May 2011

TalkingPoint: Cross-border M&A In 2011

*FW moderates a discussion on current trends in cross-border M&A between **Jeremy Cohen** at SNR Denton, **Kevin T. Connor** at Squire Sanders and **Andrew R. Brownstein** at Wachtell, Lipton, Rosen & Katz.*

FW: In your experience, which regions and sectors seem to have experienced an increase in cross-border M&A activity? Have you seen an uptick in inbound and outbound emerging market deals?

Brownstein: The energy and power sector has experienced faster growth in cross-border M&A than any other sector in the past few years, catapulting from just under $14bn of activity in Q3 2009 to $86.5bn in Q1 2011. Financials and materials cross-border M&A have also increased substantially, though not as fast as energy, and each tapered off somewhat in Q1 2011. Inbound and outbound emerging market deals peaked in real dollar terms in 2007 and 2008 respectively, although the pace of inbound emerging market deals – from developed into emerging economies – is again growing, with 2010 almost reaching the high water mark of 2007 in real dollar terms, and 2011 being on pace to set a new record.

Connor: I have seen a significant uptick in cross-border M&A over the last four months. While much of the activity is now in the early stages – letters of intent, pre-launch, vendor due diligence, and so on – this is a very positive sign. In terms of regions, I can only speak of the markets I know and work in: the Middle East and Central and Eastern Europe, two emerging markets which were relatively quiet over the past year and, in the case of Central and Eastern Europe very quiet the for last two years. In the Middle East we have seen increased activity in a variety of sectors but principally in distribution, manufacturing, construction, communications and health care, including medical devices. In addition, Middle East investors are continuing to add assets to their portfolios, not just because of increased oil revenues, but because of perceived value in the market. Agricultural, aerospace, renewable, and hospitality and leisure are just some of the areas of focus for outward bound transactions. In Central and Eastern Europe there has been a virtual resurgence across sectors and especially in real estate, data processing, meat packing and food processing, and technology.

Cohen: In terms of sectors, natural resources has been very strong. With regard to mining and metals this has reflected the surge in commodities prices, while for oil and gas the high oil price continues to drive the attractiveness of exploration assets, especially in Central Asia, Middle East and Africa. The disposal of downstream assets by a number of oil and gas majors continues. In financial services there has been activity driven by the different strategies of a number of international banks, as some reduce their commitments to emerging markets, while others have emerging markets at the centre of their strategy. In general, movements in exchange rates have helped to drive deals, for example the US dollar strength through the financial crisis has made it easier over the last two years for US buyers to acquire UK assets. Outbound emerging market deals continue to be driven principally by Chinese and Indian buyers.

FW: How would you characterise the appetite of both strategic and financial acquirers for cross-border M&A? Broadly speaking, what fundamental aspects of a business are they looking for when identifying a prospective overseas target?

Connor: While cross-border activity has picked up significantly, it is not back to pre-financial crisis levels, at least from my perspective. But, given the level of early deal activity, much of which is being driven by mandates to investment banks, I would characterise the appetite of both strategic and financial investors as 'robust'. On the strategic investor front, buyers seem to be attracted by low valuations, sellers looking to exit fast, and access to new markets. In the Middle East, especially the Gulf, the market turmoil related to the various political uprisings has not led to a dampening of enthusiasm, but actually the opposite. There seems to be a sense that now is a good time to get into the Middle East, and the UAE is clearly a portal for both inward and outbound Gulf activity.

Cohen: In the natural resources sector, strategic buyers have been driven by high commodity prices, high oil prices and continued high demand from India and China in particular. Generally, our experience for the first few months of 2011 has been M&A work driven by strategic rather than financial buyers who are generally making planned rather than opportunistic acquisitions. Financial investors are starting to look at emerging markets more actively again, attracted by the growth prospects in a number of regions, with, for example, a number of new African-focused funds recently announced. Inbound cross-border M&A, particularly for emerging market buyers, has often been driven by a perception of value in depressed western markets and the attraction of technologies that have not yet been employed in emerging markets but could be.

Brownstein: Potential purchasers are naturally somewhat more cautious when pursuing an acquisition in an unfamiliar jurisdiction, owing to differences with respect to accounting, business practices and legal regimes that affect transactions. The level of those concerns depends upon the familiarity of the acquirer with the target's overall business and particular jurisdiction. Setting these issues aside, the drivers of cross-border M&A are not distinguishable from the drivers of M&A generally.

FW: Is thorough due diligence an indispensable part of any cross-border deal? Should the findings be used to directly influence the overall deal structure?

Cohen: Obviously due diligence is a key part of any M&A transaction but even more so if a company is doing a deal in a country with which it is not familiar and with a counterparty with whom it has not dealt before.

Other than the usual data room based legal and financial due diligence exercise, there are likely to be a number of other areas of due diligence crucial in a cross-border deal, especially in emerging markets, including: assessment of political and regulatory risk and the early establishment of a regulatory strategy; an increasingly high emphasis on anti-corruption due diligence in the light of the FCPA and proposed UK Bribery Act; and, particularly in the industrials and natural resources sectors, environmental and health and safety due diligence. In some cross-border emerging markets deals, contractual warranty protection may not be as forthcoming or effective as in more developed jurisdictions, and so due diligence can assume a greater importance.

Brownstein: Wholesale application of the acquirer's domestic due diligence standards to the target's jurisdiction can cause delay, waste time and resources, or result in missing a problem. Due diligence methods must take account of the target jurisdiction's legal regime and, particularly important in a competitive auction situation, take account of local norms. Making due diligence requests that appear to the target as particularly unusual or unreasonable – not uncommon in cross-border deals – can easily cause a bidder to lose credibility. Similarly, missing a significant local issue for lack of local knowledge can be highly problematic.

Connor: There is no question that thorough due diligence is indispensible. However, this does not always mean just due diligence on the asset or opportunity. Many inward bound investors fail to focus sufficient resources in reviewing ancillary issues such as political risk, currency risk, availability of skilled labour, infrastructure risk, regulatory, and other country specific cultural issues. Finally, there are times where an investor may be very comfortable with all of the latter risks and, as a result, may not spend as much due diligence on the asset as they know the market so well, know the business of the target, and are generally confident that they can 'fix' whatever issue may be out there. This can lead to certain advantages, the main one being to close quickly and to get a good price. Obviously the risk level may go up, but sophisticated investors who do their homework know how to evaluate those risks. Due diligence necessarily drives deal structure, whether it is asset-specific due diligence or other country, or industry due diligence. While due diligence may not 'drive' deal structure it certainly is a key passenger whose views should be considered. For example, if certain risks surfaced during due diligence, there may be no choice but to add a series of conditions precedent, representations and warranties or an escrow account or other payment mechanisms. All this said, due diligence should not wag the deal dog. If a deal makes sense from a commercial perspective, then any due diligence issues can normally be dealt with. Unless something significant is uncovered in the due diligence risk matrix.

FW: What steps should a buyer take to minimise transactional risk in a cross-border deal?

Brownstein: It is essential to understand the local custom and practice in M&A transactions. Successful execution is more art than science, and early involvement by experienced advisers will be important. For instance, understanding when to respect, and when to challenge, a target's sale process is critical. Knowing how, and at what price level, to enter the discussions may make or break a proposal. In some situations it is prudent to start with an offer on the low side, while in others offering a full price at the outset may be essential to achieving a negotiated deal and discouraging competitors, including those who might raise political or regulatory issues. In sensitive transactions, hostile manoeuvres may be imprudent; in other cases, unsolicited pressure might be the only way to make something happen. US takeover regulations differ in many respects from those in non-US jurisdictions. For example, the mandatory bid concept, common in Europe, India and other countries is not present in US practice. Permissible deal protection structures, pricing requirements and defensive measures available to US targets also may differ from what the non-US acquirer is accustomed to in deals in their home countries. Acquirers must also be sensitive to the distinct contours of the target board's fiduciary duties and decision-making obligations under applicable law. Acquirers have to be mindful of disclosure norms and timing requirements applicable in the target's jurisdiction as well as their own. For example, in many cases, the US disclosure regime is subject to greater judgment and analysis than the strict requirements of other jurisdictions.

Connor: Develop a full, written risk matrix. Ideally this will be done by others than those who are working on the deal itself. The risk matrix should cover all key areas, including political risk, performance risk, currency risk, market risk, regulatory risk, availability of labour, infrastructure, financing, demographics, availability of spare parts, tax, legal, and so on. Assign a likelihood to each and every risk and then consider how the risk can or should be mitigated.

Cohen: This is a topic on which books can and have been written. Without over-generalising, buyers/investors investing in emerging markets will often be doing so with a local partner. Even straight acquisitions are often structured where the seller remains involved in the business – as an equity holder, consultant, or otherwise – for a period of time post closing, or where a new local partner is brought into the mix, in each case, to provide the acquirer with some level of comfort that 'domestic' matters are being attended to.

This may be out of necessity; depending on the country and the sector there may be restrictions on foreign ownership of assets, or it may be driven by a commercial need to have a local partner who is well connected and understands the local market. In any case it is likely to be absolutely critical to the success of the transaction and the venture going forward that the right partner is chosen, that a high degree of trust is built with that partner, and that both parties agree on a common business plan and find an effective way of working together. As part of selecting a partner it may well be appropriate to undertake formal due diligence into the past business dealings and relationships that the local partner has had. Obtaining an understanding of the political landscape, the business and consumer culture, as well as the local laws and regulations for any country in which the acquirer has not previously done business, will be crucial. Clearly this could then drive deal structure, especially around issues such as whether or not the investor can or needs to have majority control, whether and how the investment should be staggered, what type of acquiring entity to use and what jurisdiction it should be incorporated in, what law to use and how disputes should be settled, and whether there are any new laws, or amendments to existing laws, being considered that can have an affect on the contemplated transaction or on the acquired business.

FW: Can legal and regulatory issues quickly derail a transaction being carried out in an unfamiliar jurisdiction? How can acquirers overcome this potential pitfall?

Connor: Regulatory issues can quickly derail a deal. However, by completing a full risk matrix – which would include a regulatory review – this should not happen. For example, one of the main potential risks identified would be merger control. With an assignment to that risk, such as 'likely no approval needed' or 'merger control filing needed', the parties can structure and plan for such filing. This may include getting the turnover or market figures out on the table early on and an assessment made as to whether there needs to be a filing or not. The same can apply to tariffs. If the financial model is based on achieving a certain tariff increase, then the buyer must have an idea on how the regulatory regime works and whether a price increase is likely or not. In short, if the proper risk matrix is done, no regulatory issue should be a surprise. And, if a deal is going to die due to regulatory issues, better to kill it early.

Cohen: Foreign ownership restrictions may prevent an investor taking its usual legal control over an investee company, which may mean that it cannot do the deal. The requirements of regulators differ from jurisdiction to jurisdiction. Some require very early disclosure. For example, until recently, in Turkey a public company had to announce as soon as it was in talks on a significant deal, irrespective of what stage they were at or how serious they were, while in Canada the signing of non-binding heads of terms by a public company may have to be disclosed. Such aspects can have a negative impact on deal making. Similarly, legal and regulatory changes in the acquirer's home jurisdiction may have a significant impact on whether a transaction is consummated and if so, on the structure thereof. For example, the recently enacted Dodd-Frank Act in the US which, among other things, incorporates the Volcker Rule, has a significant impact on how US financial institutions structure their acquisition of foreign financial institutions. The early use of a general legal and regulatory questionnaire, sent to local lawyers when any acquisition in an unfamiliar jurisdiction is first contemplated, is a quick and straightforward step to avoid unseen pitfalls, particularly during negotiation of the heads of terms when sometimes lawyers are not involved. Standard questions would be around foreign ownership restrictions, mandatory bid thresholds, squeeze out provisions, and so on.

Brownstein: Prospective acquirers of businesses in foreign jurisdictions must undertake a comprehensive analysis of the political and regulatory implications in their own country, and in the target jurisdiction, well in advance of any acquisition proposal or program, particularly if the target company is in a sensitive industry or if the acquirer is sponsored or financed by a foreign government. It is imperative that the likely concerns of government agencies, employees, customers, suppliers, communities and other interested parties be thoroughly considered and, if possible, addressed strategically prior to any acquisition or investment proposal becoming public. Similarly, the potential regulatory hurdles require sophisticated advance planning. Regulation in these areas is frequently complex, and political opponents, reluctant targets and competitors may seize on any perceived weaknesses in an acquirer's ability to clear regulatory hurdles. Most obstacles to a deal are best addressed in partnership with local players whose interests are aligned with those of the acquirer. If possible, relationships with the target company's management and other local forces should be established well in advance so that political and other concerns can be addressed together, and so that all politicians, regulators and other stakeholders can be approached by the whole group marching in tandem.

FW: To what extent do tax issues present opportunities as well as challenges in cross-border scenarios?

Brownstein: Tax issues may be critical to structuring the transaction. Non-US acquirers contemplating a dividend stream flowing from the US target should structure with a view toward withholding tax requirements and should consider the possibility of utilising a subsidiary located in a country that has a favourable tax treaty network or other tax attributes that will minimise the taxes imposed on the dividends as they cross borders.

The relative proportions of debt and equity will be important from a tax perspective, as will obtaining US interest deductions on acquisition indebtedness. In tax-free acquisitions, special rules applicable to foreign acquisitions may be relevant.

Connor: Tax issues are always an important consideration. Some emerging market jurisdictions may offer beneficial tax rates and/or opportunities. Others may have high withholding taxes. The key tax structuring issues need to be resolved up front or in parallel with the due diligence and risk matrix as it may be necessary to have the buyer formed in a tax friendly jurisdiction. Similarly, if the deal will be leveraged, it is critical to have a full tax and legal review, especially if there will be a 'push down' of debt on local operating companies or the target.

FW: Most experts agree that integration planning is even more crucial when the two merging companies are located in different jurisdictions. What are the most common obstacles that arise in this context?

Cohen: The most common obstacles are employment and labour law issues. People are key to a successful integration. If you cannot have your preferred managers relocate to a new jurisdiction because the relevant individuals cannot get a work visa, that could scupper a well put together integration plan. There may be other impediments to free movement. For example, in Egypt for every one expatriate employee visa, an international company has to employ a certain number of local people, the costs of which may make the relocation of the expatriate employee uneconomic. An inability to restructure a newly acquired workforce to bring in new people due to employee favourable labour laws could make an integration plan problematic.

Connor: The two most common obstacles are cultural awareness and expectation management. I have seen, many times, a complete lack of basic understanding of cultural issues, or worse, a sense by a buyer in an emerging market of 'cultural superiority'. This is simply toxic. Companies should be aware of this and have this as part of a fully developed integration plan. The second problem, expectation management, is just that. Most people will accept change, bad news and so on. So, for example, if there will be a closure of one business line and the loss or transfer of employees, it should be dealt with openly. People will adjust and adapt if they are being told the truth. They hate to not know what is going on. In addition, rather than 'puff' and set expectations high – lots of deal teams like to do that – it is better to under promise and over deliver.

Brownstein: Deals sometimes fail to achieve their promised benefits due to poor post-acquisition integration, particularly in cross-border deals where multiple cultures, languages and historic business methods may create friction. If possible, the executives and consultants that will be responsible for integration should be involved in the early stages of the deal so that they can help formulate and 'own' the plans that they will be expected to execute. Too often, a separation between the deal team and the integration/execution teams invites slippage in execution of a plan that in hindsight is labelled by the new team as unrealistic or overly ambitious. However, integration planning needs to be carefully phased in as implementation cannot occur prior to the time most regulatory approvals are obtained.

FW: Every buyer wants to optimise deal value. To this end, what areas should be addressed in a cross-border that may not necessarily apply to a domestic transaction?

Brownstein: Acquirers should be willing to consider a variety of potential transaction structures, especially in sensitive deals. Structures that may be helpful in particular circumstances include no-governance and low-governance investments; minority positions or joint ventures, possibly with the right to increase to greater ownership or governance over time; making the acquisition in partnership with local company or management, or in collaboration with a local source of financing or co-investor, such as a private equity firm; or utilising a controlled or partly-controlled acquisition vehicle, possibly with a board of directors having some number of local citizens. Use of preferred securities, rather than ordinary common stock, or structured debt securities should also be considered. Even more modest social issues, such as the name of the continuing enterprise and its corporate seat, or the choice of the nominal acquirer in a merger, can affect the perspective of government and labour officials.

Cohen: In addition to the matters discussed above, it is very important for each side in a cross-border transaction to understand not only the business goals of the other, but also the culture, the dos and don'ts, for example, whether you address a person by his first or last name, and the negotiation and communication style of the other side. It goes a long way to get to know that other side and understand how they see you. Keeping in mind the obvious differences between parties in a cross-border transaction – legal system, language, foreign exchange, type of legal entities, taxes, transfer restrictions, to name a few – and finding ways to bridge them, is often as important as bridging gaps in the business objectives. Always understand in advance that you are prepared to venture into unknown terrain which is likely to require more attention, time, money and compromises than a domestic transaction.

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