Riding a Wave

M&A in France seems likely to see an uptick despite—or perhaps because of—France's economic woes.

By Howard J. Stock

For the first time since the beginning of the financial crisis, the European Union's core economies seem to be in a worse state than those at the core. Despite economic difficulties, however, many investors still look to Germany and France as the true engine of the great European experiment.

It's understandable: while both Germany and France have posted disappointing growth numbers this year, they're still the two largest economies in the European Union, they have the most companies in which to invest and they have the most consumers to buy goods once the economy firms up again. But which is the best bet?

Jean-Nicolas Soret, Partner at Altana Law Firm concedes that Germany is often considered the better place to invest in the industrial sector, but investors too blinkered to opportunities to Germany's west risk missing out. "France remains one of the most attractive countries in Europe to develop industrial projects," Soret says.

France also has a strong reputation for competitiveness in the technology arena, something France's government has actively supported. "Our capacity to innovate is intimately related to the highly skilled and productive workforce," Soret says.

Still, France cannot afford to rest on its laurels, says Julien Aucomte, Partner at August & Debouzy. "France has now and has always had a strong card to play in terms of innovation and industry, but our economy definitely need to work on its competiveness, in particular in the industrial sector where the competition with other European countries is to our disadvantage: Spain, Portugal and Eastern Europe," Aucomte says. "Our social legislation is often seen as too complex and not enough flexible."

As far as the broader E.U. is concerned, and especially important to both France and Germany as the winds shift to favor countries on the periphery, the European Central Bank is starting to consider taking action of a sufficient heft to actually make a difference to Europe's flagging recovery, although Soret doubts the ECB's current efforts will be enough on their own to turn things around. "Cash injections remained lower than in the U.S. as the ECB did not adopt the same level of quantitative easing policy," Soret says. "It may be one of the reasons why the Euro dropped down by 10% against the dollar over the past four months."

A silver lining for France, however, is that "the weakening of the euro created opportunities for French exporters, especially for exportations to the dollar zone, and French groups such as Airbus or Renault should increase their margins and profit accordingly," Soret says.

The European industrial sector suffered low imports because the euro was perhaps too strong over the past few years. At the same time, this situation created opportunities for foreign buyers—investors managed to penetrate the French market making a limited investment through carve-out deals. Indeed, some of these acquisitions were even negotiated for a negative price. So while either situation—a weak dollar or a weak euro—are a sign of systemic weakness, there is also often a bright side for opportunistic investors.

At the same time, "because of the structurally low growth of E.U. economies, European businesses are seeking sources of growth in more dynamic regions, such as the U.S., Latin America and Asia. Even Africa has shown strong rates of yield in recent years," says Raphaël Mellerio, Partner at Aramis.

EVERYTHING'S RELATIVE

Soret says that relative strength in the U.S. usually has a positive outcome for France over time. "We noticed over the years that the improvement of the American economic context always has a deferred positive impact on French markets," Soret says. "Thus the recent acceleration of the growth in the American economy in the past few months should positively influence our European markets. Another favorable factor for improvement of our economic context is the weaker euro that enabled a rise of foreign orders and exports."

Despite these favorable external factors, France still faces major challenges to increase its competitiveness, among which political reforms of tax policies and labor laws stand out as the most pressing, and France's economic problems are leading to something of a deterioration of its image from a U.S. perspective. "This situation must change and we need to gain back confidence from the U.S investors and foreign investors generally," Soret says.

Mellerio agrees. "The U.S. remains by far the largest contributor to foreign direct investment in France but the perception of France by U.S. companies is declining due to the country's structural shortcomings, such as an uncertain tax environment and cumbersome labor regulations," he says.

However, another positive is that while investors are concerned about the health of the European economy, they are no longer questioning to the same degree the viability of the euro itself. "The successful outcome of the turbulence zone the Euro went through in 2013 demonstrates the stability and solidity of the currency and of the European monetary union," Soret says.

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Finally, the banking union, promoted by the European Commission, established a single rulebook for the 28 E.U. member states contributing to the depositors' protection and the management of potentially defaulting banks. "Such a uniform regulation will bring stability to our markets and will strengthen the European overall economy," Soret says. Nevertheless, the rigidity and multitude of rules of labor law remain an important hurdle to the acquisition of French companies, he says.

As is the case with Italy, a significant amount of France's attractiveness to foreign investors is historically tied up with the luxury industry; its brands and trademarks are sought for because they are renowned everywhere in the world. International M&A are always active in this industry.

But more recently, France's competitive profile has become more like Israel's. "High technology and biotechnology markets have performed extremely well recently, due in parts to a history and culture of industrial and technical innovation," Soret says. "Thus French companies in this area are very competitive on the international market place and they always attract foreign investors."

The French government is willing to encourage the development of such expertise through performing governmental scientific research organizations

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such as the Centre National de la Recherche Scientifique, famously at the edge of innovation. Funding agencies such as BpiFrance (the French sovereign fund headed by the National Bank for Investment) also provide the high technology and biotechnology sectors with strong financial support.

"If you look at our national champions it shows that France has a great tradition of technical innovation and industrial capacity to develop such inventions," Aucomte says. "Hot spots can be found in this traditional landscape, such as G.E./Alstom this year, or in the new technologies area, from Yahoo to Dailymotion in 2013."

Mellerio adds to the mix the purchase of cement manufacturer Lafarge by its Swiss competitor Holcim for a value of €39.5 billion. "At the same time, 2014 marks the fall of the merger between U.S. Omnicom and French Publicis which would have given birth to the largest advertising group in the world," he says.

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ATTRACTIVE ASSETS

Indeed, the recent acquisition by G.E. of the energy branch of Alstom for €12.5 Billion shows that France holds attractive assets for big buyers, "despite the difficulties it has faced with the French Government, which was openly supporting French bidder Bouygues," Aucomte says.

There were also a substantial number IPOs and fundraisings in the biotech area in the first semester of 2014 on the French markets, and potential buyers are also coming from all over the world to invest in other sectors. For example, the successive takeover bids since May 2013 for the French leisure and hospitality group Club Med by both the Chinese conglomerate Fosun International and the Italian businessman Andrea Bonomi raised the bid per share from €17.5 to €23. "Such a takeover shows a continued interest of foreign investors for certain industries like tourism and hotels," Soret says.

France's telecoms sector is also undergoing a significant reshuffle, such as the takeover of Vivendi-owned SFR by the cable operator Numericable. "French targets in other sectors have been acquired thanks to a weaker euro, easy and cheap financing and attractive valuations," Mellerio says.

Mellerio says that the general feeling in France is that, due to a weak demand in Europe and budgetary constraints, organic growth is quite difficult to achieve. Therefore, E.U. companies have to find ways to improve their operational performance and return on investment: in other words, through M&A deals. "Greater profitability may be attained if this leads to significant synergies of costs and sometimes revenues," Mellerio says, highlighting the merger between Lafarge and Holcim, which reportedly led to US$1.4 billion in synergies.

"The French government is aware of such factors but lacks consistency: on the one hand, it intends to develop the attractiveness of the country—for instance, by simplifying its corporate legislation or securing a generous tax credit system for R&D expenses—and on the other it enacts new restrictive rules, such as making foreign investments in certain regulated sectors." By this he means not only the traditional ones such as the defense industry but now also energy, water, transport, electronic communication and public health) subject to a prior ministerial approval or imposing an obligation on sellers of French SMEs to allow employees to make a purchase offer, which create further burdens and constraints on M&A deals.

To foster international deals, the French government will need to ease off its politically motivated protectionism. "The political attitude is clearly seen as too defensive," Aucomte says. "As the result of the G.E./Alstom transaction, a decree has been passed extending widely the areas where a foreign investor needs to obtain clearance before to invest. This kind of legislation is hard to defend and to explain to our foreign clients when the market is definitely global."

The decree substantially widens the range of strategic sectors that require foreign takeover projects to be reviewed and approved by the government. However, Soret notes that the formal combination of several governmental agencies active in inbound and outbound investment is also a sign that the government is seeking solutions to boost international M&A.

Aucomte adds that while uncertainty over future tax rules has probably discouraged number of foreign investors, but the situation will probably get better in the coming months.

Other new rules likely to be seen by outside buyers as too protectionist will also likely not last long. For example, a recent bill targeting small and mid-sized companies forces sellers of such entities to inform employees two months before completion of transactions, with a view to enabling employees to present an offer for the acquisition of the company.

Even though the offer may not be accepted by the seller, the adoption of the bill was very unfavorably received by employers and the French Employers' Association (MEDEF) actively lobbied at the French parliament against this bill.

Both houses of the parliament finally voted in favor of amendments aimed at suppressing these dispositions and such a constraining obligation towards employees will probably be removed from the law in the near future.

While various economic think tanks, along with the legal community, are finding ways to mitigate hurdles, clearly it would be better if France's politicians ceased creating hurdles in the first place. In order to compete, "the politicians definitely need to find more courage and to admit that some deep reforms need to be carried out," Aucomte says. "It will not be possible any more to rule on a case by case basis to accommodate each time a specific group of persons or a specific industry. They need to focus on framework laws and give more room to companies, their management and their shareholders to get themselves organized."

Reforms will also be needed to reduce France's public deficit, "which is now a hurdle to any additional public investment to sustain competiveness and innovation, which would be positive and value creating," Aucomte says.

POSITIVE MOVES

The broader E.U. also has an important role to play in levelling the playing field between member states. "The European Union's major challenge is to increase harmonization of member states' regulations," Soret says. "The European Commission is a key player in the regulation of stock markets and the financial market authorities of member states are compelled to harmonize their rules." Harmonization is a key asset for the competitiveness of European companies, so the E.U. needs to speed up harmonization of tax legislation and social legislation of member states, he says.

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In the short term, at least, France's weaknesses will likely turn out to be strengths from an M&A standpoint. Largely due to the relative strength of the U.S. stock market, the number of deals significantly increased in 2014 compared to the previous year, especially in the first semester, which was very active. "The resumption of economic growth in the US as well as the weakening of the Euro may support our economy for 2015," Soret says. "These factors should positively impact international M&A in France." ■