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Roundtable

Cross Border M&A

Getting deals completed in Asia, Europe and Latin America

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Cross border deal making is more prevalent than ever before. This is good news for all interested M&A parties, but it doesn't come without its challenges. To stay find the right deals and win them overseas is not an easy feat. Additionally, navigating the waters in a foreign country also comes with its fair share of issues. To explore the nuances of completing deals in Asia, Europe and Latin America Mergers & Acquisitions recently gathered a group of M&A professionals, including a due diligence expert, a lawyer and a group of general partners who all focus on different geographies around the world. Hosted by Mergers & Acquisitions and sponsored by CT, part of Wolters Kluwer, this roundtable offers valuable insight into M&A market conditions around the world, how dealmakers participate in these markets, what challenges they face, the benefits of transacting in these markets and what lies ahead for deal makers as they look to transact outside of the United St ates. The following is an excerpted transcript of the discussion.

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Danielle Fugazy (Moderator): How you would characterize deal activity in your region?

Laura Hodges Taylor: We've been seeing a lot of interest in Europe, particularly in northern Europe right now. There, businesses are healthy and stable and there is a lot of interest in investments. I'm focused on Paris, where there appears to be tech and life sciences interest burgeoning. Similarly, we are working on an IPO for a German technology company that's going public in the U.S.

Ian Bone: From what I've seen with northern Europe, there's a lot of tech in the Nordics, and German-speaking countries. And in the southern part of Europe there's been a focus on industrial or construction kinds of businesses as the countries are trying to reinvest to get the economies going. That's where you see the split. Northern Europe has had the bulk of activity.

Alberto Gomez-Obregon: In Latin America it's very different for each country. And it varies within countries, however Brazil, even with its situational uncertainty, has remained the most active M&A market in the region. In Brazil, you see many more larger transactions compared to other countries because of the scale of the country. The deal flow historically has been very strong there.

Fugazy: Who is creating the deal flow in Brazil; nationals, U.S.-based companies or multi Latinas?

Gomez-Obregon: The local strategics in Latin America have been quite active in the last year because they've grown a lot, become very liquid and had access to financing. There's also been a lot of cross-border Latin American M&A. The international strategics come in and out depending on the cycles, but in the past year there has been a lot of M&A from international strategics. Private equity firms have a lot of competition.

Andy Rice: In China things are slowing down. As we all know, China had been growing 10% to 12% a year over 15 years, until slowing to 6%-7% growth the last 2 years. As a result, there are a lot of niche companies that had been growing at between 20% and 30% a year have slowed significantly and

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now have a lot of excess capacity.

And there's also a shift from manufacturing to services. In the long run that's going to be very good, but in the mid-term companies that thrive in a growing manufacturing, distribution environment are going to stagnate.

Fugazy: What are you seeing in Southeast Asia?

Rice: We've started to revisit Southeast Asia 2 years ago. January of this year, The Association of Southeast Asian Nations (ASEAN) agreement began to kick in. It's similar to the EC with a common market that will be implemented in phases over 10 years. Initially, they reduced 90% of all tariffs between the 10 ASEAN countries. Eventually there will be free movement of people and investments, and major infrastructure construction. It's like China was 20 years ago. So it's a good place to start looking for low cost manufacturing. But the infrastructure is not there yet. Vietnam has a lot of plans to add more highways. Singapore is investing in a high-speed train that's going to go from Singapore up to Kuala Lampur, Malaysia. Every 50 miles there will be stops with new industrial parks planned all the way up the line. And then eventually highways and railways will be expanded from Malaysia up to Thailand, over to Cambodia, and into Vietnam and China. That's five or 10 or even 15 years out. But already thousands of Chinese companies have set-up manufacturing in Vietnam. Right now, for example, if you make a certain product outside of ASEAN and sell it to a country within the ASEAN there may be a 10% import duty. So there's an effort to get underneath the tent -- it's very similar to the EC, if you can get in there and be considered local then there are no tariffs on exports within the ASEAN countries.

Fugazy: How does Brexit impact investing?

Hodges Taylor: If you ask my partners in London, they may tell you something different than our partners in Paris and Frankfurt. But I don't think we know yet. Clearly, there's an expectation (and a hope for some) that financial institutions will diversify out of London to some extent. It doesn't make sense to have all the eggs in that one basket; but whether new financial centers develop remains to be seen. The sense

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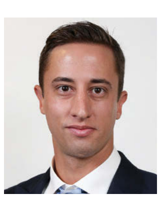
I have is that the financial players will disperse somewhat, and become less concentrated than what you see in London right now, which is the epicenter of all kinds of economic activity.

Bone: Dublin has already been gunning for London. So if there's one place that might be really happy about Brexit it would be the people in Dublin. It's an area where you still get the tent of the EC, but it's a very culturally similar to what you would have had in London or expected as an expat. The British and Irish are kind of cultural parallels to the U.S.

Hodges Taylor: Dublin has a highly-educated workforce, similar values and expectations and cultures to the British, which puts it in good position.

Fugazy: Can the slowdown in China be part of the reason that Latin American is busier?

Gomez-Obregon: There are different situations that have shifted some of the money that was going to Asia to Latin America. One of the changes that is pushing people out of China and into Latin America is the increase in real wages. This affected Mexico directly. Mexico had always been an industrial manufacturing hub, but things started to migrate to China. Wages in China increased and now you have similar wages to Mexico, but your transportation costs are much higher in China. There's cultural issues too. For westerners, it's easier to do business with Mexicans, because the culture is more similar and Mexicans don't copy your products like Chinese do. Mexico is now an industrial hub for Latin America. The closeness to the U.S. is primarily why a lot of businesses want to be in Mexico.



Miguel Ferreyra de Bone: You are also seeing an interest in the Latin American region getting together as a compact block to be able to trade with the U.S. and request better conditions for trade. I also believe that the labor in Latin countries is better than in China, but it can be expensive in Mexico depending on the benefits provided to the labor force. The unions are extremely powerful. I think the companies that are looking to move to Latin America really need to consider this.

Gomez-Obregon: Typically, it's better to have a local partner to be able to navigate the business environment and the legal environment. A lot of people do joint ventures. The deal gets completed faster and you get a larger presence immediately. This has also triggered a lot of international strategics to buy suppliers or buy operations. It's international in the sense that it's different countries, but it's a lot of Latin America multinationals buying companies in other countries, in other regions.

Rice: Many U.S. firms are starting to move manufacturing to Mexico from China. Companies are doing a better job of assessing their true cost of manufacturing in China. China labor rates are doubling every 4-5 years, and so in many industries the advantages of low cost manufacturing in China have narrowed or disappeared. In fact, most US investment in China the last 5 years is to serve the growing China/Asia market- not low cost sourcing to the US. Managing China operations is also more difficult and the cost in management time is hard to measure. If a manger in the Midwest needs to visit an operation in Mexico, they can catch a flight Tuesday morning, have meetings for a day and a half, and return home Wednesday night. In China you are gone for a week or more, and then you have jetlag.

Hodges Taylor: What about the IP issue? We see that as a real stumbling block in most of Asia, China in particular. The concern about the potential for corruption, and the general sense that the system is less predictable from a legal perspective compared to pretty much everywhere else.

Bone: Except for maybe Africa, which tends to be overlooked in M&A conversations.

Rice: Corruption is a real issue in China. As an example, we had spent 1 1/2 years looking at buying a company, and had an LOI. In China the due diligence takes two or three times as long as in the US and it's more expensive. We were finalizing our DD and purchase agreement, when about a week before our anticipated closing date we found out through an extensive background checking process that the company had bribed government officials to win several large contracts. Obviously, we couldn't go through with the deal. Unfortunately, sometimes you don't find this out until near the end of the process. But it is better to find this out before closing the deal, than to find out later and have real issues.

Gomez-Obregon: That's why ESG plays such a big role in Latin America. There's definitely a lot of corruption and illegal practices across all countries. If you're contracting to the government, there is a high likelihood of some corrupt practice going on.

Ferreyra de Bone: Sometimes the issue is that it's very hard to detect. If you're working with an infrastructure company, for instance, and they have contracts with the government, they could be over-priced. You need to call who is dealing with the company, the clients, the banker, you need to ask people about the company. Sometimes the due diligence process can take a long time and you see no serious red flags, but the moment you start talking to the competitors, providers, and even the employees, that's when you find out the really big stuff.

Bone: You need to do additional due diligence, or different due diligence than you would have to if you were looking at a purely domestic company. If you're doing a domestic deal, some of it is about checking the box, its different overseas. We're talking about China and we're talking about certain countries in Latin America that are also some of the harder ones to do business in, in general. So you have to acknowledge the compliance is more difficult in those jurisdictions. So companies can get used to finding work-arounds to be compliant there, and then it permeates all over the culture of the business.

Fugazy: What type of due diligence should be completed?

Hodges Taylor: There is definitely diligence you have to be careful with. For example, in the U.S., OFAC, the Office of Foreign Assets Control, still prohibits doing business with certain designated countries, entities and bad actors, while many other countries have loosened the sanctions You can be doing a transaction with a European company that doesn't have that constraint but may be triggering sanctions under U.S. law, and that can be a problem for you. So that's an example of the kind of due diligence you really must do. It's not quite what you guys are worrying about in Asia and in Latin America, but there is still a lot of required diligence, reconciling accounting treatments, understanding the tax differences, structuring. There is a lot more to do today than some years ago, even with a European deal that feels very straightforward compared to one in a more exotic location.

Rice: In China and other developing countries due diligence takes longer because it is common for Chinese companies to have significant liabilities associated with past practices to avoid import duties, taxes, regulations and other things. US firms typically will want to fully understand all these issues and if possible clean them up before the deal, or include in the reps and warranties in the purchase agreement. This is a major disadvantage for US firms. For example, a US company may offer the same purchase price as a competing Chinese or Taiwanese buyer. But the US offer will be more complicated because of all these issues and it will take longer to get the deal done.

Ferreyra de Bone: I'm not saying that things are dramatically changing in Brazil, but we do see better practices and governance. We see how factors like the impact that you have on the environment or the impact that you have on the communities are actually more of a concern because they understand that in the long-run you might have some sort of backlash with an emissions scandal or contaminating so change is coming from the bottom up. And the companies and the business communities are actually pushing for the change.

Gomez-Obregon: Due diligence takes longer and it is more expensive and I see also top down push from foreigners, international strategics, development banks, so ESG has become a much more important issue. As a private equity firm, when you're trying to invest in a region, you have to have a formal ESG, guidance, poli-

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cies and you need to obviously have anti-money laundering, compliance, all of these things are very relevant in the region.

Bone: The main thing you need is to have someone on the ground. When we work internationally, we have partners that actually have offices in the countries where we're offering the due diligence services, so that they can go do that and physically see things. You don't get an uncertified scanned copy where maybe somebody copied some paperwork, altered it, and sent it over. You need someone to see the original documentation.

In some of these places compliance can be really tricky to navigate as the laws are constantly changing, exacerbated by inconsistencies as governments change. Companies can be trying their best and the foreign investor may have more procedures and systems in place to help keep themselves compliant which may in turn bolster the company's practices. So if they're doing the right things, but you find out they're a little bit out of compliance and perhaps the laws have changed recently, this is the kind of people and the kind of culture that will fit with trying to be compliant. Sometimes even finding that something is wrong as you do your due diligence, as long as the process behind it has been good, is not always bad; it's like okay, good, now we know what to fix.

Gomez-Obregon: You need local advisors for sure.

Rice: We almost always want control, which means that from day one we need to have procedures and processes in place to prevent bribing and corruption. Going back 10 years in China, many private equity firms focused only on minority investments and did not want control because they were not prepared to implement proper controls and oversee day-to-day oerations

Fugazy: How difficult is it to steer a portfolio company from overseas?

Gomez-Obregon: In our case, our strategy is always to partner with a local -- we call them the owner operators, but it's basically the current CEO of the company. So we tend to always partner with the guy that's the CEO of the company or the president of the board. And then you have to incentivize him in the right way so that things will go in the right direction. I'm in my portfolio companies three, four days every month down in Mexico or Colombia. We tend to put in the CFO of the company and we sometimes put in another analyst on a permanent basis. Then the auditors that have to be selected by you, and that's more of a yearly process, but you control cash and you control the audits.

Ferreyra de Bone: I would add we do continuous monitoring. Not to the point that is exhausting for the firm, but at least every three, every four months, they do have to report how they're doing regarding some strategic implementation, for instance, because it's very important in Latin American companies usually they're owned by the families. And they keep a big stake in the company, and they are sitting on the board. So it's very important to not leave any sort of space for informality so you help them a lot by being on top of things and it's the only way.

Fugazy: What are some of the challenges you encounter working with companies overseas?

Hodges Taylor: One of my favorite things to tell people is, if the person is too hard to cut a deal with, there's something wrong with the company. You can't believe how many times you can look at someone and say, 'don't do this deal, it's been pulling teeth the entire way.' And they say, 'no, it's a great deal, we're getting it at a great price.' And inevitably there's post-closing litigation and you find out stuff after the escrow is gone.

Rice: It could be where the company is supposed to run it by you before they order a million dollars worth of equipment. And you find out they not only ordered two million dollars worth of equipment, but they prepaid 50%. And you're like, we need to have a business discussion about that. We need to have a say in that. It's a shift for them.

Bone: It's no longer their cash going out and portfolio companies sometimes feel like they can spend a lot more.

Fugazy: How do you maintain compliance from a far?

Hodges Taylor: You are on top of it. You ask hard questions. You show up. You get somebody that's your person to come in and do an audit. You check on things regularly.

Rice: We always control the bank accounts and cash. Typically we will have an A account that is for our investments, bank laons and receivables. The money from there can only go into a B account, which is the operations account. This transfer from the A to B account requires our approval, and now is all done online with verification codes. Then every two weeks, the management team has to make a list of what cash they need. It's not only good as a type of operational review every two weeks, but there's no room for funny stuff such as the GM and controller stealing $5 or $10 million and disappearing.

We also often keep the former owners and senior managers onboard because they know all the local government officials, customers and suppliers- and if you get rid of them you lose all the company relationships. However, we also bring in our own controllers and other managers to run these companies. These new managers have typically worked previously with 1 or 2 other western firms, where they have already learned western practices and how to work with foreign owners.

Bone: One thing that we've also seen on the compliance front for these international transactions is that sometimes you see funds acting more like a strategic buyer or multinational going into the jurisdiction. The fund will take over and make sure all of the international compliance is maintained all in one place and they're actually overseeing all of this. If a fund bought a U.S. company, they often trust them to run themselves. With international transactions, if the investee manages their own compliance, the funds want an extra layer of reporting up into a system that provides a quick dashboard to quickly see that, okay, have all these things been filed. Alternatively, we see funds using compliance management services so the company doesn't have to take on some of the compliance burden since there's a trustworthy international provider managing that. You take compliance off of their plate so they can really focus on selling in the region or building widgets or whatever it is that they're really good at. And you take away some of these more back office, less core skill sets.

Rice: Sometimes strategic add-ons in China that fit one of our US portfolio companies are small entrepreneurial or family businesses. With these companies it is a challenge to implement US management and/or accounting systems, especially when these companies may have never been audited prior to the acquisition and have not put information into systems or databases that US management prefers. We do not want the China managers focusing so much on these new systems that they lose focus on their core business. Sometimes we have just said, we don't care if you fax us the info you have and we'll enter the info in our system in the format we prefer.

Gomez-Obregon: You have to have legal advisors throughout the whole process.

Hodges Taylor: And you need local counsel. That's another thing. We love it when the client wants us to handle everything, but we really need good local people in the cities or countries where we don't have offices.

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