

MANAGING THE INSTITUTIONAL HAZARD: THE PRICE OF CAPITAL GAINS



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What is the value of an asset that cannot be sold or that can no longer be bought? This is the question raised by the presence of the State in mergers and acquisitions (M&A) involving strategic sectors. This question is particularly relevant in cross-border transactions subject to the control of foreign investments in France (FDI screening), i.e. areas where the State has the power to approve, modify or refuse a transaction.

By taking a seat at the negotiating table of M&A transactions, the State has made the issue of screening foreign investments as important, if not more important, than merger control or compliance. Indeed, whereas practitioners used to be mainly concerned with obtaining the approval of merger control (antitrust) authorities for third-party agreements, deals that fall under the scope of national security now require the approval of public authorities. Especially since the State wants to be involved as early as possible in all the options envisaged by the seller or the target, and thus to be part of the operation.

INSTITUTIONAL RISK AFFECTS THE VALUE OF THE STRATEGIC ASSET

When the State takes a seat at the negotiating table, the parties to a foreign investment in a strategic sector will encounter an institutional hazard that affects the value of the asset in question. This risk is threefold.

First of all, there is a regulatory risk, as the government can change its regulations quickly, for example by simply issuing a ministerial order to classify a sensitive technology as belonging to a strategic sector. This is what the government did on April 28, 2020, when it brought biotechnologies within the scope of FDI screening overnight. It can also modify the thresholds for triggering the screening process, as it did with its decision in July 2020 to lower the threshold from 25% to 10% for listed companies. In a way, the State can increase the size of the net while narrowing the mesh. These regulatory uncertainties are likely to impact a transaction, both during its structuring and its completion.

Secondly, there is an interministerial hazard. While the Ministry of the Economy is the gateway for authorization requests, the approval process also involves other administrative departments and/or ministries. This interministerial interaction involves a number of power relationships and negotiations that need to be understood. This was the case in the now **emblematic sale of Photonis in 2020**, where the negotiations with the Ministry of the Economy did not reveal the reality of the opposition expressed by the Ministry of the Armed Forces. For the sellers, this situation closed the market to competition and thwarted their valuation strategy. The difference between the price offered by Teledyne and that of the buyer finally authorized by the State amounted to a loss for the seller of 130 million euros. **It is therefore quite possible to measure the impact of this hazard on the valuation of an operation.**

Finally, a political hazard. It is undeniable that the protection of strategic assets has become a key issue for public authorities. The French Parliament took up the issue in 2018 with the Parliamentary Commission of Inquiry into the protection of industrial flagships. It has since called, on numerous occasions, for stricter control of authorizations issued and commitments made by the investor. Regarding the takeover of Carrefour by Couche-Tard, the Ministry of the Economy did not even pretend to give the agreement a chance when it announced that it would be refused on food safety grounds. Just a year before a presidential election and in the midst of a health crisis, the Ministry conveniently got rid of an eminently symbolic operation. Because of the profile of the buyer, an asset can be made non-purchasable due to the intervention of the State, thus making it illiquid. In the end, however, it is the value of the strategic asset that is at stake.

Nonetheless, the institutional hazard does not only result in a loss of value for the parties. It can be reversed to their advantage and offer an opportunity to increase the value of the asset in question. For example, in a bid involving several competitors, it is possible that the value of the asset will increase because it is in a strategic sector and may encourage the search for alliances where the State would be a stakeholder, facilitator or intermediary. Having the State at the table is therefore not in itself always a problem. For a highly sought after strategic asset, the State's reluctance to sell it could cause an increase in its market value. In these circumstances, the unavailability of the asset could be used as leverage.

In a transaction subject to foreign investment screening, the target asset is subject to an additional liquidity risk; pricing thus becomes an additional difficulty. The market

value of the asset will therefore depend directly on the parties' understanding of the institutional dimension and on negotiations with government.

DEMANDS OF THE STATE AFFECT THE END-TO-END OPERATION

The question of the State being at the table is now central, but the question of how to deal with it is even more critical. At what point, and above all in what way, should the institutional hazard be managed?

Ideally, the institutional hazard will be treated during the structuring of the operation with the same degree of importance as the financial, legal and operational construction of the transaction. This "institutional due diligence", in the near and long terms, must be fully addressed so that the transaction will be acceptable to all, especially to the government. This strategic and institutional analysis must also be carried out in order to structure the transaction when the time comes for the foreign investor to sell the strategic asset or company. It should therefore be carried out as far in advance of the transaction as possible, so as not to explore disposal options that may or may not be acceptable to the State.

Institutional risk is also addressed during negotiations with government. In the foreign investment screening procedure, these negotiations are encouraged to get advice before the application is filed and even more so during the approval phase. Such negotiations are essential to ensure not only the success of the transaction, but above all to preserve the value of the asset, technology or business in question. It is important to avoid any request from the State that would distort the transaction itself. It requires specific and tactical expertise, in consultation with other boards. Close dialogue with public authorities (or government, as it were) is the only way to ensure the security and durability of the operation.

The institutional hazard is also dealt with in parallel to the operation itself. As soon as the operation brings the State to the table, it brings with it all the rules relating to the functioning of public authorities, including interministerial and parliamentary control. Just because the State is present does not mean that it has a single face. In the foreign investment screening procedure, the State is represented by the foreign investment office (Multi-com 4), but in reality it is more a reflection of the positions of the various ministerial departments whose positions it coordinates. It is therefore necessary to deal with the smallest player in the decision chain that will lead to the final position of the State in the negotiations. In the case of Photonis, it should be remembered for future transac-

tions that despite the conditions set by Bercy (the French finance ministry) for the takeover by Teledyne, it was the position of the competent sectoral ministry that prevailed, in this case the Ministry of the Armed Forces.

The institutional risk is also dealt with at a later stage, once the authorization has been issued and the foreign investor's commitments have been fulfilled. These commitments are increasingly scrutinized by Parliament, which — independently of the powers of control provided for in the FDI screening procedure and in article L.151-7 of the CMF (French monetary and financial law)— exercises certain powers of control over the ministry and the government that made them, as constitutionally devolved to the legislative power. It is therefore not uncommon to see a transaction being subjected a posteriori to supervision by a fact-finding commission, or even a parliamentary commission of inquiry, as was the case for the most emblematic transactions involving an FDI screening procedure (Alstom-GE, Alcatel-Nokia, etc.). Logic dictates that future commitments made by the foreign investor to public authorities (or government) should be the subject of particular attention. Not to mention the risk that a political changeover may call into question the decision of the government that previously authorized an operation.

LOBBYING TO SECURE THE STRATEGIC ASSET TRANSACTION

In reality, once the parties to the transaction understand that the State is at the negotiating table, the institutional hazard poses a risk not only to the feasibility of the transaction, but more broadly to its security.

By managing the institutional risk and dealing with it appropriately at each stage, the operation is made secure. This aims in particular to ensure that the operation is sustainable, i.e. that it offers all the necessary guarantees so that the State cannot consider that circumvention ma-

noeuvres have been used to undermine the essential interests of the State. Such a situation would inevitably lead to the revision of the operation, or even to it being reversed.

In this respect, one of the challenges is also to comply with the legislation on transparency in public affairs and the obligation to make a declaration to the HATVP (French authority for transparency in public affairs). Many players avoid their transparency obligations by hiding behind legal texts, pretending to forget that such practices are perceived as circumvention manoeuvres. These are all arguments that will be used against the investor and the reputation of their advisors in the event of an audit after the fact.

The institutional hazard thus encumbers the target with the risk of an increase or decrease in the gap between enterprise value and market value. Managing this risk is therefore no longer a simple theoretical question or even a mere source of irritation for those who have to part ways with a thirty-year-old practice; it is now a key aspect of M&A in strategic sectors. It is at the heart of structuring the transaction as well as the valuation of the asset.

Gone are the days when public authorities endorsed transactions that were put together in a way that saw them approved, complained about or tolerated. For players in M&A transactions, institutional risk must now be integrated right from the due diligence stage, and dealt with both before and during the transaction, without overlooking the smallest stakeholder, whether in government, the administration or parliament.

M&A players who have lost the habit of talking to public authorities in their transactions will have to integrate this essential institutional dimension or watch their operations fail. This is a major turning point in the practice of mergers and acquisitions in strategic sectors for the coming decade.