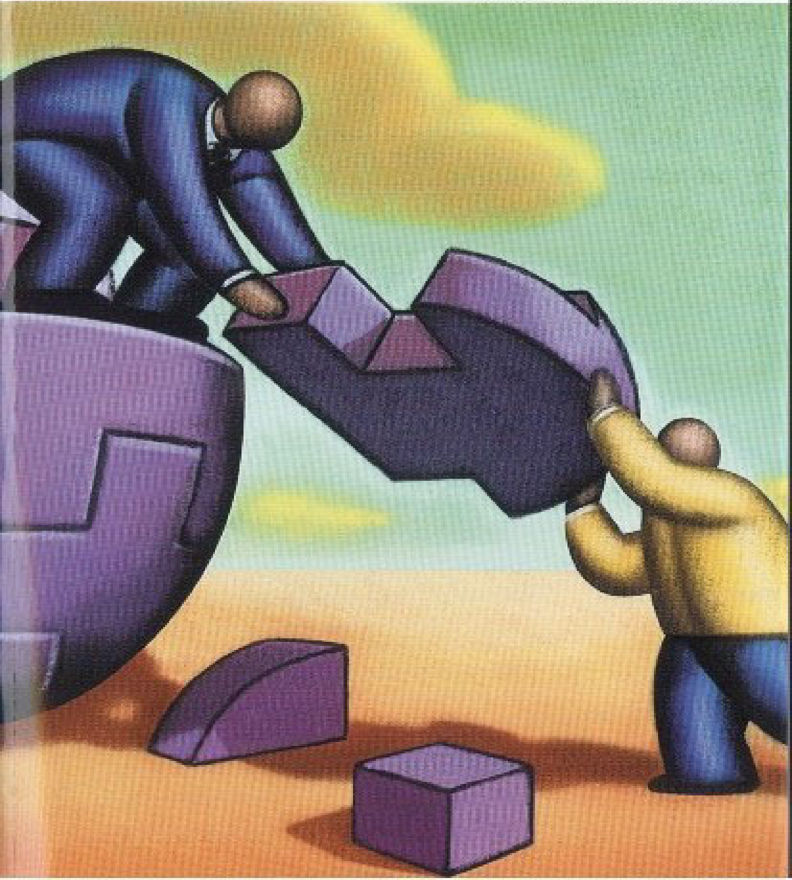
International Mergers & Acquisitions

Review 2003/2004



ITALY

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Starting in 2001 merger and acquisition activity in Italy suffered a decline in line with the international slowdown, and estimates for 2003 are not encouraging. Continued development of the Italian capital markets and ongoing legislative reforms are among the conditions likely to reverse this trend and create a turnaround by the end of 2003.

Introduction

Italy, since post World War II reconstruction, has positioned itself as one of the six wealthiest nations in the world with a gross domestic product averaging US$1.4 trillion. This growth has developed in two stages: the success of large enterprises, both state-owned and private, in the 1950s and 1960s; and more recently, the development of a multitude of highly dynamic and aggressive private small and medium enterprises in the 1980s and 1990s.

This evolution, in light of current trends in the global competitive strategies, and the current needs of the Italian entrepreneurial class have produced the conditions for an important development in the already substantial merger and acquisition ("M&A") activity in Italy. In the following pages we will outline the potential of the Italian M&A market by analysing the "country system", the most recent trends of financial transactions in Italy and describing the most important legislation reforms already in place or in the process of being defined, which could increase M&A activity.

The "Italian System"

Italy, among industrialised countries, has had the lowest GDP growth rates for the last few years: GDP grew at an annual average 1.9% rate over the period 1995 to 2001 as compared to an average of 2.4% registered by other EU countries, and 3.6% in the US.

The restrictive tax policies adopted by the various Italian governments in the last decade to restore public finance, which became necessary in order to join the European Monetary Union, has been one of the main factors limiting the growth of the Italian economy.

As presently reported by many economic analysts the Italian economy, as a result of its structure, has lost competitiveness in global markets. In fact, the Italian industrial system is characterised by a large number of mainly family-owned small and medium-size enterprises. The average size of Italian enterprises is 40% smaller than that of other European firms.

This structure is the outcome of an industrial reorganisation that characterised the Italian economy in the 1970s, generated both by the 1973 oil crisis and the down-sizing (in particular de-verticalisation) and outsourcing trends in the Italian companies. The adoption of information technology and the search for more flexible organisation solutions gave rise to the same results in all advanced industrial countries.

Despite their relatively small organisation sizes, at the end of the 1980s and the beginning of the 1990s, Italian enterprises were able to specialise in some production phases and market niches, developing high innovation attitudes with their creativity and organisation flexibility. This has undoubtedly allowed Italian firms to develop competitive advantages in some segments (textile, luxury, industrial equipment, basic construction materials, ship building, etc.) in international markets.

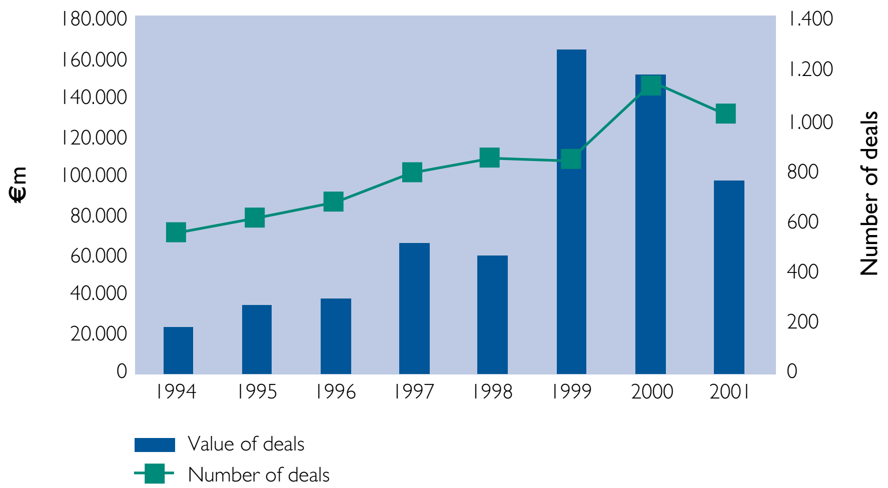
However, the new economic scenarios could weaken these advantages. The need to constantly invest in technological innovation is one of the most important and evident factors changing the competitive rules in the industrial sectors and the company's size is critical in order to make cost effective investments in research and development, and increase production efficiency.

The M&A market in Italy

The Italian M&A market has developed substantially from 1994, with a significant growth in the number and value of deals completed. In 2001 1,031 deals were reported for a value of €100bn as compared with 558 deals reported in 1994 with an approximate value of €24bn. This has resulted in a 9.2% and 22.3% compound average annual growth rate in the number of deals completed and deal values, respectively.

In 2001 Italian M&A activity suffered a significant contraction, particularly in terms of transaction value, even though this contraction was less than the sharp decline recorded at the global level.

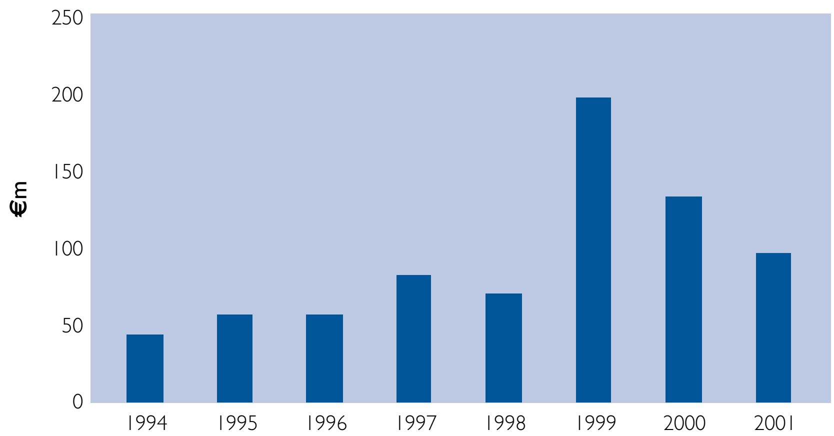
Figure 1: Italian M&A market – deals value and number



Preliminary estimates for 2002 appear to outline a mixed environment with an additional decline in the number of deals performed (-24%, a decrease higher than occurred at an international level, -10%), and an increase in the total value (+5% as compared to the contraction experienced at a worldwide level, -24%).

The reduction of total M&A market value in the years 2000-2001 has coincided in the reduction of the average transaction value down to €97m in 2001, from €198m in 1999. However, the average size of transactions in the period 1994-2001 increased by 12%, from €44m to €97m, in line with the trend of

Figure 2: Italian M&A market – average deal size



prices applied in the stock market.

In 1999 the average deal size reached its peak during the "new economy bubble", corresponding also with the closing of top-deals such as the hostile takeover of Telecom Italia.

The Italian M&A market still overwhelmingly remains an internal market, as approximately two-thirds of transactions are performed between Italian purchasers and sellers. During the 1990s, with the peak in 2000, Italian outbound investments increased primarily focused in the US, France, and Germany. After 2001 the trend shifted, and inbound investment, mainly from Europe, exceeded outbound investments.

In terms of M&A activity by industry, industrial companies accounted for approximately 40% of total deals completed in 2001 (focusing on companies specialising in the construction of industrial equipment, electrical, and electronic equipment), while non-financial service companies accounted for approximately 34% of the total (with particular reference to the internet and information technology sectors).

During the last few years share deals have been the prominent deal structure. Share deals have accounted for approximately 80% of total transactions in recent years, while asset deals accounted for only 10% of the total. The residual 10% of the market is composed of marginal transactions (such as pure mergers). The objective of most of the share deals completed has been the acquisition of a majority shareholding in the target. Approximately 70% of deals completed related to the acquisition of more than 50% of the stock capital, while 40% related to the acquisition of 90% or more of the target's equity.

Hostile takeovers are quite rare in the Italian market as compared to practices in other countries with developed financial systems and large stock exchange markets. They only account for approximately 5% of total deals. Telecom Italia in 1999 and Snia in 2002 are the main exceptions. This is due to the fact that a significant development of the Italian stock exchange recently took place in the second half of the 1990s as result of regulation reforms, which have brought the Italian market in line with the most evolved western financial systems.

Additionally, following the decline of government bonds yields, huge amounts of private savings have been reallocated to the Italian stock market. These changes have not yet impacted the way in which deals are consummated; as a consequence, private-to-private transactions are still the most common deals in the market. They account for approximately 90% of total transactions in Italy.

Private-to-private transaction will continue to play a central role in the Italian M&A market until the number of listed companies, as well as companies that could be potential take-over targets, increase. Within a general evolution of the Italian capital market and the entrance of new financial and industrial players heading the Italian companies, a further evolution of the Italian stock market, and a significant increase in the M&A private-to-private transactions are expected.

Cash is undoubtedly the main payment form, accounting for approximately 80% of the total types of payment. Settlement normally takes place at closing, and payment in instalments and earn-out structures are scarcely utilised. It is however necessary to note that the Italian market is very rapidly evolving, and the structure of transactions is becoming more and more complex, both from the legal (carve-outs, spin-offs, put & call options structures, etc.), and financial points of view.

Private equity deals are relatively new in the Italian M&A market. The market for private equity deals has begun to develop in the last few years. Between 1998 and 2001 the number of private equity deals in Italy increased by 22%, while their value increased by 32%. Consistent with the M&A market in general, the number of private equity deals decreased by 24% from 2000 to 2001, and the value of those deals decreased by 26% in the same period. Preliminary estimates for 2002 indicate a recovery in private equity activity mainly generated by buy-out transactions connected with the disposal of business segments from large Italian and foreign groups.

Legislative reforms and government actions

The current government (whose term expires in 2006) is introducing significant changes in corporate law and tax regime.

A new set of rules governing merger leveraged buy-out transactions is among one of the most relevant legislative reforms affecting M&A activity. In the last three years the lawfulness of these transactions has been called into question by some legal courts and some academic leaders, discouraging these deals structures. Legislators have attempted to resolve these doubts through recently introduced reforms, while at the same time establishing a series of precise procedural requirements aiming to increase the level of information and safeguards for creditors of companies involved in merger leveraged buy-outs. In addition, the new set of corporate laws allows greater flexibility in the choice of the most effective corporate governance system and simplifies merger procedures.

Proposed tax reform could simplify taxation of corporate income and decrease the tax rate. The reform is expected to be approved by parliament in 2003, and should become effective in 2004. Although a detail reading of the final text of the law is necessary, we have outlined below the most significant changes in corporate taxation scheme, which might affect the structuring of M&A transactions.

The reform introduces the exemption from taxation of capital gains arising from the sale of investments held for at least one year, and also includes the introduction of the concept of the "*participation exemption*" in Italy, which already exists in other European countries. An unavoidable consequence of the introduction of this rule is the non-deductibility of write-downs and losses realised on investments. Dividends received by entities subject to corporate tax will benefit from a 95% tax exemption. This applies to both domestic dividends (abolishing the present system of tax credit on dividends) and foreign dividends, while the controlled foreign companies (CFC) regulations remain in force.

The abolition of Law Decree 358/97 will have tax consequences for corporate reorganisations. If certain conditions are met the current rule allows the company to deduct goodwill amortisation resulting from mergers, spin-offs, and business contributions; or if those conditions are not met the company can still deduct goodwill amortisation with the payment of a 19% substitute tax. Upon completion of the tax reform goodwill amortisation will not be deductible and the companies will no longer have the opportunity of paying the substitute tax. Accordingly, in the near term, asset deals could appear more attractive than share deals in light of the immediate tax deductibility of the price paid.

A significant impact is expected from the future introduction of rules regarding thin capitalisation and consolidation for tax purposes. The thin capitalisation rule will introduce limits to the deductibility of financial charges in the event holding investments held benefit from the "*participation exemption*" regime. Only the enacting decrees will determine the maximum leverage for the deductibility of financial charges, this will also affect leveraged buy-out transactions.

The opportunity to choose group taxation, which consolidates the taxable income of subsidiaries at an Italian level or world-wide basis, as well as the expected abolition of the IRAP tax (regional production tax) and the decrease in the IRPEG tax (corporation tax) to 33%, should represent a simplification (for instance, the target absorption could no longer be essential to benefit from its net operating losses) and an incentive to invest in operations in Italy.

Social security reform is another item in the Italian government's agenda, which should result in the funnelling of employees' leaving indemnity into pensions funds. This will result in an annual flow into financial investments (including private equity and the stock exchange market) estimated at €12bn-€14bn.

In addition the government is extending the amnesty for the repatriation of capital illegally held abroad by entities, which should bring additional non-recurrent cash into the Italian financial system.

Future changes to bankruptcy procedures could be proposed, which would make enterprise dynamics livelier, and could represent an incentive to the realisation of distressed M&A transactions.

According to the intentions of the government, and European Community directives, there is likely to be further deregulation in infrastructures (public transport, utilities, etc.) and privatisation of important enterprises such as ETI, Mediocredito Friuli, Enel, Eni, Fincantieri, Tirrenia, Alitalia, the Post and the Railways.

After several years of reduced spending the government is actively promoting the construction of significant public infrastructures (for instance the extension of the Milan-Naples highway, the improvement in city mobility, a bridge to span the Strait of Messina, etc.), which are expected to generate positive effects in the Italian economy.

Outlook for the "Italian System"

The government's projections for 2003 GDP show a 2.3% increase, followed by an additional 3% per year expansion starting in 2004. Other recent estimates (Prometeia, Confindustria, Cer, OECD and the European Commission) appear more prudent, suggesting a growth rate ranging between 1.4% and 1.8% in 2003, driven by a recovery in foreign demand in the second half of the year. The same sources also estimate that a recovery in domestic consumption during the short-term could be hindered by inflation (estimates for 2003 range from 1.8% to 2.2%) and a further contraction of the labour market (a consequence of the Fiat Group crisis).

Economist from leading banking groups are even more prudent, and estimate that GDP development in 2003 will average 1.3%. In their opinion, it is only possible to project an improvement if there is a recovery in European Union Countries as a whole, which can only result from instituting structural reforms.

The Banca d'Italia is even more explicit, when it reports that "*a progressive and lasting decrease in the tax and social contribution withdrawal is necessary, and the strengthening in infrastructures*", as well as "*reforms affecting current public spending*". Furthermore, the eventuality of a war could negatively affect the economic scenario, increasing uncertainties regarding consumers' attitudes and inflating prices.

The Banca d'Italia reports that the banking system is stable and able to finance a recovery in investments.

Despite difficulties that lie ahead, M&A activity could benefit from the expected positive evolution of the private equity market (funds development, entrance of secondary buy-out fund in Italy, existence of a consolidated set of operators with positive track records, and changes in the portfolio strategies of banks, insurance, and pension funds) and from a revision in multiples paid.

Conclusions

The current economic scenario is characterised by difficulties, limited growth, and uncertainties in the global political environment. Presently companies and shareholders are discouraged from pursuing external growth strategies even when significant acquisition opportunities are available. These unfavourable conditions will presumably persist during the entire year and we believe that an inversion of the negative trend of the M&A activity will not occur in the next months. The more realistic scenario is a holdover of the limited level of transactions experienced in 2002.

Only by the end of 2003 are we projecting an upturn in the M&A market. We believe that continuing evolution of Italian securities markets, infusion of additional capital into those markets, increased private equity activity, deregulation and development of public infrastructure, corporate law and tax regime reforms, and recovery of the European Union economy; along with reduced scepticism toward the market and integration, will facilitate growth in Italian M&A activity.

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