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UP, UP, M&A?
Outlook and main trends in the Portuguese market

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Mergers and acquisitions (M&A) activity in the Iberian market in 2021 was remarkable, exceeding the positive outlook envisioned at the end of 2020. Resilience was the moto, with people and organizations continuing to adapt to an environment of accelerated digital transformation and battling the lockdown and remote work fatigue that growingly settled in.

According to Mergermarket's Iberia Trend Report for FY2021, there were 715 transactions in this market (the highest number since Mergermarket started to compile deal data back in 2006) with a total value of US$59.1bn. Still according to Mergermarket, Private equity activity was a key driver leading to this outcome, recording a total of 147 PE buyouts and 48 to 69 PE exits. This is consistent with the perceived pressure on PE firms to invest their large amounts of capital.

The activity levels and transaction values were significantly higher in Spain, naturally reflecting the size and attractiveness of the Spanish economy when compared to the Portuguese one, but the trend of accelerated growth in deal volume and value was also observed in Portugal. In fact, looking at the latest Annual Report on the Iberian Market released this February by TTR, it is observed that "M&A deal volume grew 32% in Portugal in 2021 to 560 transactions", with an "aggregate deal value increased by just under 2% to EUR 19.22bn, based on 253 deals of disclosed consideration". Out of these, the leading sector was the technology sector (93% increase to 110 transactions), followed by Real Estate (86 transactions) and Financial and Insurance (63 transactions). As also observed by Mergermarket for Iberia as a whole, Private equity deal volume in Portugal increased 24% to 51 transactions in 2021, targeting smaller transactions in a broader spectrum of sectors (glass, ceramics, paper, plastics, wood and timber industries, distribution and retail, healthcare and consulting). Another trend observed in TTR's report is the accelerated growth of Venture Capital investment, which increased 85% in volume and 75% in aggregate value to 113 transactions worth a combined EUR 1.56bn, based on 90 deals of disclosed consideration. Most of these transactions targeted the tech sector, followed by the health industry and financial services.

As the end of the first quarter of 2022 is approaching, the trend observed in 2021 appears to be sustainable, as the deal flow in Portugal has surpassed the 2021 levels: for the same period. There are good reasons to be optimistic regarding a strong performance for M&A in 2022, driven by a cash rich and (still) low-interest rate environment (especially for private equity and infrastructure players), a

significant pressure to invest and a strategic repositioning of companies. As far as companies are concerned, the imperatives of ESG and digital transformation will persist and there will be continued appetite for M&A as part of the companies' value story and growth. With the start of public funding beginning to show in the horizon, it is expected that companies will have access to the means they require to become more robust, pursue those imperatives and therefore deliver a better business case for their stakeholders and investors.
2022 and 2023 will be the big years in terms of intensity of flow of European funding to the Portuguese economy. Indeed, Portugal will be one of the biggest recipients of European funding (on a per capita basis) through the so-called Resilience and Recovery Plan. Be that as it may, if public funding finally proves not to be available to all companies with good prospects, we should expect some private investment to step in - needless to say, where the companies at stake meet the selective criteria defined by private equity or venture capital investors.
In terms of sectors most targeted by M&A activity, we expect these to remain similar to 2021, with strong appetite for assets in the TMT, real estate, infrastructure and energy sectors – especially renewable – and an expansion of M&A to almost all sectors, especially Health, Banking & Insurance, Industry and Agrobusiness.
We would expect the market to remain a sellers' market in the most attractive sectors, with value records in the most attractive transactions, and for special situations and other opportunistic M&A to rise in parallel with "regular" M&A. It would be, however, foolish to overlook the risks and uncertainties the market is facing.
The COVID-19 pandemic seems to have a decreasing impact on the economic outlook as the percentage of fully vaccinated people has risen, but it is not over yet. Growing inflationary pressures, which may lead to rising interest rates, and friction in the readjustment of production chains will affect the cost of acquisition and/or the value of target companies to levels still difficult to predict. And last, but certainly not least, the effect of the invasion of the Ukraine which translates not only into a severe humanitarian crisis but also as a severe hit to the economies of Russia, Ukraine and their neighboring countries and to their international trade counterparts. The size and length of these new geopolitical risks and disruptions will largely depend on the duration of the present crisis and the nature of its aftermath, but from a short-term perspective it will definitely bring a steep increase in energy prices, as well as renewed market volatility and inflation.
Looking at the features of the deals completed since 2021 and at the interactions we have had with investors and companies, we can single out three trends that we believe have settled in the deal making structure:

(RE)ALLOCATION OF RISK: THE SURGE OF W&I INSURANCE

In the last few years we have witnessed a progressive growth in the use of W&I insurance on M&A transactions in Portugal, but since the last couple of years it is fair to say that W&I insurance has settled in as part of the transaction structure checklist. Access to this tool has improved significantly due to the simplification and acceleration of the contracting process and the availability of policies in good terms for competitive premia. In the current seller's market, most (if not nearly all) transactions targeting attractive assets and conducted through auction processes require the liability for W&I to be substantially transferred to an insurance policy, allowing for a clean exit by the Seller and removing the protective package negotiations from the top of the auction score. In other types of transactions, conducted through bilateral negotiations or targeting less attractive assets, W&I often comes into play to top up the protective package that Sellers are prepared to offer or to cover risks associated to the Sellers' solvency. We have seen the W&I insurance market offer more flexible solutions of coverage for known issues and of offering a waiver of sub-rogation rights, which are quite attractive to Sellers. This is a trend that appears to be here to stay, and which M&A advisors need to adequately navigate and advise on.

HYBRID MINORITY INVESTMENT

Recently, there is an increased appetite of investors to take on minority investments in Portuguese companies with hybrid structures inspired by the US deal-making dynamics. These structures bring into an equity investment certain capital markets features that generate downside protections for investors often combined with capped high-yeld capital returns and have been more and more seen in Portuguese deals. In an entrepreneurial environment where companies are facing transformation or succession challenges, we expect to see an increasing number of this type of deal surfacing.

INTEGRATION OF ESG INTO M&A DEALS

It is ever truer to assert that investors increasingly expect companies to do good while doing well. This is driven by several factors such as the COVID-19 pandemic, greater social and ecological awareness and a growing regulatory imperative. As a result, ESG factors are more and more present in investors' – notably asset managers and private equity firms – decision making process.

The full extent of ESG issues to be addressed by investors remains to be seen. In fact, as this article was being written, the European Commission issued its long-awaited Proposal for a Directive on Corporate Sustainability Due Diligence to tackle human rights and environmental impacts across global value chains. The proposal, albeit controversial both from the viewpoint of companies (which regard it as imposing far-reaching and costly obligations) and of NGOs (which consider that it should have targeted a higher number of companies and should have been stricter in terms of imposing bans on products made with forced or child labour), has been described as "a watershed moment for human rights and the environment". The proposal will complement the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation and was accompanied by the publication of a Communication on Decent Work Worldwide (outlining plans to tackle forced labour and promote decent work worldwide, paving the way for a future ban of products produced with forced or child labour from the EU market).

Other initiatives will likely unfold and, in the interim, practice will continue to step in and play a role ahead of the regulation.

Indeed, there is a perception among investors that they cannot afford to be associated with companies that are known to have a negative impact on the environment and on society, which needs to be built into the investment deal flow. ESG has not just changed the focus for companies but has also impacted on the practicalities of day-to-day businesses. At each stage of the investment process, ESG represents an additional angle that must be considered and managed.

This trend presents opportunities and challenges for investors, who will need to reinforce their ESG competencies, for the sellers and target companies, who need to bring ESG into the corporate agenda so that investors can evaluate their ESG standards, and for legal professionals, that play a pivotal role in helping these agents navigate the ESG waters and create the necessary conditions for deals to be pursued and close within price terms that are fair for both buyers and sellers.

From the M&A deal viewpoint, lawyers must be ready to support target companies who pave the way to be on the right ESG track – ideally on an ongoing basis and ahead of M&A processes kicking off – whilst being equipped with the skills and means required - together with specialists in the field concerned - support sellers and investors on ESG due diligence and, after a deal is completed, in providing support to investors and investees in addressing issues identified during due diligence and aligning ESG related policies and strategies to the investors' profile and market best practices.

In the last couple of years, law firms have launched ESG platforms aggregating multidisciplinary teams which focus is precisely to assist clients tackling the complex ESG issues and navigating the increasingly complex regulatory context. The trend has spread across the globe and I am proud to have witnessed VdA take on a pioneering role in the Portuguese market with the creation of an integrated ESG platform which will help create long-term value for businesses and society alike, including in the M&A sphere.

All in all, Portugal has proved to be a mature economy, with agile and sophisticated individuals and organizations deeply rooted in the market, well equipped to provide top quality support and local insight to sellers and investors in these challenging times.