Ellex

Transaction radar

Summary of the first half of 2024

Ellex transaction radar, summary of the first half of 2024

New economic cycle has started, investment courage is back

Commentary by

Risto Vahimets, Sven Papp, Dmitri Rozenblat, Rutt Värk, Karl Rudolf Org

Summary

Transaction Radar summarises the most important trends of the transaction market in the first half of the year.

Situation in Estonia

The recovery seen in the IV quarter of 2023 continues and the trend is clearly positive for the number of transactions – compared to the same period last year, there were 28 more transactions in the first six months of the year (94 vs 68).

Risto Vahimets, Partner and Head of Transactions | Ellex in Estonia

In the first half of 2024, a total of 94 transactions were registered in Estonia, divided as follows:

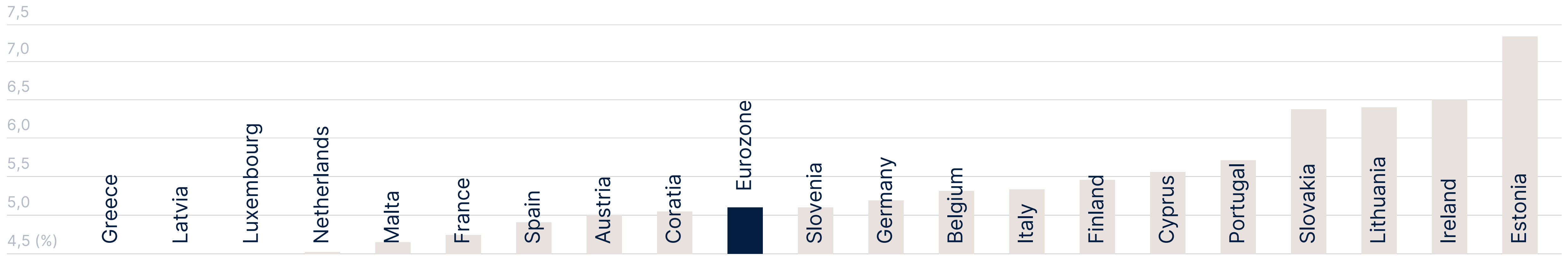
36 venture capital and technology transactions	49 traditional M&A transactions
4 share issues (incl. OTC issues)	5 major real estate transactions

The activity on the transaction market is significantly influenced by interest levels and inflation. Transactions can be done if the understanding between the buyers and sellers about future cash-flows and company values are converging.

Although the interest rate and inflation can be predicted, inflation worries are not completely over yet – in May the euro area inflation rate increased to 2.6% (it was 2.4% in April). The long-awaited base interest cut by the European Central Bank came in June. The cuts are expected to continue in 2024 which would make financing acquisitions cheaper and would further converge the price expectations of buyers and sellers in company M&A transactions.

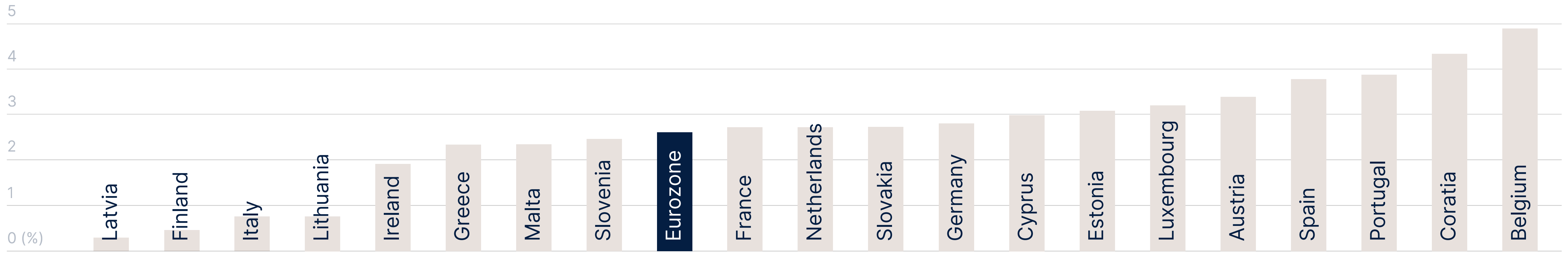
Estonian economy has been in decline for already 9 quarters but the recession in the I quarter (2.4%) is lower than in previous quarters. Let us hope that the economy will soon start growing. Increased activity of the transaction market shows that the courage to invest has been restored, which in turn, albeit with a delay, has a positive impact on economic growth.

Interest rates on business loans



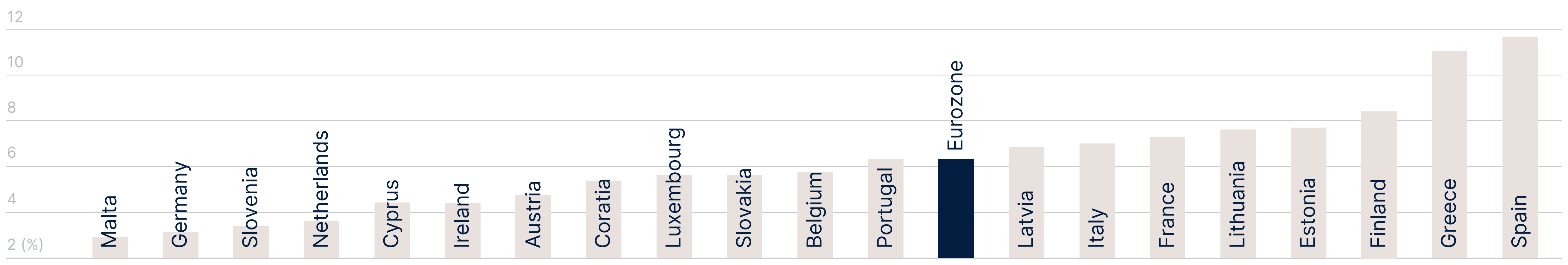
Meanwhile we have risen to the top in Europe by the cost of business loans which is a negative trend even compared to the end of 2023. We have made some progress with inflation but there are only 6 euro area countries with an inflation higher than ours.

Inflation



Rising unemployment and economic problems in European countries with other long-term structural problems, such as Spain, Greece and Finland, also affect Estonia. Although Finnish economy has grown 0.5% in the first quarter though, which gives hope.

Unemployment rate



In summary, the revival of the transaction market correlates nicely with the continued increase of investments in the third quarter, which is a positive sign in a complicated economic environment.

Global situation

Taking a look around the world, there have been some interesting developments in the M&A (mergers and acquisitions) sector. The US has broken through the trend of the low number of and small transactions - from the beginning of the year to this date there have been 12 transactions exceeding $10 billion in value. The largest of these are ConocoPhilips acquiring Burlington Resources for $35.6 billion (natural gas deposits and production in North America) and Capital One Financial Corporation acquiring Discover Financial Services with a transaction value of $35.3 billion (financial services, payment platform in America).

The small number of transactions continues to be a problem in Europe. According to the Datasite Deal Drivers Q1 EMEA report, M&A had a slower start in 2024 than in 2023 and 2022 but had the same pace as the beginning of 2021. The combined value of transactions is on the same level as the quarterly average in 2023. The macroeconomic environment poses challenges but the region as a whole still offers noteworthy transactions.

On the European transaction market, the only interesting and noteworthy deal at the beginning of the year was the Novo Nordisk transaction where the company acquired production capacity for $10 billion.

Novo Nordisk is a phenomenon worth keeping an eye on - this company has found a new market for antidiabetic medicines in a increasingly massive global weight loss industry and is huge compared to the economy Denmark, its country of origin, and is undoubtedly an important factor in the entire country's economy.

Private equity is about to go on the move in terms of transactions. According to Brain & Co, at the beginning of 2024, $3.9 trillion of dry powder had accumulated globally – money waiting for the suitable time for transactions (the corresponding amount at the beginning of 2023 was $3.5 trillion). When this amount of money starts looking for transactions at the same time, there might be some unreasonable moves - transactions that should not be made.

In Estonia, there were 8 technology sector transactions in the first half of the year. The Starship (90MEUR), Stargate Hydrogen (42MEUR), Elcogen (30MEUR), Tuum (25MEUR), Botguard (12MEUR) transactions had a significant impact on the sector. The areas of the transactions were energy and cyber security which reflect the modern day problems of the world.

Globally there have been several major transactions - five transactions worth in excess of $10 billion have been made in the natural gas and oil sector, which is an indication that although the introduction of renewable energy and a greener worldview are important, we still need fossil fuels to burn or as raw material in the chemical industry. Particularly active is ConocoPhillips who in addition to Burlington is also acquiring Marathon Oil for $22.5 billion.

In addition to the above major energy technology transactions, nine more energy sector transactions were made, in clear continuation of the 2023 trend where the energy sector played an important part in our transaction market.

What will the future bring?

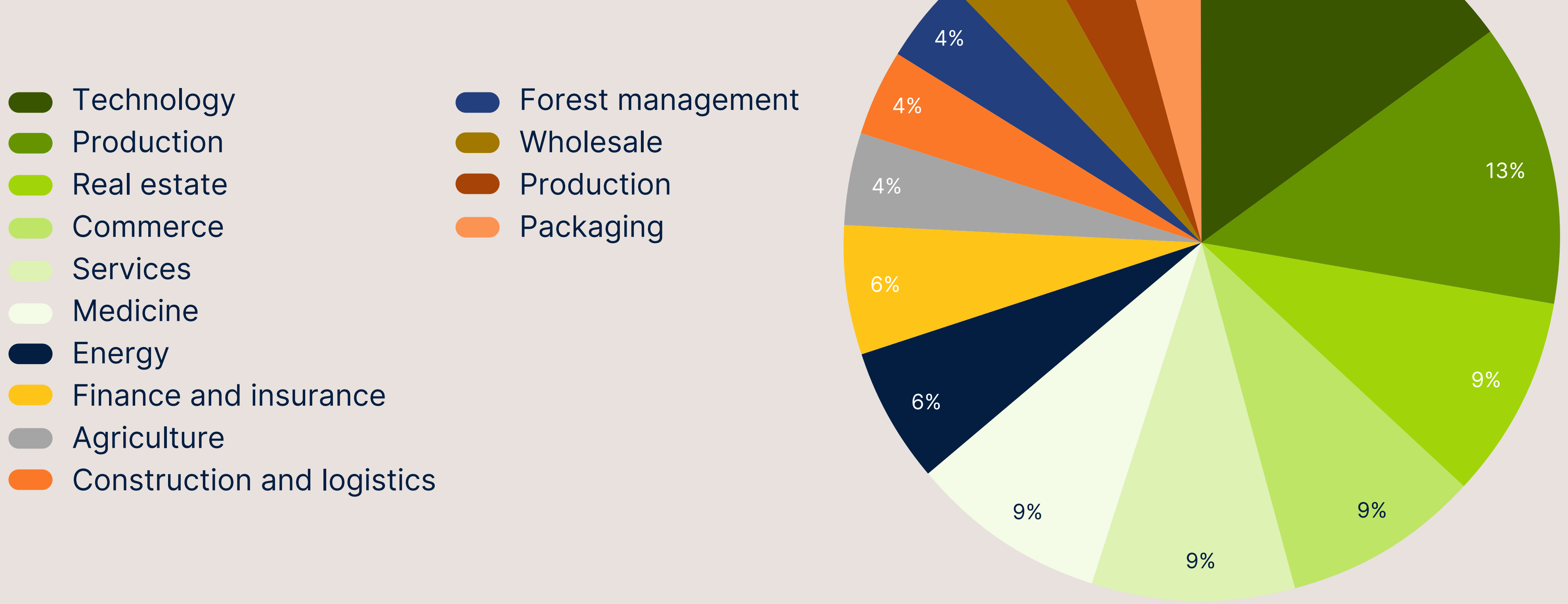
Today it can be argued, with even more confidence than half a year ago, that investment courage has returned (see also the data from Statistics Estonia) and the transaction market is recovering.

The global private equity and venture capital funds were just recently equipped with a lot of money and now it seems that this money is finally being invested. Trillions of dollars in accounts is by no means sustainable.

I can also see the technology sector growing significantly in the Estonian transaction market, in 2024 and beyond, especially with technology companies raising funds. There are talks here and there that the banks in Estonia are “open” and want to give loans.

Still life is continuing in the real estate sector but it cannot stay that way either. In summary, the recommendation would be that if there is intention to sell a company, now is the right time to start preparing. And if the intention is to anticipate the market as a buyer and get something for less money, you should already act quickly.

2024 I half-year M&A and real estate transactions (%)



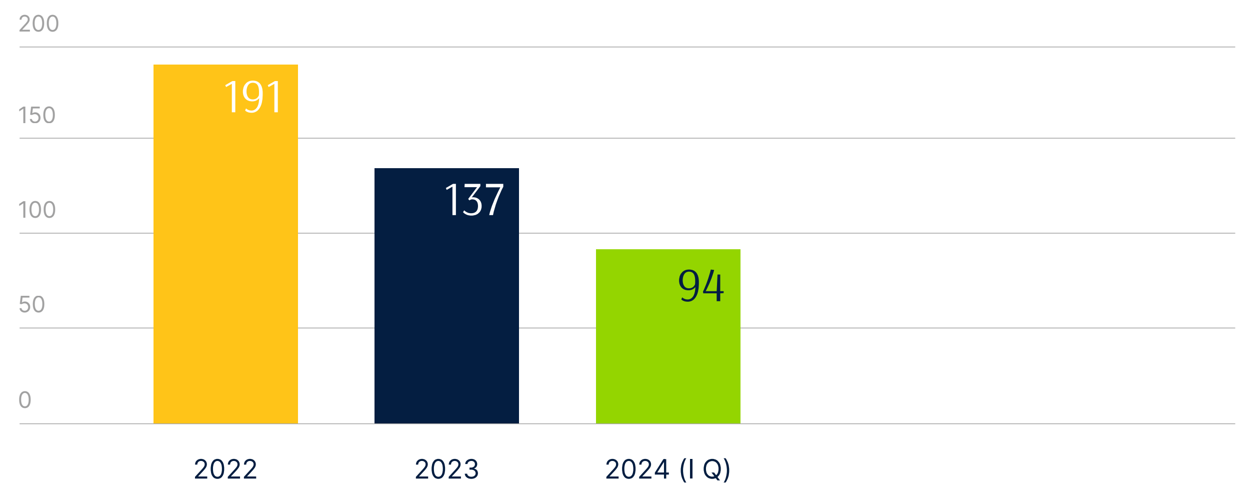
Noteworthy M&A transactions in the first half of 2024

- Qualitista (Klaus) – technology as an M&A trend
- Mergers of Walless&Fort and PWC Legal& TGS – changes in the legal market
- Takeover offer of Nordic Fibreboard, intention for the takeover offer of Tallink, intention for the takeover offer of Baltplast - changes in the market of publicly traded companies
- Eagle Vision and Pere Optika transactions - consolidation of trade, with the optics business as an example
- Telema - private equity (Livonia) is once again on the buying side
- Acquisition of City Clinics by Meliva - medical transactions as a trend

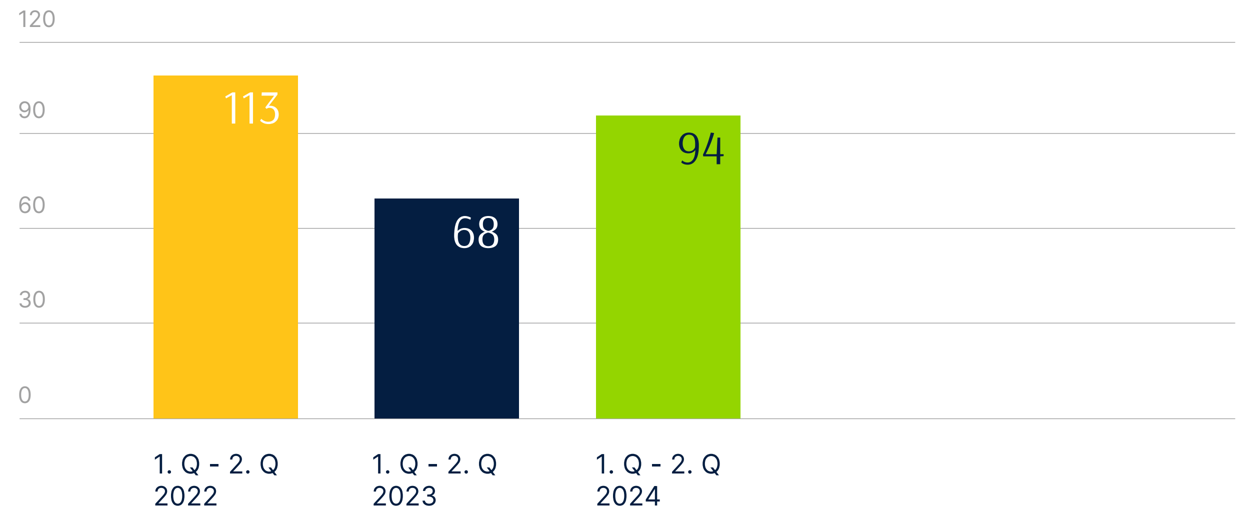
Noteworthy global M&A transactions in the first half of 2024

- ConocoPhillips & Burlington Resources 35.6 BUSD (energy)
- Capital One Financial Corporation & Discover Financial Services 35.3 BUSD (finance and insurance)
- Synopsys & Ansys 35 BUSD (technology)
- Diamondback Energy & Endeavor Energy Partners 26 BUSD (energy)
- ConocoPhillips & Marathon Oil 22.5 BUSD (energy)
- Home Depot & SRS Distribution 18,5 BUSD (trade)
- Stone Point Capital and Clayton, Dubilier, Rice & Truist Financial Corporation 15,5 BUSD (insurance)
- HPE & Juniper Network 14 BUSD (technology)
- EQT Corp & Equitrans Midstream 14 BUSD (energy)
- Silver Lake & Endeavour Group Holdings 13 BUSD (entertainment)
- Chord Energy Corporation & Enerplus Corporation 11 BUSD (energy)
- Blackstone Real Estate Partners X & AIR Communities 10 BUSD (real estate)

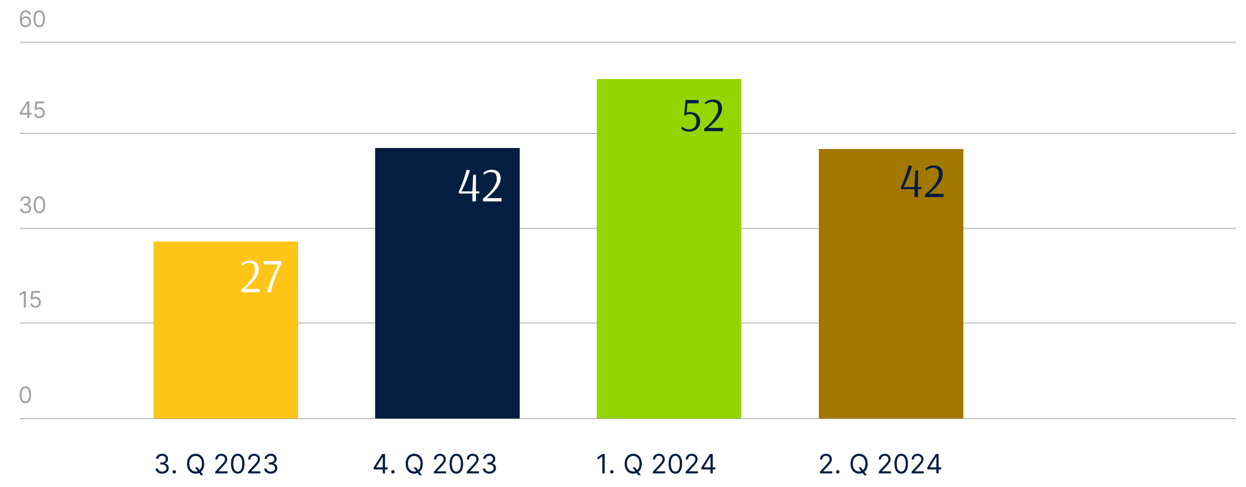
Total number of transactions (2022-2024)



Total number of transactions in the I half of the year (2022-2024)



Total number of transactions in the last 4 quarters



Legal focal points of the technology sector transactions

While the second half of 2023 brought a significant decrease in the number and volume of transactions in the technology sector, according to publicly available statistics, 2024 has so far shown signs of market recovery. As more generally on the transaction market, the players in the technology sector base their hope on the improved inflation prospects and the resulting anticipation of a decrease in the "cost of money". Some optimism for the future also comes from the fact that the volume of transactions in the technology sector has so far been driven up by strategic buyers and the share of private capital is the lowest it has been in recent years. Given the amount of available money that the private capital funds had at the start of 2024, the technology sector definitely holds more potential for additional growth. The improvement of macroeconomic conditions and a sense of certainty could finally turn on these money taps.

Rutt Värk, Counsel, and **Karl Rudolf Org**, Lawyer | Ellex in Estonia

Similarly to 2023, the hottest global trend in the technology sector is still AI. On the one hand, companies who are developing robust AI-based products provide venture capitalists with an attractive growth prospect. On the other hand, more mature tech companies are looking to AI for efficiency and additional growth and strategic M&A could be the suitable means to achieve this capacity. In Europe, and the Baltics more specifically, the defense industry is also worth mentioning. In Estonia, this is illustrated by the government's decision to establish a 50-million-euro fund that will invest in the equity capital of companies who develop defense technologies.

Allowing ourselves some optimism with regard to the further recovery of the technology sector, it is worth mentioning the legal focal points which should be given special attention in transactions with tech companies.

Who have a shareholding in the target company?

First, regardless of the sector and somewhat self-evidently, it is important to identify who the parties of the intended transaction should be, meaning who have a shareholding in the target company. With the tech sector it has become common that in addition to direct shareholders, the option holders also need to be considered - these being mainly the employees and management of the company but in practice, share options are also allocated as a fee to advisors, consultants and other service providers.

In recent years, through raising funds, many tech companies have welcomed a new group of shareholders who need to be taken into account in any transaction – convertible investors. In 2023 much more various convertible instruments were used to raise money in order to avoid down-rounds (i.e. investments with a lower value than during a previous financing round) and postpone the valuation of the company to the future. With the market conditions improving, we might see more traditional equity investments again as well as the sale of majority or all shareholding in a company (exits).

Transactions like this may lead to the conversion of investors who previously granted convertible loans to the company into the equity of the company. For this reason it is extremely important that the capitalization table kept by the company correctly reflects all the persons who have a shareholding in the company – this means persons with a direct and indirect holding, including share option holders and convertible investors. If a person with a (indirect) holding in the company is left unidentified, an investor or buyer may end up in a post-transaction situation where they own a smaller share than anticipated.

In any case, the buyer or investor should mitigate such risk by adding the relevant seller or company confirmations about the accuracy of the capitalization table in the investment or sales agreement.

How to evaluate the legal strength of a product portfolio?

Secondly, a potential buyer or investor should definitely evaluate the legal strength of the company's product portfolio. Undoubtedly the pricing and transaction terms of many tech companies are affected by intellectual property related matters. Therefore, it is crucial to map before the transaction which intellectual property the company has created in the course of its operations, who owns it and whether the company has the right to use the intellectual property required for the continuation of its business activities. The important principle that applies here is that intellectual property is created only by natural persons which means that a legal person cannot create intellectual property. Intellectual property related proprietary rights – for example, the right to permit and prohibit the use of the creation and the right to proceeds from such use – can be transferred to the company. Although based on the law, the employee's proprietary rights to what has been created in the course of performing work tasks transfer to the employer to a certain extent, this might not be sufficient for the company. The transfer of the employee's proprietary rights should be regulated in more detail in the employment contract to ensure sufficient protection of intellectual property that is relevant for the company. The proprietary rights of persons doing outsourced work do not automatically transfer to the company and this matter should definitely be addressed in the respective service provision agreement.

Whereas it is not always enough to include a provision whereby the employee or service provider transfers to the company all their rights arising from intellectual property. In addition to proprietary rights, a natural person will have personal rights that cannot be transferred. A significant personal right is the right to make amendments and prohibit amendments to the created work – this enables the right holder to prohibit any further development of a product in the absence of necessary agreements. Therefore, it is important that in addition to the transfer of proprietary rights, the employment or service contracts also include an agreement on the company's right to exercise intellectual property rights to the extent in which these rights cannot be transferred to the company. In other words, these contracts should include, in addition to the agreement on the transfer of proprietary rights, also the agreement on the exercise of personal rights, i.e. the licensing of personal rights.

It is also necessary to evaluate whether the product or service could fall under a regulated sector. For example, with the mediation of payments through a platform or app, it should be checked whether the company needs a payment service authorisation. For the buyer or investor, the regulatory risks of a product can be mitigated with the inclusion of the relevant seller or company confirmations in the sales or investment agreement. Even if the company being acquired has all the required authorisations, the acquisition of a qualifying holding in such company could require the approval of the regulatory authority of the respective sector – which could significantly impact the course and duration of the transaction process. For this reason, the regulatory requirements concerning the company should be mapped in the earliesr possible transaction stage and taken into consideration in the completion of the transaction.

How does cyber security affect the transaction?

Lastly, the issue of cyber security has emerged in the technology sector.

In 2023 over 3,000 cyber attacks with a significant impact were registered in Estonia and the number of cyber attacks is expected to grow. On the one hand, cyber attacks can paralyse a company's business, on the other hand, inadequate cyber security entails several legal risks. First, it is worth noting that a cyber attack (e.g. a denial of service attack) does not usually release a company from its contractual obligations and a breach of contract caused by a cyber attack could lead to liability before the other party. Moreover, tech companies, primarily software companies, often collect a considerable amount of personal data. Such companies are obliged to take sufficient measures for the protection of the collected personal data. Personal data that is leaked in a cyber attack could result in damage claims from the data subjects as well as supervisory proceedings by the Data Protection Inspectorate.

While matters narrowly related to personal data have become a standard part of the legal due diligence of a tech company, based on the specific nature of the company, it is worth engaging a non-legal expert who evaluates the broader risks of cyber security. The buyer can protect itself from risks arising from the circumstances that exist at the time of the transaction (e.g. malware) with contractual means – mainly the seller's confirmations and indemnity obligation – but this might not be sufficient. Inadequate cyber security means that the company is vulnerable also after the transaction.

Engaging a cyber security expert early on enables the buyer to identify the target company's deficiencies in cyber security already before the transaction and plan the necessary steps to eliminate these deficiencies after the transaction. So, the buyer can protect itself from the problems that exist during the transaction with contractual means, but post-transaction cyber security will be the buyer's responsibility – the mitigation of this risk should be planned already before the transaction.

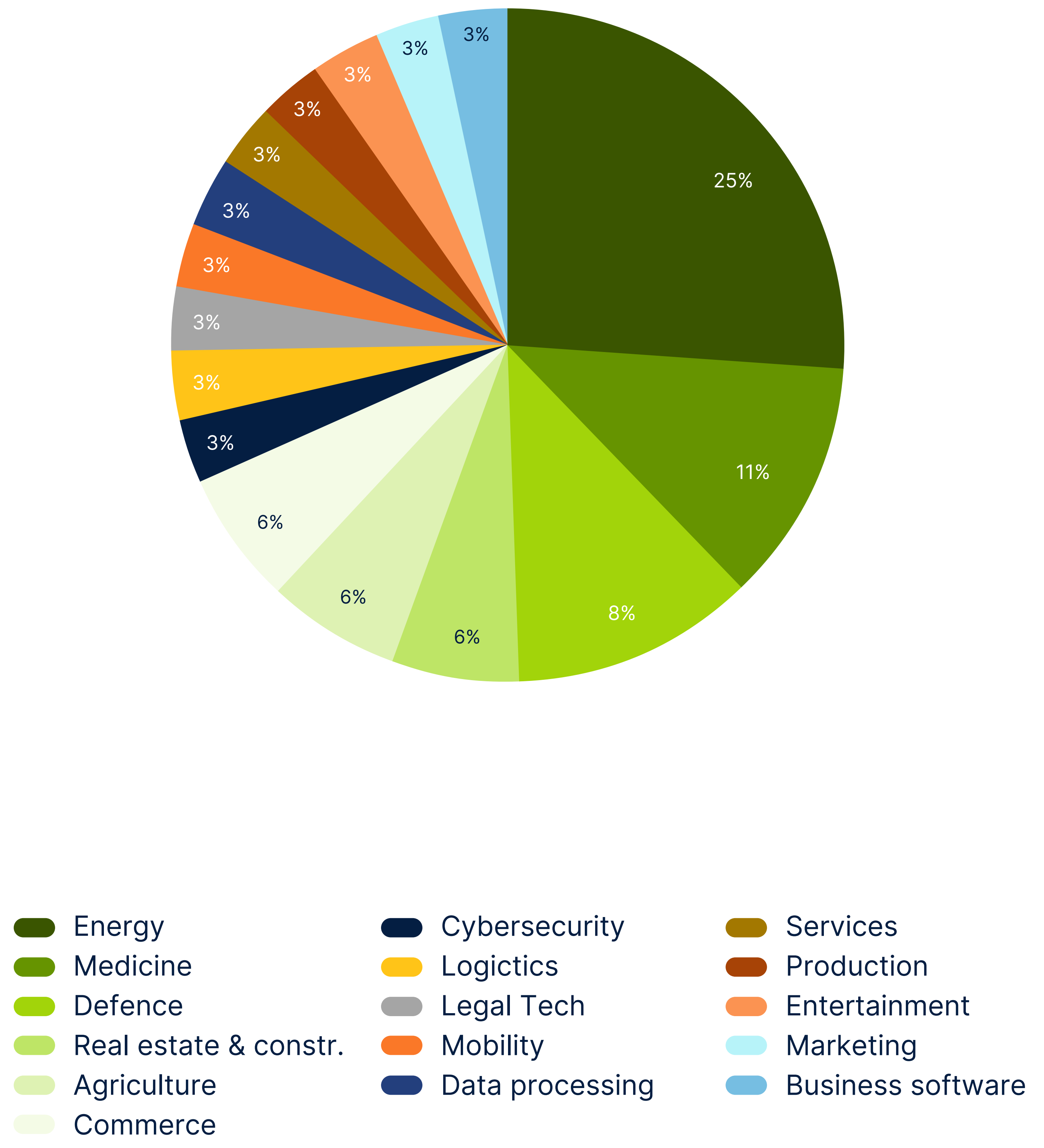
Summary

Although the tech sector transactions are largely subject to the same principles and transaction stages and documentation as any other M&A or investment transaction, there are still various legal nuances associated with the tech sector companies that are typical of this sector. Therefore, it is important that the tech sector transactions involve advisors who have experience in the relevant field and who understand which legal and non-legal aspects should be the focal point of the specific transaction.

Noteworthy venture capital transactions:

- Starship – 90MUSD raised
- Tuum – 25MUSD raised
- Botguard – cyber security sector transactions as a trend
- Elcogen – 90MUSD raised
- Stargate Hydrogen – 42MUSD raised
- SensusQ – defense industry transactions as a trend
- Nanordica Medical – medical transactions as a trend

2024 I half-year venture capital transactions (%)



Using debt push down financing is riskier than ever

2023 saw several developments on the tax front but it was inarguably the re-emergence of the taxation of the so-called debt push down that caught the attention of the market participants the most.

Dmitri Rozenblat, Counsel | Ellex in Estonia

Debt push down is a financing structure that is widely used in Estonia and globally where the financer provides an acquisition loan to a holding company founded by the buyer for this purpose and which after the acquisition transaction merges with the target company. After the merger, the loan granted initially by the financer to the holding company transfers to the target company which will also continue to service the loan from the cash flow generated from its business activity.

Although the reasons for using the described financing structure are mostly corporate law considerations (restrictions of financing prohibitions) and the need to ensure collateral for the financer in the form of actual activity and assets of the target company, the Tax and Customs Board has for a while now expressed its discontent with these structures.

The question of possible taxation of debt push down was first raised nearly 10 years ago but the discussions back then did not lead to any specific outcomes and the question remained unresolved. The tax authority had indirectly, through binding preliminary decisions and inquiries, hinted at the possibility of taxation but with the lack of actual tax proceedings, the market participants continued to use the debt push down structures.

Serious progress on the matter was made last year when the tax authority presented the draft guidelines for debt push down taxation and held several round tables on the guidelines with stakeholders (banks, funds, tax advisors etc.).

Understandably, the initial version of the Tax and Customs Board's guidelines, whereby after applying the debt push down structure, all loan servicing payments (interest and principal part) of the target company are subject to income tax (as expenses not related to business), provoked a rather sharp response among the market participants. This was due to legal reasons as well as a considerable negative effect on the M&A market and the Estonian investment climate in general.

In the course of thematic discussions around the guidelines, the tax authority has adjusted its positions to some extent. The latest draft of the guidelines has changed the basis of taxation to enable to take into account the income tax paid on the loan servicing payments in future profit distributions. As a result of this amendment, should it remain in the final version of the guidelines, the taxation of debt push down would follow the principle of a deposit payment where during the loan servicing, the income tax has to be paid but in the future, the distribution of profit is exempt from tax to the respective extent. The intention to abandon the idea of taxing historical transactions (dating pre-publication of the guidelines) can also be considered as significant progress.

Regulating the taxation of debt push down is without a doubt a complicated task and a great challenge for the tax authority. Legal uncertainties persist regarding the correct legal basis of the taxation as well as whether such a controversial topic with a strong market impact can even be resolved with tax authority guidelines or would it actually require legislative amendments with a thorough ex ante impact analysis.

Today the draft guidelines for the taxation of debt push down are still in the works and the amended version, which hopefully has taken into account the feedback from market participants as much as possible, can be expected from the tax authority soon. Nevertheless, regardless of the final wording of the guidelines and how long the preparation of the project might take, the latest developments have turned debt push down into a very high risk structure. Therefore, market participants have to consider the possibility that in the near future, debt push down is subject to tax in one way or the other and they need to be prepared to use alternative acquisition and financing structures or for the considerably higher cost of using debt push down structures.

Prospects of the Estonian transaction market in 2024

Two consecutive years of decline in the transaction market. 2023 was a modest year for the global transaction market, this of course if one expects new records to be broken each year. The number of transactions in 2023 decreased by 11% compared to 2022 and the total value of transaction fell by 26%. This means that the transaction activity fell for the second year in a row and the records set in 2021 remained out of reach also in 2023.

The low point of the global transaction market is also evident in the fact that in 2023, the total value of transactions worldwide decreased to EUR 2.3 trillion. The last time the total value of transactions did not exceed EUR 3 trillion was in 2013.

Sven Papp, Partner and Co-Head of Transactions | Ellex in Estonia

The main reasons behind the fall were the same as in 2022 – geopolitical situation, interest rates, inflation, volatility in the energy and raw materials market etc. Lack of confidence in the future made the investors cautious.

After two years of downward trends, the expectations and hope for 2024 were high. Unfortunately, the first half of 2024 has not lived up to these expectations – global conflicts have expanded (in addition to the full-scale war waged by Russia in Ukraine, there is military conflict between Israel and Hamas etc.), inflation is still high, interest rates have not fallen significantly etc.

2024 is not expected to bring significant improvement in the economic environment but it is expected of 2025. Optimism is not lost in the world – positive trends include the falling prices of raw materials and energy carriers, alleviation of supply problems, inflation slowing down and the anticipated lowering of interest rates. However, it is still noted that interest rates will unfortunately remain high, inflation will slow down but is still high etc. The Bank of Estonia is optimistic in its economic forecast, saying that Estonia is on the brink of economic growth but no significant improvement is foreseen for 2024: domestic price levels will rise 1.6% (with tax effects up to 3.2%), interest rates will remain high, unemployment will increase to 7.6%, export will hopefully increase but not considerably because problems in Estonia's main export markets will persist.

Main challenges in 2024. The biggest challenge for companies in 2024 seems to be the continued uncertainty in the markets, which forces to caution with expansion plans and investments. The following have been mentioned as the main challenges for companies and the transaction market in 2024:

- due to market volatility and uncertainty, the price expectations of buyers and sellers are still worlds apart, which significantly reduces the number of transactions in the market;

- due to high interest rates, the cost of money is high and buyers have little desire to pay the so-called price premium in transactions and they prefer to keep the price multipliers in the transactions low, which in turn discourages the sellers from accepting the price offers;

- the prospects for a rapid improvement and recovery of the economic environment in 2024 is subdued, it is rather expected that the inflation continues at the same high level and there is no faith in the quick fall of interest rates;

- a complicated geopolitical situations generates a lot of protectionism by states which is reflected in stricter regulations for the protection of own markets;

- a complicated economic situation, high price of capital and tougher regulations mean for the companies that the preparation and negotiation of transactions takes considerably more time and is also more costly than before.

All this does not mean that transactions will disappear altogether, although there is probably no reason to be too hopeful in terms of increased activity in the transaction market in 2024.

History has shown that in troubled times, the share of foreign investments decreases to some extent and domestic capital is given the opportunity to acquire businesses.

For Estonia it is good that foreign investors have not talked about giving up on investments in countries bordering hostilities, such as Estonia. Instead, they have spoken of the geopolitical situation as a factor that complicates the economic environment and not as a factor that would deter investments from our region altogether. This means that although there are risks, investors are still interested in investing in Estonia.

Entrepreneurs are inventive with turning the worst challenges in their favour and we can hope to see increased investments in our defense capabilities, continued investments in Estonia’s traditional sectors, such as information technology, fintech etc., as well as their newer forms, such as cleantech, greentech etc. There is still active interest in the renewable energy sector where consolidation as well as the sale of companies can be expected. Estonians have always been a “real estate nation” but it seems that this sector will remain in recession also in 2024. Troubled times have always given the domestic capital an opportunity for transactions over the more cautious foreign capital.

We advise on matters concerning public and private sector mergers and acquisitions

Risto Vahimets
Partner
Head of Transactions
Ellex in Estonia

Sven Papp
Partner
Co-Head of Transactions
Ellex in Estonia

Dmitri Rozenblat
Taxation Counsel
Ellex in Estonia

Rutt Värk
Counsel
Ellex in Estonia

Karl Rudolf Org
Lawyer
Ellex in Estonia

See **our services and team** on our website and contact **risto.vahimets@ellex.legal**, +372 515 0949.

World-class legal advice in the Baltics

ellex.legal
Experience success

Ellex Raidla Advokaadibüroo OÜ
Reg. kood 10344152
VAT EE100101799
Ahtri 4, Tallinn

Ellex

ellex.legal