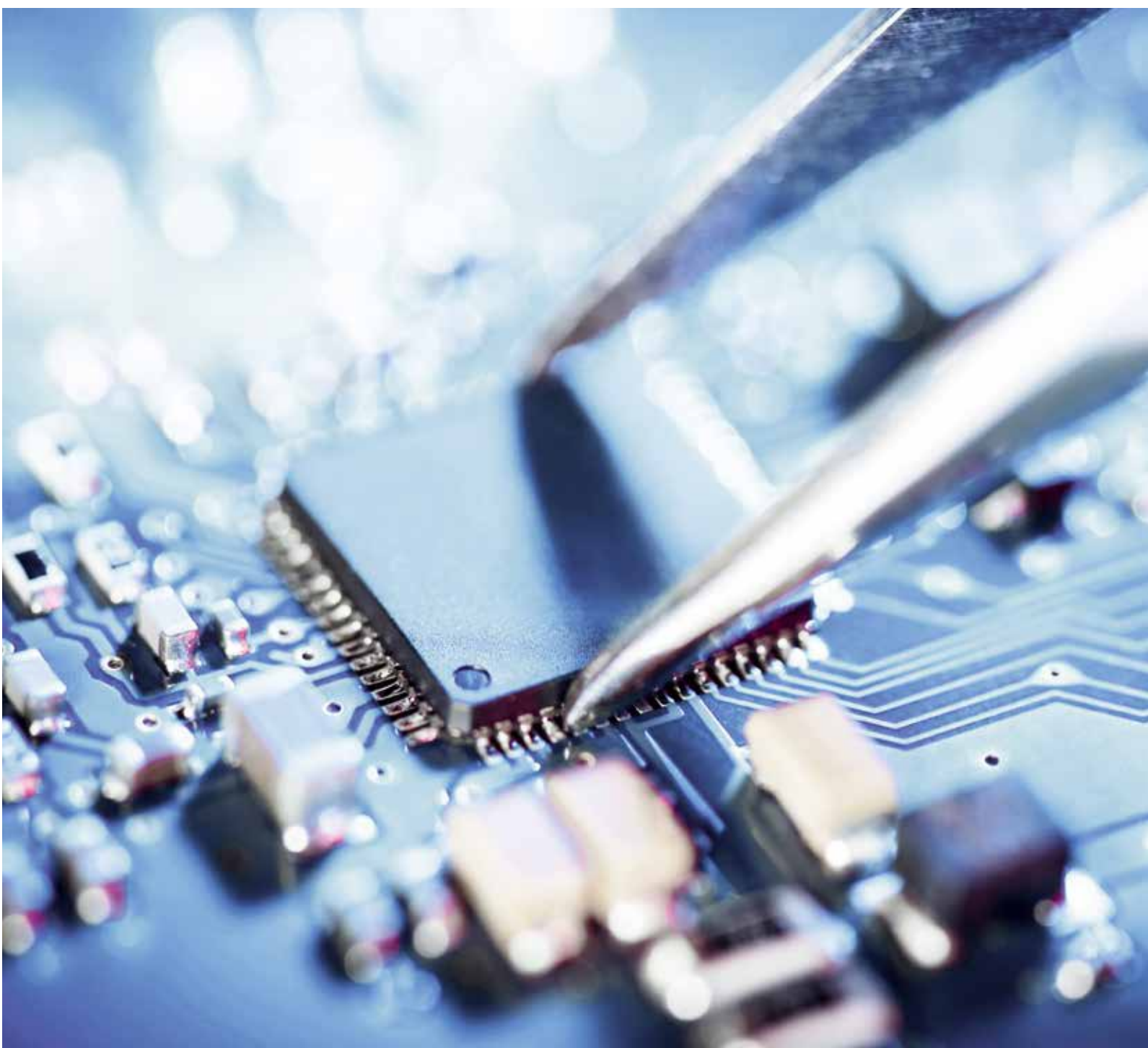




Tech M&A in Germany

Insight · Analysis · Trends





Contents

Editorial	3
Executive Summary	4
Study Results	6
Specific Challenges presented by Tech M&A	6
Transaction Motives	8
Data Rooms and Clean Teams	9
Due Diligence	10
Use of Notaries	12
Structuring the Purchase Price	13
Earn-Out	14
Closing Conditions	15
Exclusion of Warranty Claims	16
Limiting Liability for Damages	17
Survival Period for Breach of Warranty	18
Indemnity	19
Types and Amounts of Security	20
Material Adverse Change Clauses (MAC Clauses)	21
Post-Contractual Non-Compete Clause	22
Dispute Resolution Mechanisms	23
External Advisors	24
Contacts	28
Feedback Form	29
About Our Study and This Report	31

Keeping an ear to the ground: Asking questions will put you at an advantage.

The complexity of advising companies on commercial law issues requires a great deal of specialisation on the part of everyone involved. Pinsent Masons accordingly concentrates on a small number of key industries – and in Germany, on the technology sector in particular.

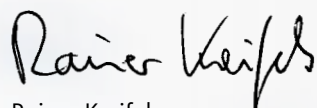
We regularly advise technology companies on M&A transactions and are frequently confronted with inquiries about standard practice in the market. Of course we can provide answers in these areas based on our practical experience. However, we want to be in a position to provide more definitive insight. Whereas numerous publications on the Tech M&A market in the US are available, there is no reliable information on the German Tech M&A market. For this reason, we conducted our own market study. This report outlines the results which are, at times, surprising.

First, a quick word on our study. We decided on a qualitative approach: extensive interviews with individuals responsible for Tech M&A deals in Germany. This has a particular advantage: we received a multitude of detailed information that cannot be deduced from published transaction data. Naturally, there are quantitative limits to a qualitative approach. Consequently, we do not claim that the results are representative, however they do provide valuable insights into trends in the German Tech M&A market.

In addition, we asked the technology companies about their experience with external advisors – here, too, the results are astounding.

We would greatly appreciate hearing from your thoughts on our survey. For this purpose, you may use our Feedback Form on page 29. Do the results of this study correspond to your experience with Tech M&A transactions in Germany? Are there any additional aspects in this area that we should pursue next time? Let us know.

I hope you find this study interesting and informative reading.



Rainer Kreifels
Head of German Corporate and M&A



Tech M&A in Germany – Specific issues are not given enough attention

Facebook buys WhatsApp, Oracle continues its shopping spree, Pfizer reaches for AstraZeneca. These are only a few headlines from recent international business publications regarding significant Tech M&A transactions. This specific area of corporate transaction is also very important in Germany. A number of deals reported recently bear witness to this: Siemens sells its hospital IT business, Telefónica purchases E-Plus, etc. In planning and executing such Tech M&A deals, certain aspects must be considered, especially in the legal area. German practice in this area has dealt with these aspects to a certain degree, yet in our opinion, insufficiently. This is also borne out by our study.

Before we share with you the detailed results of the study on the following pages, we have put together a short overview of what we consider to be the key findings:

- **IP, the core area:** The specific challenges and risks connected with the essential significance of intellectual property in a Tech M&A deal are basically recognized, however only in the course of the transaction, or even only retrospectively. However, an IP-specific approach from the onset, and in particular due diligence, is still nowhere near being the norm.
- **No radical break, yet in flux:** There have been interesting new developments. For example, it is no longer unusual to stipulate that a clean team conduct due diligence, and mitigating warranty risks with specialist insurance policies is becoming more commonplace.
- **This is not uncharted territory:** Market standards already exist for numerous areas that leave very little room for what can be considered a serious negotiating position. Examples include liability regimes and non-compete clauses.
- **Strong sellers:** Some of the results of our study indicate that the current Tech M&A market in Germany is generally seller-friendly. During the course of the study we observed contractual provisions which sellers can only push through if they are in a strong negotiating position.
- **Almost always with external advice, but not always with tech expertise:** In most transactions, the individuals responsible for the deal consulted (external) lawyers, but they relied less often also on corporate finance or financial due diligence advisors. However, while specific technology expertise did not play a role in selecting legal counsel, it was required when choosing financial advisors.
- **Compliments with reservations:** 'Deal makers' assessment of lawyers' efforts is positive overall. With regard to mastery of technology-related challenges, however, their feedback is mixed. In some instances, they criticise the lack of understanding of technology and business models.

Specific Challenges and Market Response

Specific Challenges presented by Tech M&A

We asked the study participants what the most important challenges of the deal were:

Biggest Challenges: Top 7 (open-ended question)

Biggest challenges			
1	(IP-) Due diligence	<div></div>	36%
2	Sellers lack knowledge/experience	<div></div>	28%
3	Involving former shareholders	<div></div>	24%
3	Structuring the purchase price	<div></div>	24%
5	Diverging interests of seller	<div></div>	20%
6	Ambitious time/project schedule	<div></div>	16%
7	Convincing one's own stakeholders	<div></div>	12%
-	Other	<div></div>	20%

"The biggest challenge was due diligence.
...The other side continually requested
new data. ...Due diligence turned out
to be an immense task for us."

It was not price negotiations or a (too) ambitious time frame that the interviewees mentioned as the biggest challenge of their Tech M&A transactions, rather due diligence and the seller's lack of experience.

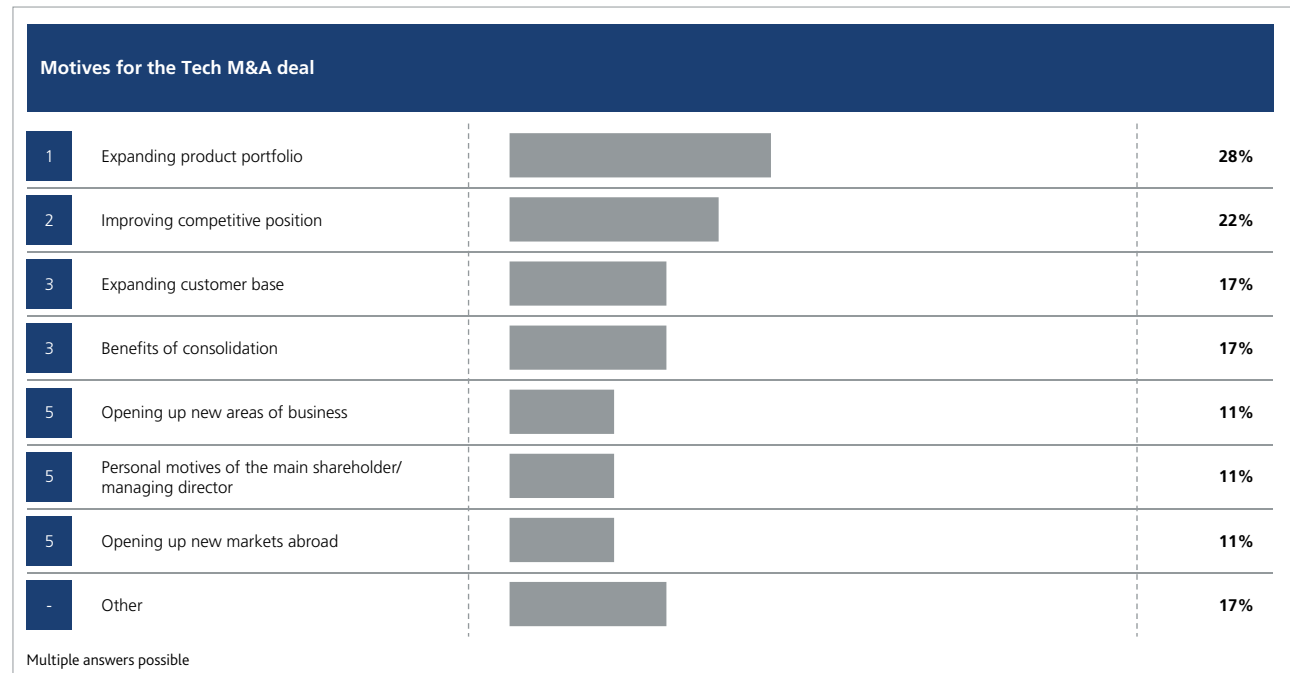
After rather casual warm-up exercises such as non-disclosure agreements and non-binding letters of intent, it was during due diligence that the diverging expectations of the seller and buyer often became apparent for the first time. Buyers that request too much too soon can be just as frustrating as sellers providing too little information too late. The appropriate amount and a suitable date are decisive. Planning the due diligence process, though, apparently does not get enough attention. It would be helpful to have requirement lists that were better thought out – that is, shorter, broken down into categories and more specifically adapted to the respective transaction (and for Tech M&A, especially with more emphasis on IP).

It is relatively common in Tech M&A transactions in Germany to see fairly or entirely inexperienced sellers confronted with experienced buyers. This situation is conceivable for example in the case of start-up exits or in relation to the issue of succession in family-owned companies. The success of a transaction in such cases often depends on how well the sellers are informed about the steps involved and the conventions observed in the Tech M&A business.

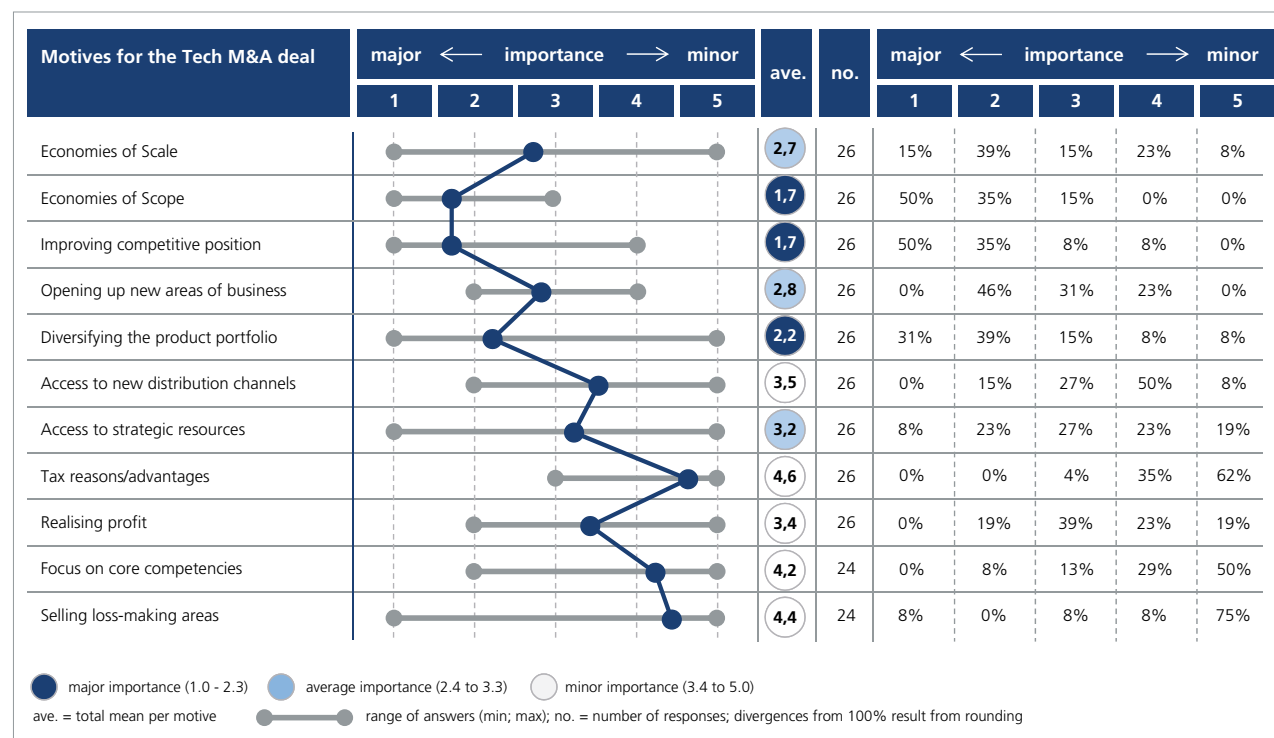
“Despite our recommendation to obtain financial and legal advice, the seller did not do so until shortly before conclusion of the transaction.”

Transaction Motives

Deal Motives Cited Without Prompting (open question)

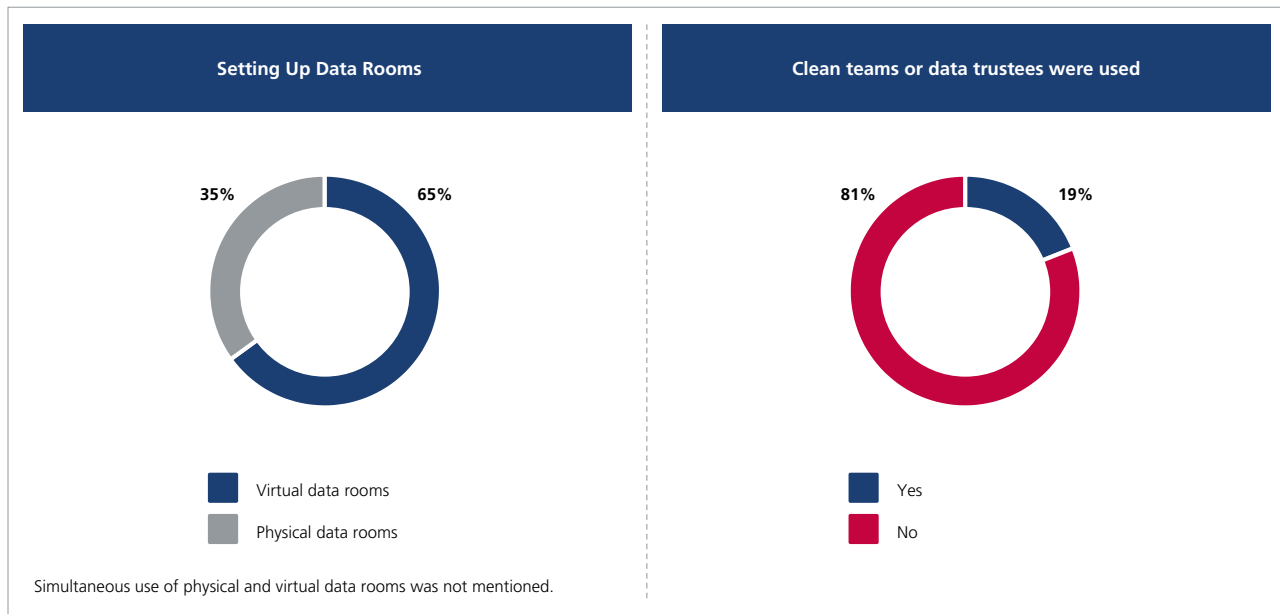


Importance of the Motives



Data Rooms and Clean Teams

Setting Up Data Rooms / Using Clean Teams or Data Trustees



The survey shows that virtual data rooms are currently the preferred solution for due diligence, but have not yet completely replaced the physical data room. As many as 35% of the transactions still used a physical data room, but we would expect this proportion to continue to drop in the next few years.

It is interesting how often clean teams are now used for data inspection and evaluation for due diligence purposes – specifically, in 19% of the transactions. Employing a clean team, whose members are obliged to maintain confidentiality and are only allowed to disclose information with restrictions or in aggregate form, serves to protect the trade secrets of the target company and even those of the seller. In view of the increased stringency of the competition authorities, there is another aspect that is almost more important: clean teams shift the potentially anticompetitive sharing of information between competitors to a controlled environment conforming to antitrust regulations.

Deploying a clean team increases the effort and complexity of due diligence, however, the advantages discussed above should be particularly relevant to many Tech M&A deals and make the additional effort worthwhile. We expect that clean teams will be used more frequently in the future.

"Originally, we were rather skeptical of the clean team concept. In retrospect, it was clearly the right decision."

Due Diligence

It seems surprising that less than one-third of the study participants carried out IP-specific due diligence – especially since intellectual property usually plays such a fundamental role in Tech M&A transactions. This means that routine M&A due diligence procedures are much more likely to be used than any specifically adapted to Tech M&A requirements. Consequently, there is certainly room for improvement.

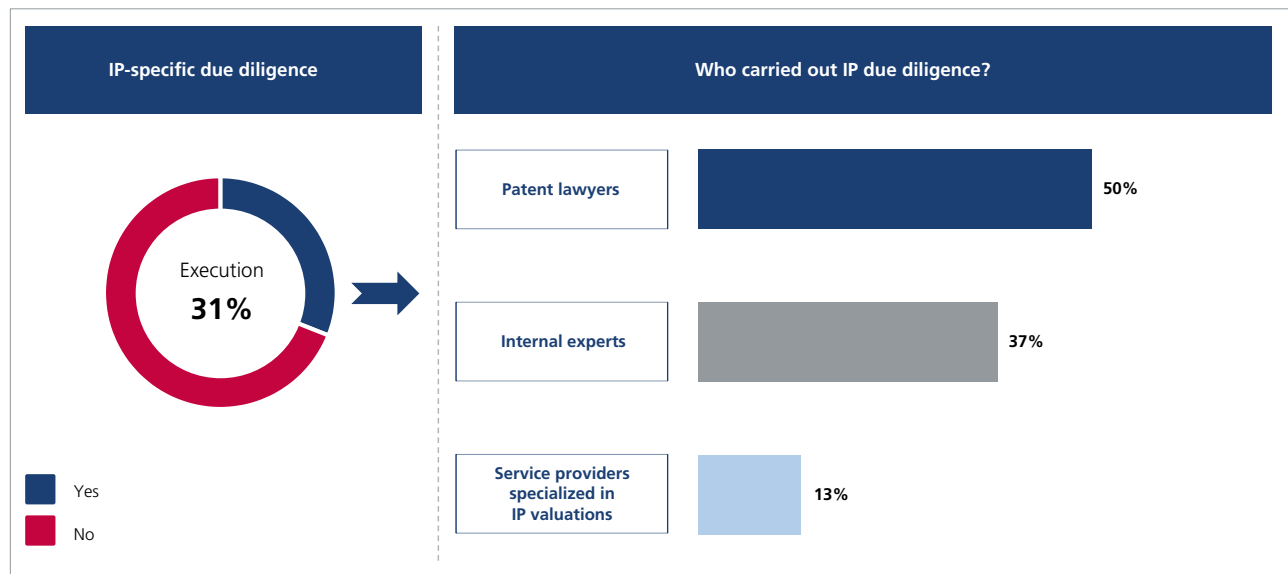
The importance of intellectual property rights, i.e. trademarks and patents, is evidenced by the fact that deal makers cited them as their number one priority risk. Risks linked to IT licenses and rights of use come second. Interestingly enough, there was no mention of know-how and trade secrets. But these ought not to be underestimated. Often know-how and trade secrets constitute the actual heart of a company's IP (e.g. Coca Cola's recipe). Many due diligence requirements lists that we encounter in practice do not explicitly address this. If however such "soft" intellectual property aspects are not taken into consideration during due diligence or the Q&A process, it is hardly possible to build in adequate protections in the final transaction documents.

"We certainly completely underestimated the structure and value of the patent portfolio. In hindsight, this was our biggest obstacle."

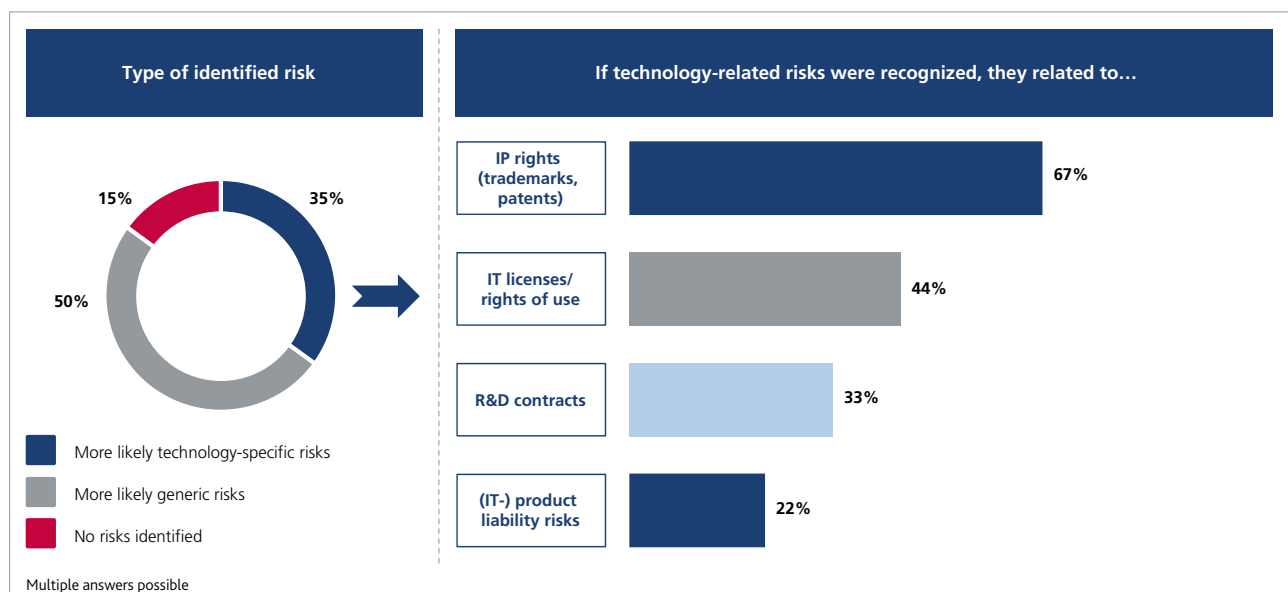
"We did have access to the intellectual property rights in the data rooms of our target, yet the actual challenge lay in the tedious review."



IP-Specific Due Diligence



Identified Risks

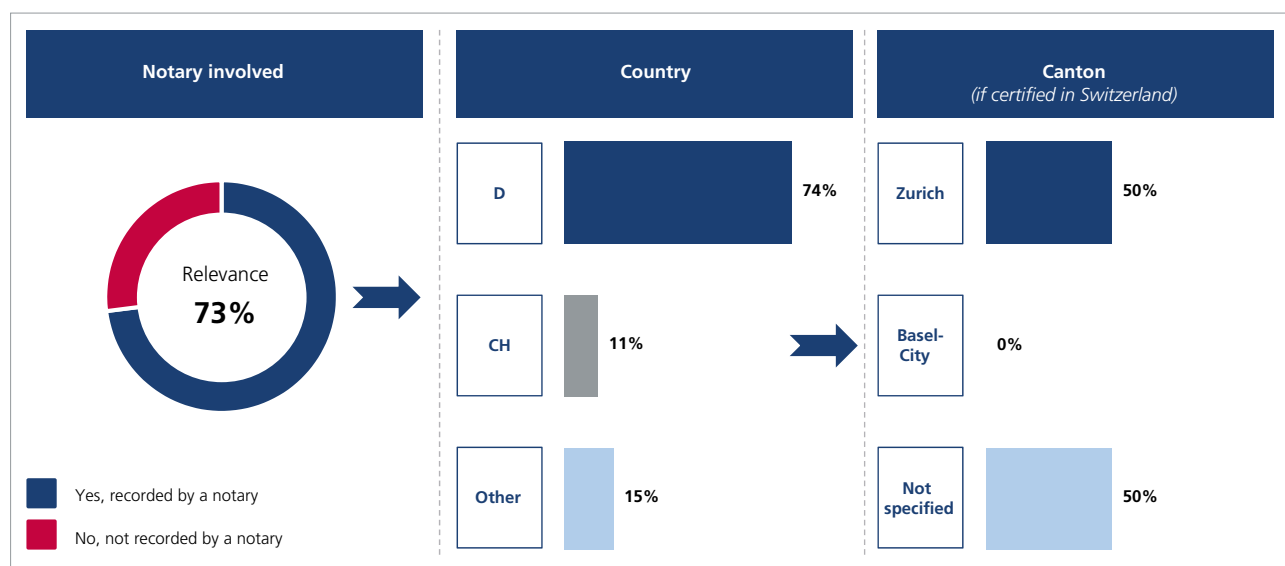


Use of Notaries

The use of notaries is common in German Tech M&A but notary services themselves can be very expensive in Germany. Accordingly, a market has developed for the use of notaries outside of Germany which may be more cost effective. However, whether an inexpensive foreign notary is a viable legal alternative is the subject of heated discussion. Our study shows that some companies nevertheless settle for notarial recording abroad, and indicate that Switzerland is the country of choice.

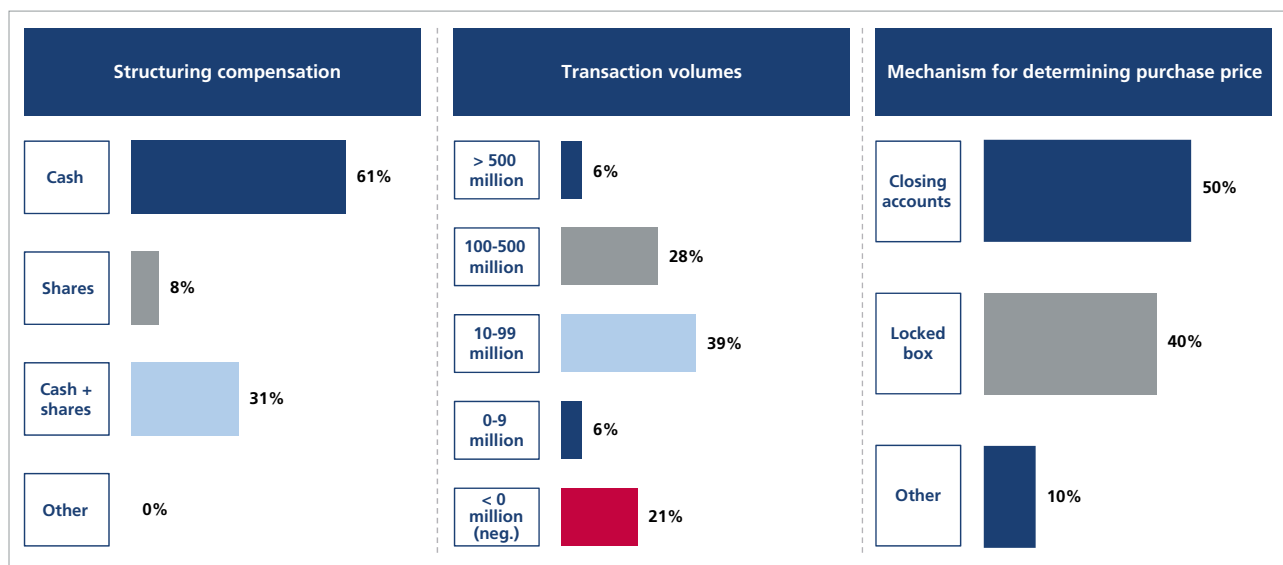
"I simply don't understand why such an important issue is not clearly and unambiguously regulated."

Use of Notaries: Relevance and Location



Structuring the Purchase Price

Structuring Consideration, Transaction Volume and the Price Mechanism



The “locked box” – an early fixed agreement on the purchase price without opportunity for subsequent review and adjustment was mentioned as the mechanism for determining the purchase price in almost half of the cases. Apparently a number of sellers in the German Tech M&A market are in a strong enough negotiating position to be able to achieve a locked box price mechanism, putting them in the comfortable position of knowing that their agreed price is secure and conclusive as the transaction progresses. Nevertheless, closing accounts remains a very common pricing mechanism which ultimately determines the “correct” purchase price at a later stage. In a less seller-friendly market the distribution between these two purchase price determination mechanisms would be clearly skewed towards closing accounts.

It is also noteworthy that in almost one-third of the transactions included in our study consideration consisted of a mixture of cash and shares. These so-called cash-paper deals are especially preferred by US buyers who are currently rather active in the German Tech M&A market. In order to evaluate the actual risks and opportunities of cash-paper deals offered by American buyers, sellers must in particular be aware of the types of shares being offered them by the seller. There are large differences between classes of US shares and an uneducated seller may find that their shares are worth a lot less at resale than the value attached to them as consideration under the transaction.

“In my view, the buyer did not initially completely understand or accept that he was also buying future income. ... Our external lawyers accepted the challenge and ... formulated purchase price rules that were acceptable.”

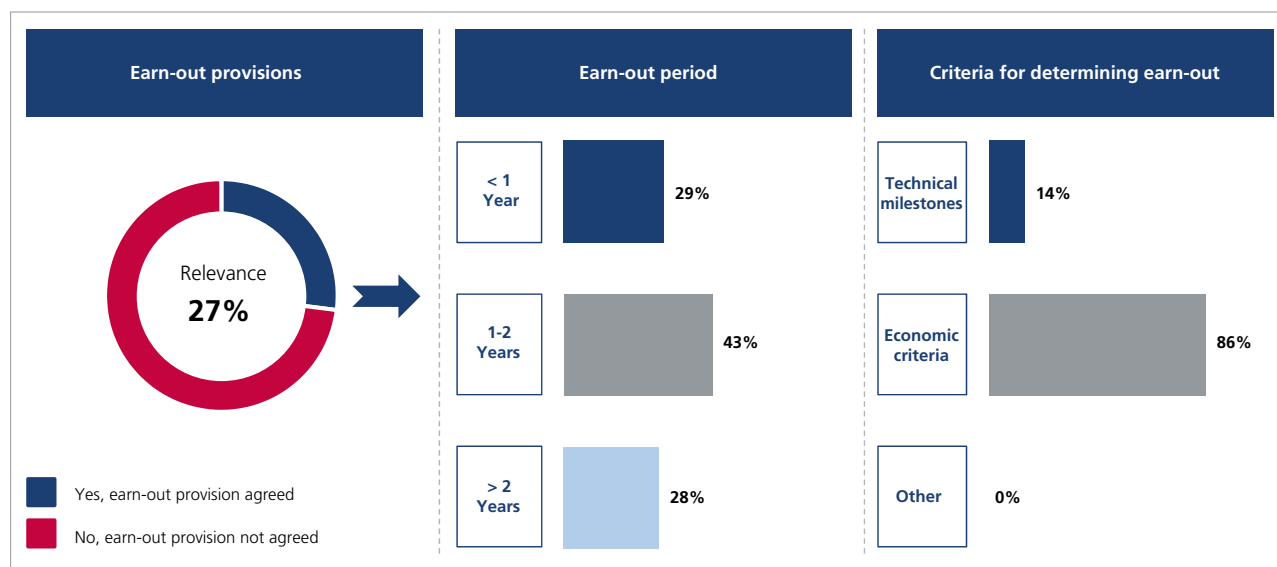
Earn-Out

The currently good condition of the German Tech M&A market is also reflected by the fact that only a minority of buyers were able to negotiate an earn-out provision into the purchase price. Currently it is relatively difficult to translate buyer-side expectations into contractual provisions that project into the future and depend on more or less fixed prerequisites.

In those cases in which an earn-out provision was agreed, the earn-out period was less than two years and was dependent upon certain economic criteria. This is also an indication that sellers presently are not willing to accept vague and indeterminate promises regarding the sale of their company.

"Every day that my money sits at the bank it loses value. There was no way that I could agree to a reduction in the purchase price through the back door."

Earn-Out

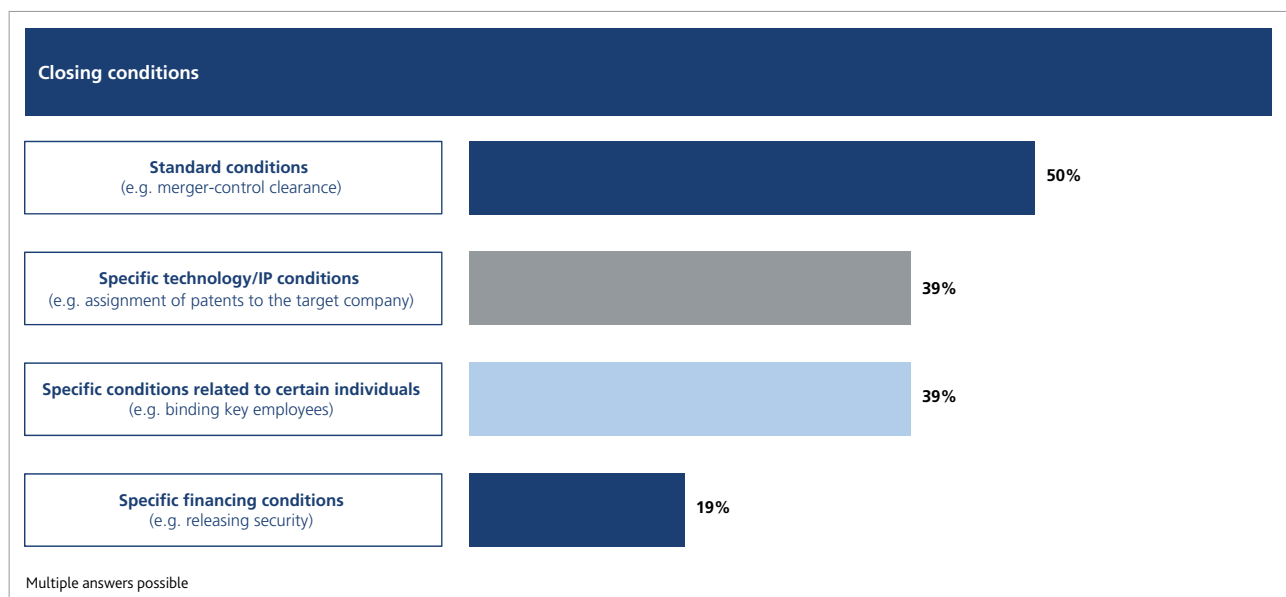


Note: 86% of earn-out provisions were based on economic criteria (e.g. EBITDA).

Closing Conditions

In nearly 40% of the transactions, technology and IP closing conditions were stipulated. This shows that the parties now tend to prefer an IP-specific transaction structure over the previously common IP-specific due diligence procedure. Precise knowledge and, where possible, early knowledge of the IP situation is however mandatory for being able to be prepared for it during the course of the transaction and finally, to properly incorporate it in the transaction documents. Accordingly, it seems to be very advisable to use an IP-specific structure from the very start when planning a Tech M&A transaction, and in particular, due diligence.

Agreeing on Closing Conditions



Exclusion of Warranty Claims

How will liability be affected when facts are already disclosed during due diligence? Buyers tend to assume that due diligence only serves to provide them with information and not to exclude seller liability. Conversely, sellers usually maintain that disclosures made during due diligence preclude any subsequent liability.

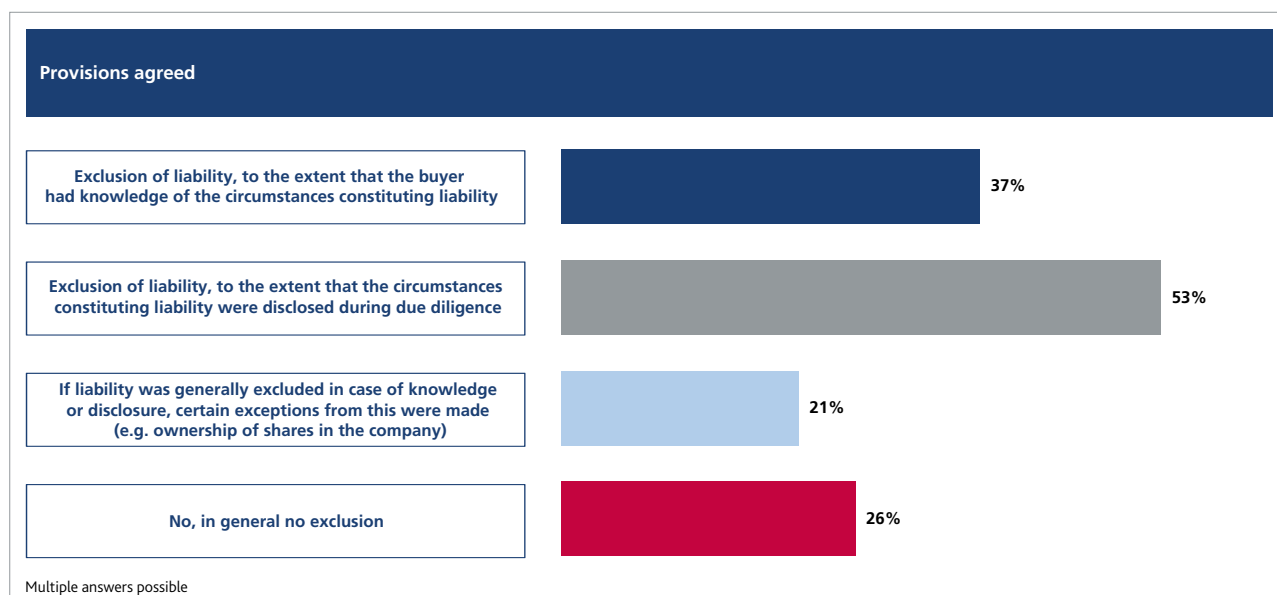
In actual fact, neither view should be taken as read and explicit contractual provisions in relation to facts disclosed during due diligence are essential.

What is more, there are numerous ways of drafting the contract to allow the parties to address this issue specifically within the context of their transaction. Needless to say, it is not just the material arguments around due diligence that will need to be weighed up – each party's relative negotiating position is also obviously material.

In practice, contracts have frequently included the contents of the virtual data room in the form of a CD-ROM. This has a particular advantage: what was disclosed in due diligence is clearly documented.

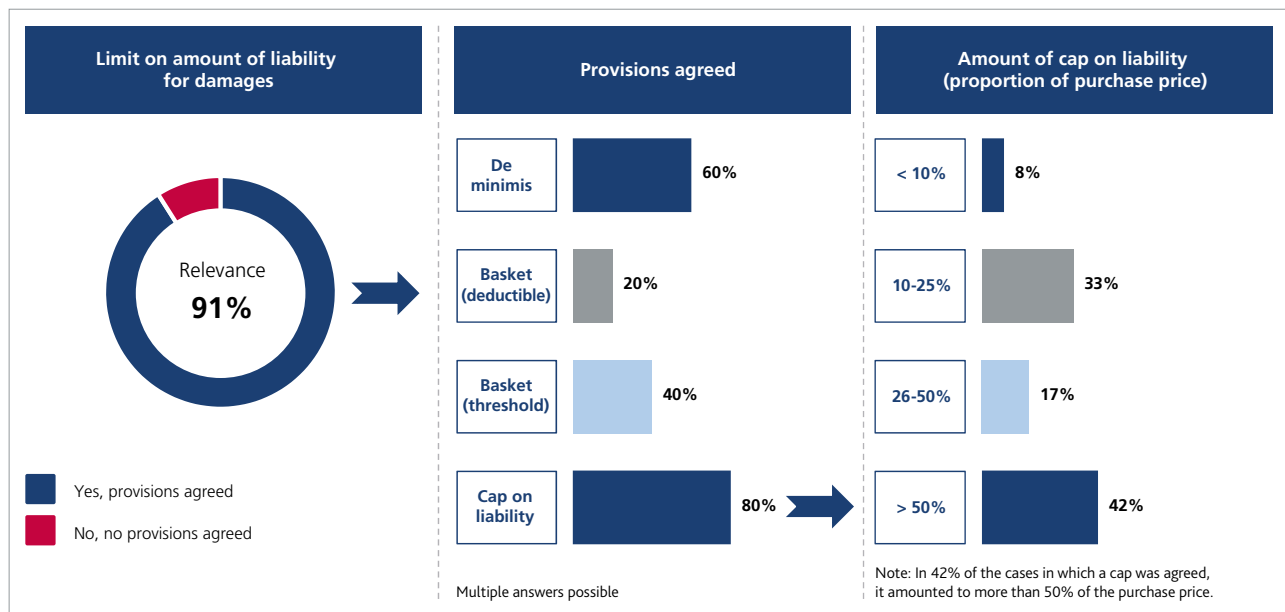
The seller should also document additional information in the framework of the Q&A process as extensively as possible, for example by adding the questions and answers from this process to the virtual data room.

Provisions on Exclusion of Warranty Claims



Limiting Liability

Provisions on Limiting the Amount of Liability



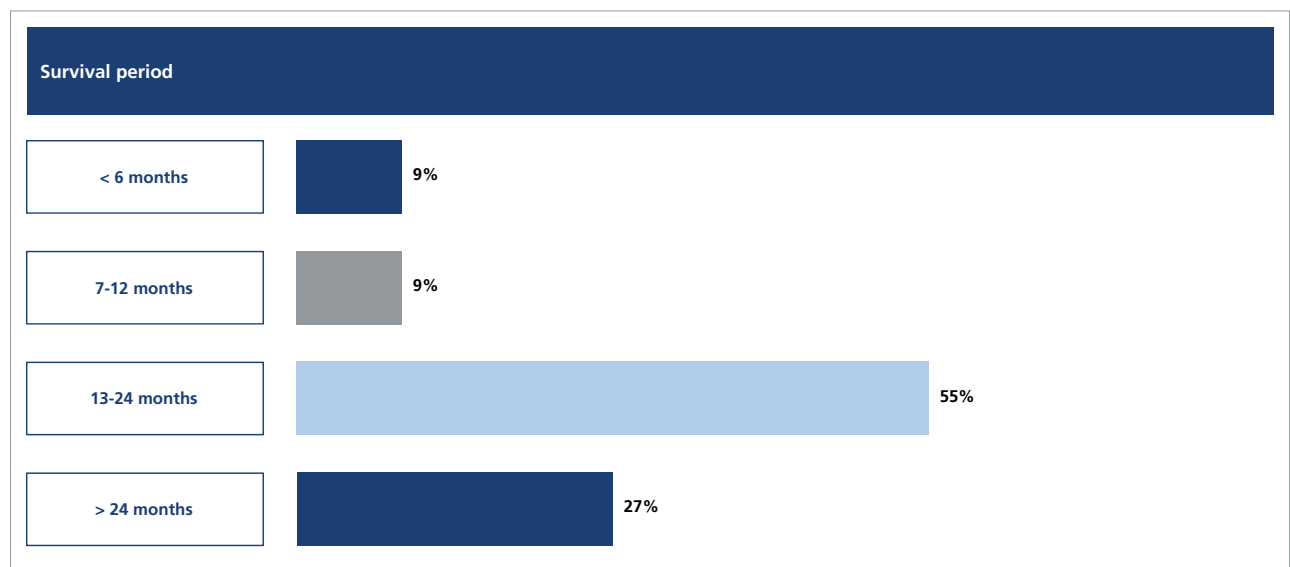
An agreement on upper limits for seller liability (liability cap) has proven to be the market standard. The responses regarding the amount also confirm our assumptions: a liability cap of over 50% of the purchase price was agreed in a large number of cases.

Survival Period for Breach of Warranty Claims

"I have never witnessed a transaction failing because the parties could not agree on the legal consequences of the warranties. And then it ends up being a bazaar after all."

The study results regarding the survival period for breach of warranty claims also correspond to our expectations of market standards: In the majority of the transactions the parties agreed on survival periods of 13 to 24 months.

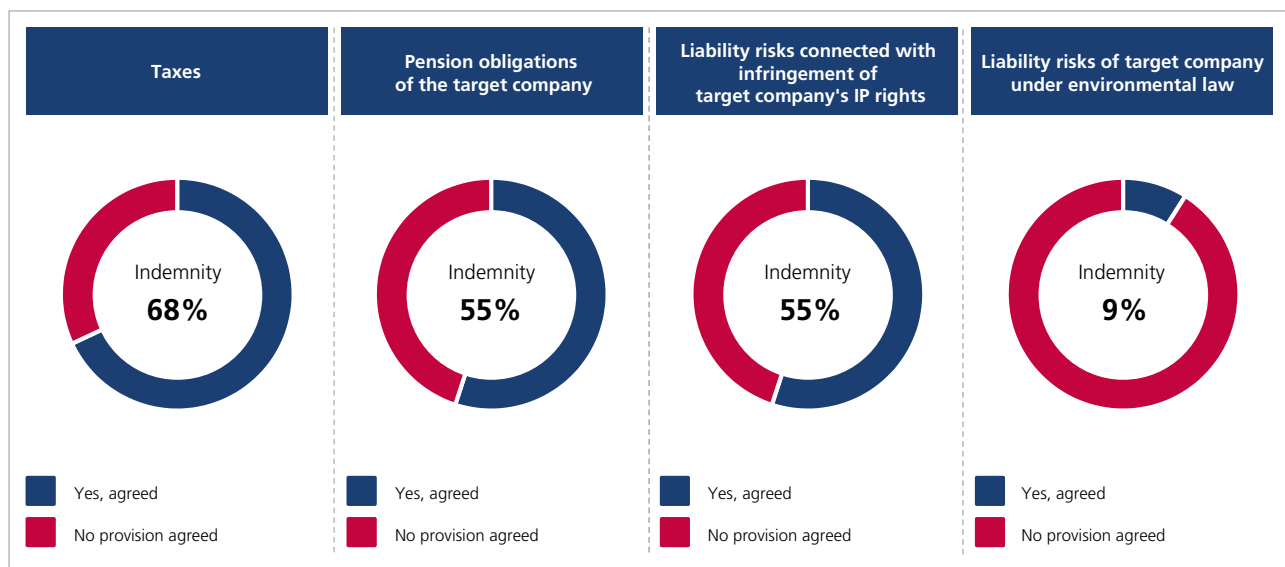
Survival of Warranty Claims



Indemnity



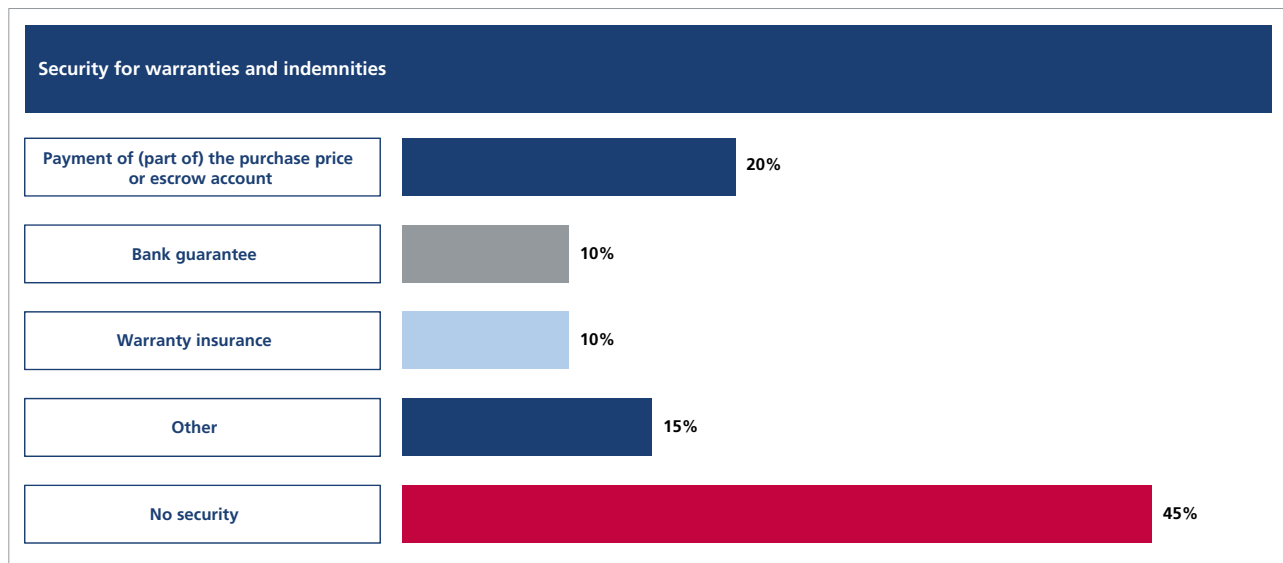
Indemnity of Buyer and/or the Target Company by the Seller for...



Provisions for indemnifying the buyer or the target company are usually agreed in the typical problem areas of taxes, pension obligations and IP. Environmental risks in Tech M&A, however, have up until now played only a minor role, and are more likely to appear only when conventional manufacturing operations are being sold.

Types and Amounts of Security

Provisions on Security for Warranties and Indemnities



The fact that 45% of the deals are made without any security for warranty claims or indemnities is in line with our expectations.

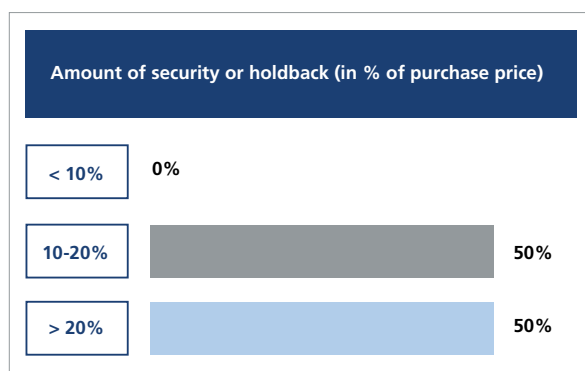
However, in the majority of instances in which security has been agreed, this takes the form of a portion of the purchase price withheld from seller (holdback) or a partial payment of the purchase price to an escrow account.

In the majority of cases where an escrow account has been agreed, party counsel (lawyers) are still named as trustees, which may raise issues of professional ethics. We have, however, witnessed an increasing awareness of this problem.

The amount of these holdbacks or escrow payments confirms our assessment that usually less than 10% of the purchase price is non-negotiable.

We were surprised about the number of transactions using warranty insurance. We consider this to be an interesting option and are curious whether acceptance will continue to rise.

Amount of Security



"Our lawyers suggested warranty insurance. It was the first time we had used it."

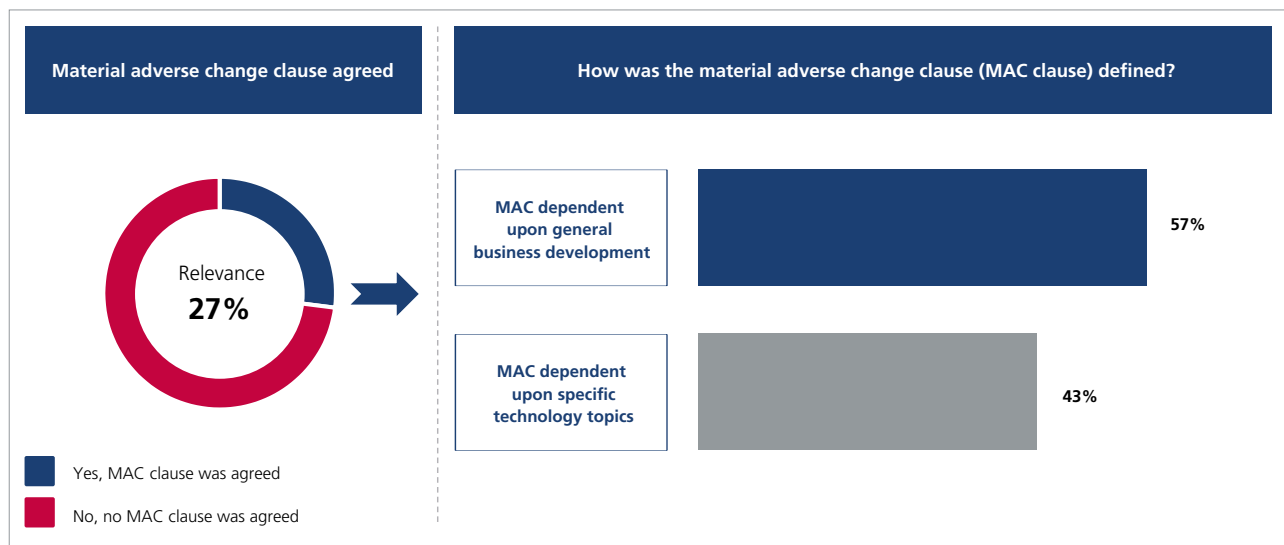
Material Adverse Change Clause (MAC Clause)

In one-fourth of the transactions in our study a MAC clause was included and in nearly half of these cases, a material adverse change was defined in technological terms.

As with the IP-specific closing conditions, it is clear that if signing and closing do not occur simultaneously, the parties link the ultimate success of the transaction to the development of IP/technology during the period up to the closing. This is not surprising for Tech M&A transactions.

"We quickly agreed that a MAC clause was necessary. However, negotiating the details took a long time."

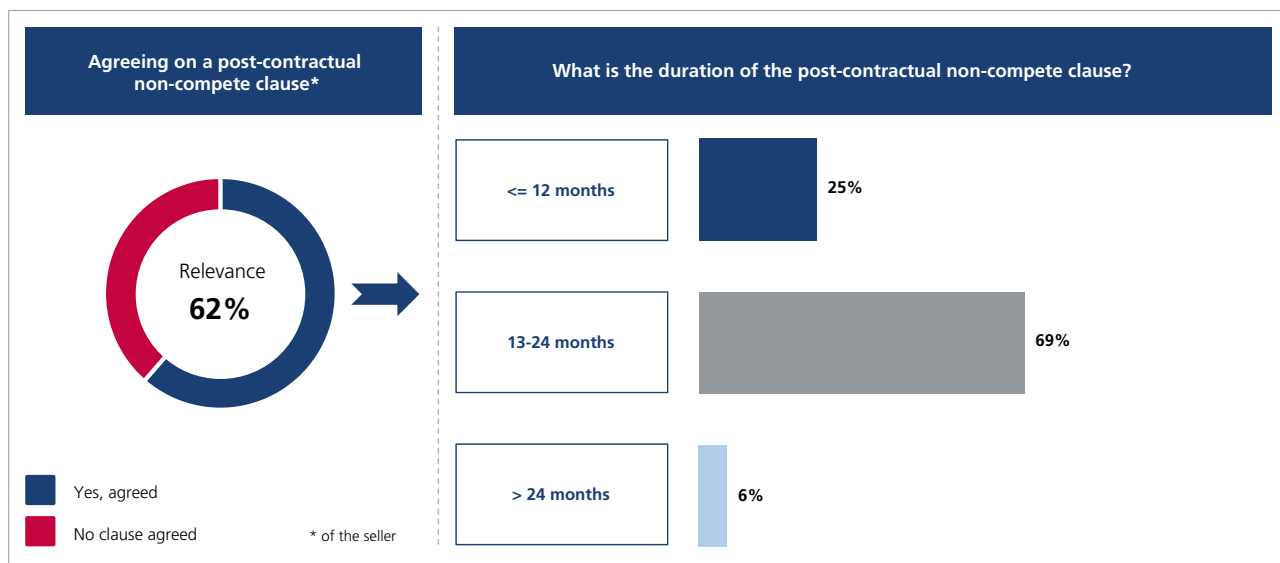
Material Adverse Change Clause: Relevance and Definition



Post-Contractual Non-Compete Clause

"A big point of contention was the discussion with former owners regarding their role and influence as minority shareholders."

Post-contractual Non-Compete Clause Agreement and Period



The agreement of a (post-contractual) non-compete clause is logical to any M&A transaction. As expected, such provisions were agreed in nearly two-thirds of the cases in our study. The fact that the majority agreed to periods of 13 to 24 months was also not surprising. Terms exceeding 24 months are the exception in practice, and legally may be hard to enforce.

Dispute Resolution Mechanisms

Almost one-third of the respondents had agreed to a dispute resolution mechanism particularly for purchase price disputes. Whether this type of provision is recommendable in the case at hand is largely dependent upon the complexity of the price determination. Differences of opinion often occur over earn-out provisions. It is easier to agree beforehand on how to proceed in case of dissent rather than waiting until disagreement has already disrupted the atmosphere. Thus parties should determine from the very beginning when and how an expert arbitrator should be consulted, for example.

"Another challenge was three different jurisdictions."

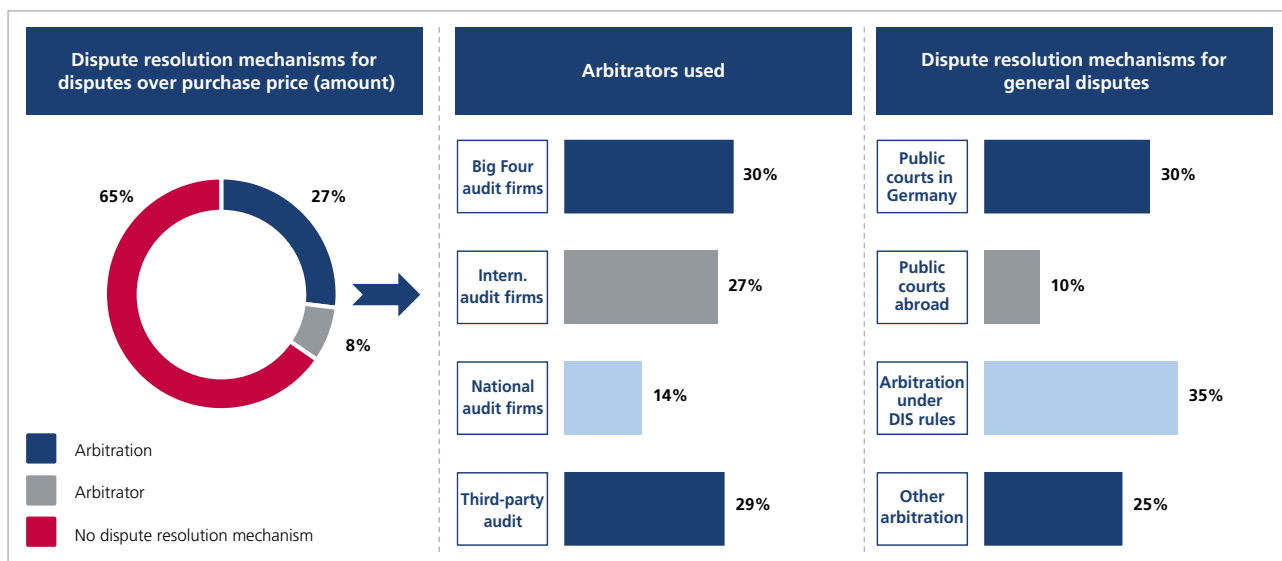
In general, arbitration plays a big role in dispute resolution.

An important impetus for agreeing such provisions is that they allow for influence on selection of arbitrators, with the prospect of finding an arbitrator with suitable expertise. Other arguments for or against arbitration relate for example to the language of proceedings, the expected duration and costs, the possibility of an appeal and the confidentiality of proceedings.

Maintaining confidentiality – which can be made a requirement of private arbitration, in contrast to litigation in open court – also furthers the case for arbitration as a dispute resolution mechanism for Tech M&A deals.

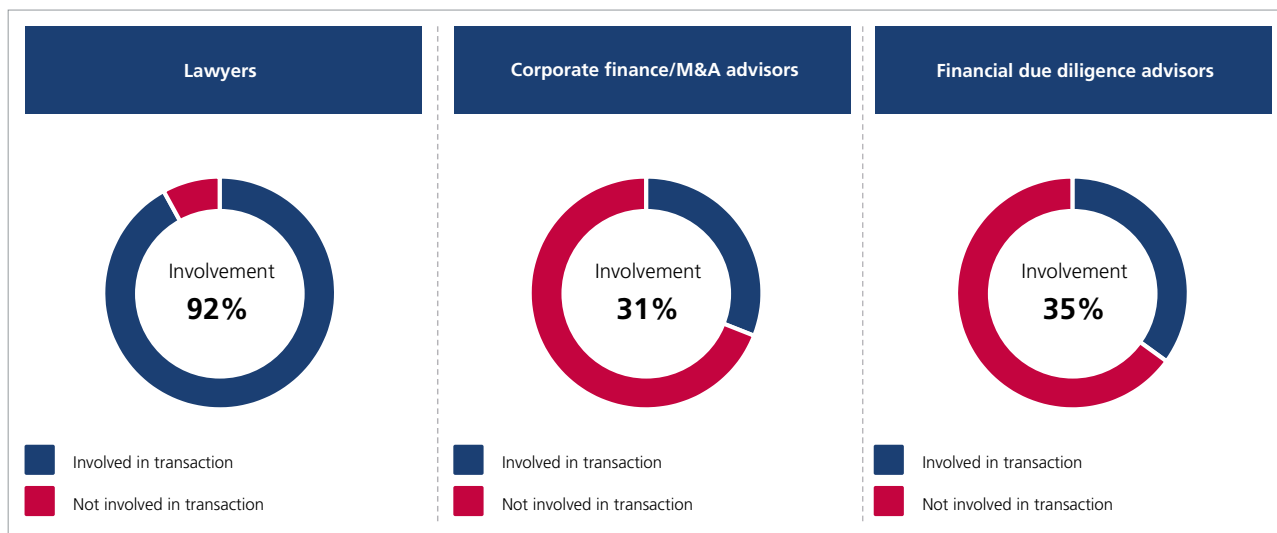
"Deciding whether to opt for public court proceedings or arbitration was very important to us."

Resolving Purchase Price and General Disputes

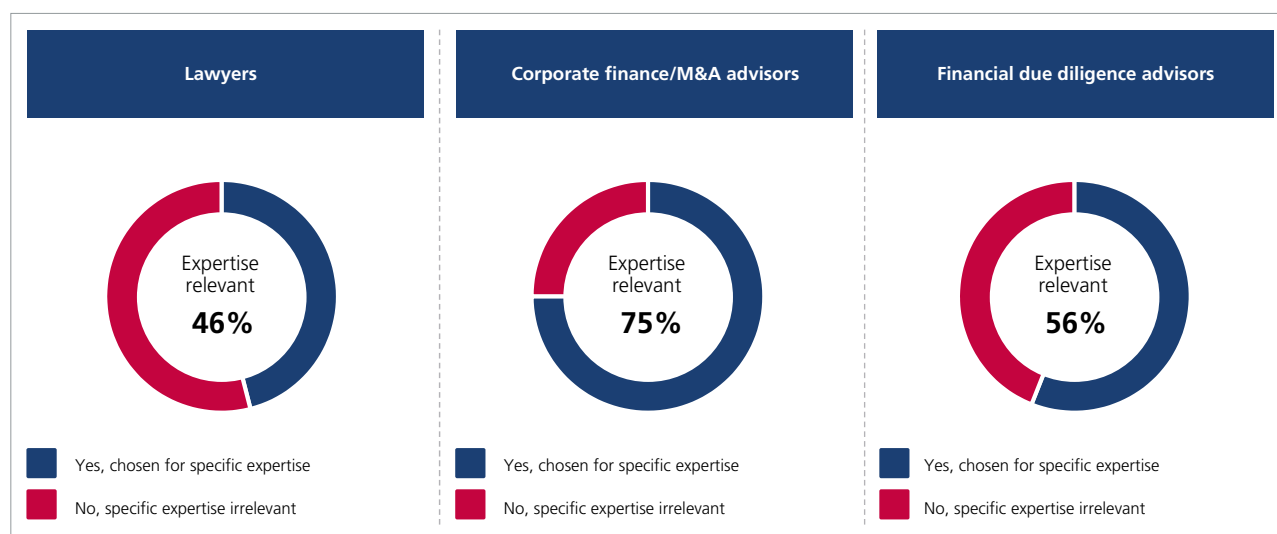


External Advisors

Involving External Advisors



Selecting External Advisors Based on Specific Expertise (Technology)



It is interesting to see that especially in corporate finance, but also in the area of financial due diligence, external advisors are selected according to their technology sector expertise far more frequently than lawyers.

It is also surprising that more than half of those surveyed did not consider special expertise to be a decisive factor in hiring Tech M&A lawyers in Germany. Whether a lawyer versed in insurance M&A transactions can advise equally as well on the purchase of a software company as on the purchase of an insurance company is debatable, in our view.

When we asked to what extent the technology-specific circumstances or requirements of the companies were taken into consideration by the lawyers, the participants in the study gave very different impressions, both positive and negative:



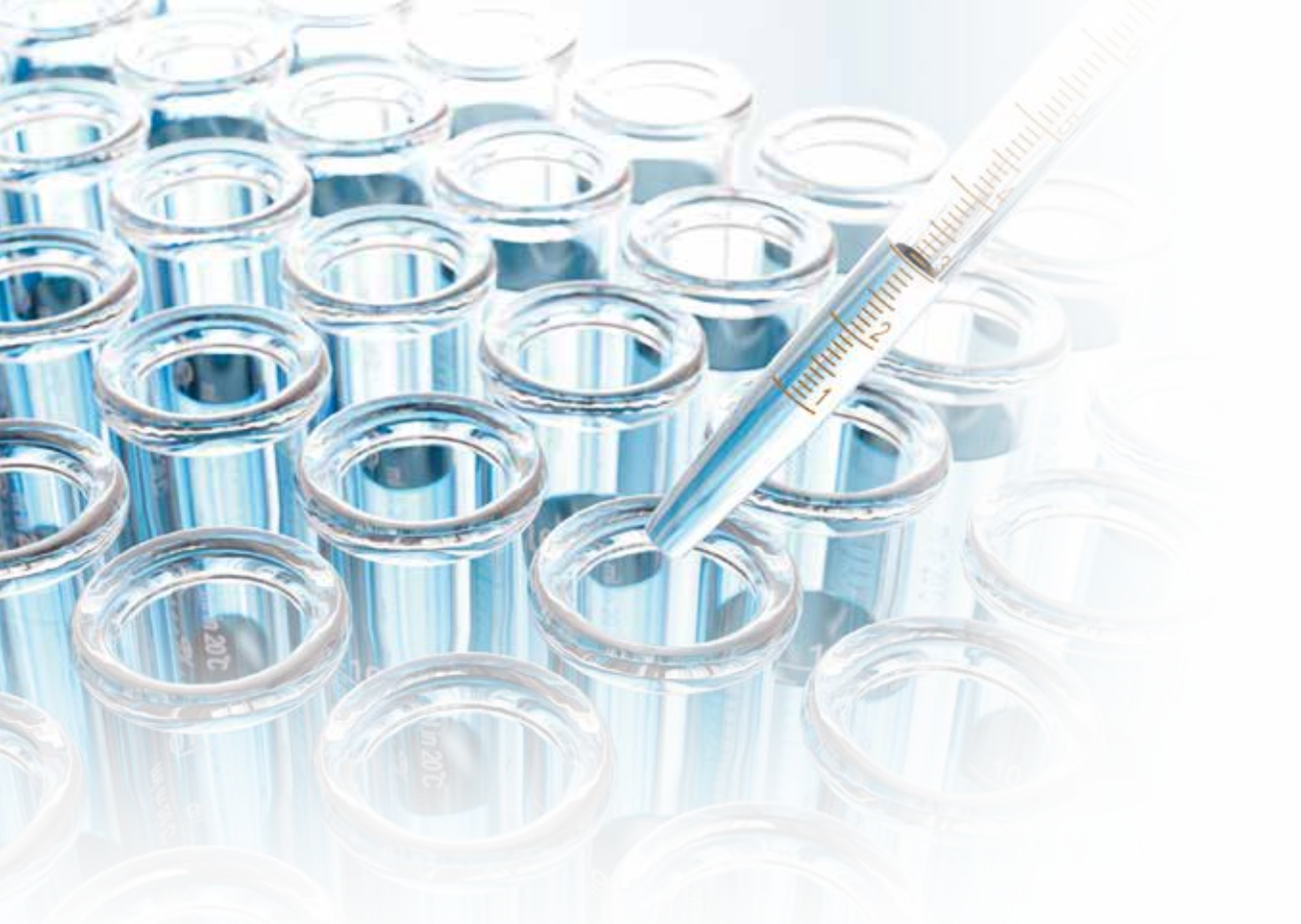
"I think that happened. The lawyers...conferred frequently with employees in order to understand our specific technical processes."

"Everything was perfectly coordinated, from the pre-contractual negotiations, to due diligence, right up to the closing. I never had the feeling that they had a patent recipe they used in the pharmaceutical industry yesterday, and on us today. Everything was perfectly adapted to our needs."



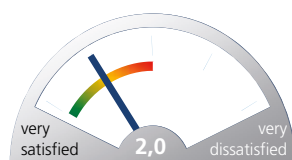
"We had...the impression that the lawyers provide only minimal expertise."

"This was only rarely the case in our experience. We therefore also decided to engage additional, that is, specialised M&A advisors for the transaction. They ultimately also took on the entire coordination of the transaction."

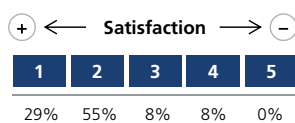


Satisfaction With External Lawyers

General satisfaction with external lawyers



Proportion of (very) satisfied: 83%



Mainly positive evaluations as ranked by category (top 8)



- 1 Straight forward explanations and reports
- 2 Exact knowledge of buyer requirements
- 3 Strategic and networked thinking
- 4 Involvement, availability
- 5 Interdisciplinary, international ability
- 6 Experience in M&A projects in general
- 7 Identifying gaps in the data room
- 8 Legal fee arrangements

Mainly negative evaluations as ranked by category



- 1 Lack of expertise in the M&A process
- 2 Lack of strategic and networked thinking
- 3 Insufficient review or analysis
- 4 Lack of central/reliable contact

Note: Scale from 1 = very satisfied to 5 = very dissatisfied. The mean (average) grade is 2.0.

We are pleased that lawyers' efforts are rated positively overall. However, as is often the case, the truth is in the details – what is often missing in otherwise good legal services is sufficient understanding of the target's technology and business model.

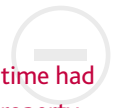


"There were a number of risks resulting from specific liability issues. These were explained transparently and comprehensibly by our lawyers."

"...in this way gaps in the data room were identified that ultimately posed a big risk."

"...the issues of cross-licensing and also patent risks were clearly defined."

"The results were summarized very well, from the work level through an intermediate level and on up to the decision level, so that they were very manageable for the supervisory bodies."



"As it later turned out, our lawyers at the time had only insufficiently reviewed the intellectual property rights of our target."

"I had the impression that the lawyers.... had only a rather vague understanding of the company figures. They had to have employees explain many things to them... In this way, the lawyers quickly become the pawn of the various employees. I doubt whether it is possible to prepare a reliable risk analysis in this situation."

"...one might say that risks were identified, in my opinion there was a lack of solutions as to how these risks can be reasonably reflected in the purchase agreement."

"...however, we received very little support regarding the strategic dimension. Or, put differently: I felt that there was too much emphasis on minutiae and no view to the big picture. That however would have been particularly important for our stakeholders."

Your Contacts

If you have any additional questions about Tech M&A, or any of our other services, please contact us. Our partners with many years of experience in the area of Corporate and M&A will be pleased to help you.

As the case may require, our partners work closely with colleagues from other specialisations, for example in the areas of IT/IP & Outsourcing, Infrastructure & Energy Projects, HR & Employment, Tax or Dispute Resolution.



Rainer Kreifels

Head of German Corporate and M&A

T: +49 89 203043 532

M: +49 171 266 05 77

E: rainer.kreifels@pinsentmasons.com



Dr. Florian Anselm

T: +49 89 203043 538

M: +49 172 368 01 71

E: florian.anselm@pinsentmasons.com



Eike Fietz

T: +49 89 203043 530

M: +49 172 368 01 82

E: eike.fietz@pinsentmasons.com



Dr. Nina Leonard

T: +49 89 203043 533

M: +49 176 101 985 20

E: nina.leonard@pinsentmasons.com



Dr. Johannes Maidl

T: +49 89 203043 539

M: +49 172 368 01 81

E: johannes.maidl@pinsentmasons.com



Tobias Rodehau, LL.M.

T: +49 89 203043 548

M: +49 174 233 85 30

E: tobias.rodehau@pinsentmasons.com

Your Feedback

We are interested in hearing your opinion. Please fill out this form and fax it to **+49 89 203043 501**.

We will donate €25 to Doctors Without Borders for each response.

Did this report provide you with useful information?

☐

1

☐

2

☐

3

☐

4

☐

5

☐

6

Please mark where applicable

1 = very useful, 6 = not at all useful

What do you consider to be particularly helpful?

What information was lacking? Which questions should we include next time?

What trends do you see in Tech M&A transactions in Germany?

Please let us know how you are involved in Tech M&A transactions in Germany:

☐

as a decision-maker

☐

as a lawyer in a law office

☐

for other reasons

☐

in the area of Business Development

☐

as an advisor in corporate finance

☐

as in-house counsel

☐

as an advisor in other areas

Your Information (voluntary)

Last name, first name

Company

Address (street and house number, postal code, city)

Telephone

E-mail

☐

I consent to the use of the information I have provided here by Pinsent Masons LLP, for the purpose of contacting me

☐ by mail ☐ by e-mail ☐ by telephone

regarding relevant legal developments and services provided by Pinsent Masons LLP (e.g. additional reports, white papers, newsletters).

I may revoke my consent at anytime (also partially) effective immediately, for example by e-mail to: unsubscribe.PMGGermany@pinsentmasons.com.

Thank you very much for your response.

About Our Study and This Report

This report describes the results of a market research study conducted by SMF Schleus Marktforschung on our behalf. SMF Schleus Marktforschung conducted extensive interviews with 26 decision-makers, business development managers and in-house counsel at well-known technology companies who have been involved in numerous Tech M&A transactions in Germany.

The quotations were taken from our own practical experience and from interviews conducted for the study.

All of the graphics were created by SMF Schleus Marktforschung.

Editorial Team

Publisher

Pinsent Masons Germany LLP
Ottostrasse 21
80333 Munich
Germany
T: +49 89 203043 500
F: +49 89 203043 501
www.pinsentmasons.de

Market research institute

SMF Schleus Marktforschung, Hannover, Germany

Concept, design and composition

EGGERT GROUP, Düsseldorf, Germany

Print

Woeste Druck + Verlag GmbH & Co KG, Essen, Germany



Pinsent Masons

Legal notice:

Publisher:

Pinsent Masons Germany LLP, Ottostrasse 21, 80333 Munich, Germany

T: +49 89 203043 500, F: +49 89 203043 501

Pinsent Masons Germany LLP is a limited liability partnership incorporated in England and Wales (registered number: OC373389) with its registered office in London: 30 Crown Place, Earl Street, London EC2A 4ES, United Kingdom. The partnership has a German branch with a place of business in Munich at the address provided above, registered in the register of partnerships of the Munich District Court (registered number: PR 1154). The word "partner", used in relation to Pinsent Masons Germany LLP, refers to a member of Pinsent Masons Germany LLP or an employee or consultant of Pinsent Masons Germany LLP or any affiliated firm who is a lawyer with equivalent standing and qualifications. A list of the members of Pinsent Masons Germany LLP, and of those non-members who are designated as partners, is available at the above noted place of business in Munich and at the above noted registered office in London. "Pinsent Masons" is used to refer to Pinsent Masons LLP and affiliated entities, including Pinsent Masons Germany LLP, that practise under the name "Pinsent Masons" or a name that incorporates those words. Reference to "Pinsent Masons" is to Pinsent Masons LLP and/or one or more of those affiliated entities as the context requires.

© Pinsent Masons Germany LLP 2014

For a full list of our locations around the world please visit our websites:



www.pinsentmasons.de



www.pinsentmasons.com



www.Out-Law.com