PRUDENTIA M&A FOLIO

BALTIC M&A OVERVIEW

Jan – Dec 2014

Deal Overview

As previous M&A Folio indicated, the year 2014 has been closed with a noticeable upswing in the deal count as compared to 2013 – 163 transactions versus 101 (+61%). Overall deal activity in the Baltic region follows the general global trend, although with a much more volatile dynamics, likely to be affected by relatively small size and openness of the Baltic economies.

Although the outlook on the global M&A activity for 2015 is bent towards a positive side (especially, for the EMEA region, which the Baltic States are part of), supported by another round of planned quantitative easing measures by ECB, we would keep our view on the Baltic M&A activity in 2015 more moderate. It looks like the deteriorated geopolitical climate has not yet properly reflected in the recent M&A activity in the Baltic region, and we are yet to witness its phantom in 2015, be it a result of a short-term pause in expansion or consolidation activity or a fundamental shift in M&A vectors.

This, in light of a huge increase in the deal count in 2014 coupled with relatively higher volatility, is likely to bring slow-down in Baltic M&A activity growth rate (if not a downward correction) in 2015.

Five Largest Baltic M&A Deals in 2014

Largest Baltic M&A Transactions in 2014*		
Target Company (Country)	**Acquirer (Country)**	**Deal Value (M EUR)**
Lietuvos Draudimas (LIT) AAS Balta (LAT) Codan Forsikring (EST)	Powszechny Zaklad Ubezpieczen (POL)	270.0
Liepajas Metalurgs (LAT)	KVV Group (UKR)	107.0
Amber Grid (LIT)	EPSO-G (LIT)	104.0
Lietuvos Dujos (LIT)	Lietuvos Energia (LIT)	75.9
Citadele banka (LAT)	Ripplewood Advisors LLC (USA)**	74.0

** Table includes only deals with publicly available transaction value.*
*** Unites a consortium of financial investors, with the deal executed via a Kleinwort Benson Advisor.*

Acquisition of insurance operators in all three Baltic States by a Polish insurance major Powszechny Zaklad Ubezpieczen (PZU) from a trade seller RSA was the largest Baltic M&A deal of 2014. By virtue of the geographic nature and complexity of the deal, it has also received a newly introduced "Baltic M&A Deal of the Year" award at the last Baltic M&A and Private Equity Forum. The acquisition was a logical expansionary and diversification step for PZU in light of its strategic goal to gain significant market share outside their home market Poland by 2016. Furthermore, the acquirer sought to benefit from the pan-Baltic entry to the Eurozone in 2015 and the associated improvement in predictability and stability of the group-level operations. Finally, this acquisition brings PZU to the leading position in the insurance industry in their region.

Geographic Location

When looking at a geographical breakdown of Baltic M&A activity in 2014, all three countries had relatively similar market shares (30-40%), with Lithuania, not without of effect of a relatively sizeable economy, leading the ranking.

According to the FDI flow statistics for 2014[1], German investors were the most active ones in Latvia, followed by Russia and Sweden. Respective top-3 for Estonia included Latvia, Denmark and the Netherlands[2], while for Lithuania – Sweden, Latvia and the Netherlands[2].

Industries and Deal Types

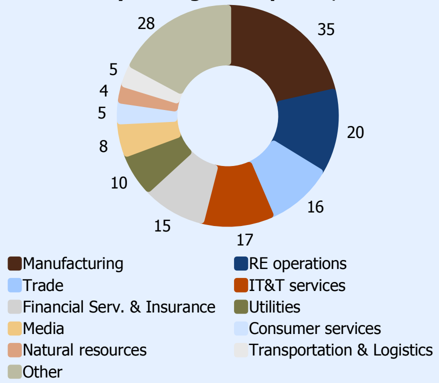
Manufacturing sector was the most prolific for the number of deals in 2014 (with a 22% pan-Baltic share). This indicates both at importance of the sector as a source of consolidation opportunities (with this theme expected to maintain its drive in 2015) and at attractiveness of the Baltics for foreign investors as an operating venue or as an important link in the acquirer's value chain. Estonia generated the largest deal count (42%), with Latvia being a runner-up (35%).

The largest number of deals was observed in the sub-segment where an acquirer and a target operated in the same or horizontally related industry. This brings no surprise since it is typically less challenging to justify motives for M&A deals of this kind, with economies of scale/scope, market entry and build-up of market power being the most frequently mentioned ones. Particularly, it is easier to identify and exploit synergies in the horizontally related deals (i.e. when seeking strategic and operating fit, benefits from sharing expertise, cost savings etc.).

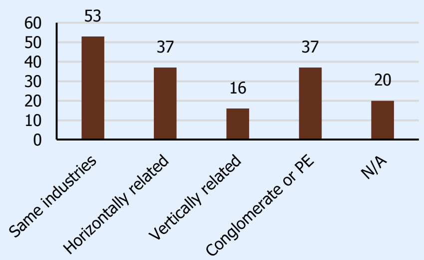
Already an established pattern, corporate strategic investors were the most frequent buy-side party in the Baltic M&A deal flow in 2014, accounting for roughly 2/3 of the total deal count. Institutional financial investors[3] followed with a 22% share and with a quite stable deal count vs. 2013.

[1] *Information on FDI flows for first three quarters of 2014.*
[2] *Data on direct investors is used.*
[3] *Including selected VC-financed deals.*

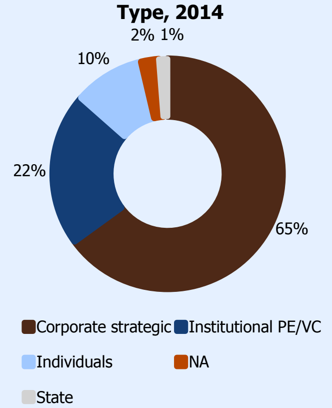
Breakdown of Deal Count by Industry of Target Companies, 2014



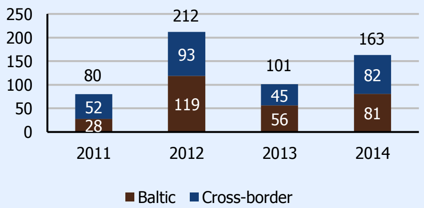
Breakdown of Deal Count by Relatedeness of an Acquirer and a Target, 2014



Percentage Breakdown of Investor Type, 2014



Breakdown of Deal Count by Geographic Orientation of the Transaction



Sources: S&P Capital IQ database, Advisors' homepages, NASDAQ OMX Baltic, Bank of Latvia, Bank of Lithuania, Bank of Estonia

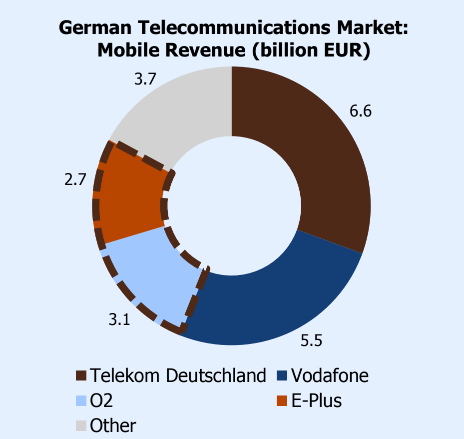
Telecommunications Market

Telecom industry witnessed palpable build-up of competitive pressure in recent years. Companies have to keep up with all the recent trends: improvement of LTE 4G networks, expansion of fiber optic broadband, proliferation of cloud computing services, etc. As a result we see very active market consolidation – larger companies are more likely to survive the fierce competition. Although the number of deals in Europe has been dropping for the last three years, transaction value has been consistently growing, indicating at increasing role of more sizeable targets in the M&A deal flow. One of the largest and prominent recent deals in Europe was takeover of E-Plus Mobilfunk by Telefonica Deutschland Holding AG.

Takeover of E-Plus

In Q3 2014 Telefonica Deutschland Holding AG (owner of O2 operator) announced about closing of the acquisition of E-Plus (prior subsidiary of Royal KPN N.V.). This transaction was considered groundbreaking for several reasons, particularly, the venue (Germany is the largest telecom market in Europe) and complex antitrust clearance procedure (with the German and the European Commission antitrust authorities expressing opposite views on the merger).

The merger allowed Telefonica to become the largest wireless carrier in Germany by number of customers with almost 47 million subscribers. It is now ahead of Deutsche Telekom AG by number of connections, however behind by mobile sector revenues (according to financial data for 2013).



Source: http://www.atkearney.com/

Initially the deal was valued at 8.1 billion EUR, however after one of the largest minority shareholders threatened to block the deal the offer was upped to 8.6 billion EUR, representing valuation of around 9.5 times EBITDA. Telefonica issued new shares in amount of 3.62 billion EUR to finance the deal (besides cash).

Synergies and "Drawbacks"

It would be logical to expect that prominent M&A moves of the sort reflected in the Telefonica and E-Plus deal would be subject to scrutiny with respect to potential value added and incremental returns for shareholders. For Telefonica Deutschland and E-Plus the deal is expected to bring total estimated synergies of 5 billion EUR, identified in both cost and revenue side.

On the cost side, the major contribution comes from staff reduction by 1 600 employees by 2018 (18% of the headcount), mainly driven by cutting duplicating positions (e.g., sales and call-center employees) and tailoring the sales operations to increasing role of the Internet channel (reduction of store headcount). Additional cost-cutting potential is sought in the marketing and store maintenance functions. On the revenue side, the merged entity aimed at better position and improved abilities to bring more innovative products and services to the market, as well as enhance customer experience.

Overall, the above-mentioned benefits look logical, identifiable, realistic to implement, and endowed with value-adding potential, nevertheless as always it will come at a cost to somebody – in this case to those who will have to change their employment status.

Challenges

Discussions of the merger between Telefonica and E-Plus were initiated in 2012. However, due to constrained liquidity position (the Spanish carrier entered the discussions with already huge debt load, pressured to refinance 14.5 billion EUR of debt in two years), as well as looming macroeconomic backdrop in both Europe and in Spain, Telefonica neither could tap the equity market nor had sufficient cash available, and the deal was postponed.

After a string of asset disposals and other cash saving activities Telefonica went back to the table. Even though at first the German anti-trust authority has not given a green light for the deal, eventually the merger has received political support even from Angela Merkel who referred to the deal as bolstering dynamics of infrastructure investments in the sector and supporting the overall strategic aim for the EU to "score internationally".

Owing to the scale of the deal and its implications on the competitive landscape, the deal was subjected to an anti-trust review by the European Commission. Eventually, the EC has cleared the deal, but subject to a string of requirements for Telefonica to mitigate the post-merger risks for smaller market players. Telefonica will have to sell upfront 20% of its mobile network to a smaller competitor Drillisch (with the latter retaining an option to increase it to 30%). In addition, Telefonica extended its wholesale agreements and undertook to offer its 4G capacity to anyone willing to employ it in offering related services.

Information and Communications Technology Industry Consolidation in Latvia

"Global market trends prove that consolidated companies stay in the market" with these words previous Minister of Economic Affairs Mr. Dombrovskis announced that the government should consider Lattelecom and Latvijas Mobilais Telefons (LMT) merger. Discussions about integration and further privatization of the two largest Latvian telecom carriers were reinvigorated since 2013, although no definitive conclusions have been reached yet.

Overall, the benefits identified in the potential merger of Lattelecom and LMT are of similar nature to those sought in the Telefonica and E-Plus – cost cutting through elimination of duplicating functions in similar functional areas, enhanced bundling of services through cross-selling between the fixed and mobile segments. Moreover, with an integrated services portfolio, the merger would allow the carriers to conquer market share more effectively (which among others is reflected in the GfK-run poll on customers' expectations). Based on the preliminary evaluation of merger consequences initiated by the Latvian government and the carriers, the integration is expected to yield 70 million Euros in synergies or ca.10% of the combined enterprise value of Lattelecom and LMT as per the latest TOP101 estimates (ca.730 million EUR).

It seems like a good deal for customers and current owners of LMT and Lattelecom, including the Latvian government. Nevertheless, there are few concerns that are likely to pose material obstacles to the merger or at least require particularly tedious negotiations. The first one is related to post-merger split of ownership and control between the Latvian government and TeliaSonera, which (considering the latest available financials and existing ownership structure) is likely to result in the former ending up as a minority shareholder.

Another issue is related to anti-trust matters – the Competition Council of Latvia might be overwhelmed by a super-monopoly spectre and the associated deterioration of competition expected to materialize in case the merger is cleared. This concern, however, is likely to subside in light of the recent precedent-setting events of the sort like the merger of Telefonica and E-Plus. These are the cases where perceived consolidation benefits – achievement of efficiency gains, improvement of prospects to keep up in the infrastructure modernization race and bolstering motivation to invest in such modernization initiatives – are likely to overwhelm anti-trust concerns, especially if the government is ready to provide mitigating measures against potential crippling of competition.

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