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M&A Update and Cross-Border M&As: Considerations for Middle-Market Firms

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INTRODUCTION

Global activity in mergers and acquisitions (M&As) has weakened during the past year and a half. With continued concerns about the recovery of the global economy, many large companies were reluctant to close mega-deals. Economic and political events, such as increased fiscal crises in Europe, slowing economic growth in the BRIC countries, and political gridlock in Washington, reduced confidence among many dealmakers. Despite companies' record cash reserves, many were reluctant to execute new M&A deals. In this article, we discuss global M&A activity in 2011 and the first half of 2012. The article concludes with a discussion of factors for middle-market companies to consider in pursuing cross-border M&As.

A SUMMARY OF M&A ACTIVITY WORLDWIDE IN 2012 (Q1 AND Q2)

The number of M&A deals significantly slowed worldwide in the first half of 2012. Global M&A activity decreased by 22 percent with a total reported deal value of $1.1 trillion, and number of deals decreased by 17 percent with less than 18,000 deals (Thomson Reuters, 2012). The decline in M&A activity began in late 2011 due to worldwide financial and political turbulences that currently prevail. In comparison, M&A activity in the first half of 2011 totaled $1.5 trillion, with about 20,000 announced deals.

Fewer mega-merger deals were announced in 2012 compared to the same period in 2011 when deals including Duke Energy, Time Warner, and AT&T's $39 billion merger with T-Mobile (which ultimately failed due to a U.S. Justice Department ruling and opposition by the Federal Communications Commission) were among those announced. Some experts believe the debt crisis in Europe, slowing growth in the BRIC countries, and general economic uncertainty discouraged large deals. Executives seemed concerned about the state of the economy at home and abroad, and may have avoided the risks that come with larger deals in an uncertain global environment.

M&A activity in the United States also trended downward by 35.3 percent in the first half of 2012, with a total deal volume of $475.1 billion, compared to the same period in 2011 (Thomson Reuters, 2012). The number of M&A deals fell 16.2 percent, with 4,934 announced deals, yet the United States still dominated the M&A market in terms of overall activity (Hoaxiang, 2012). The power and energy industry led U.S. M&A activity with $76 billion in deal volume, and 23 percent of total U.S. M&A activity. Healthcare deals led as well, with $40.7 billion, a 12.3 percent share. Real estate, high technology and consumer staples followed closely, with \$37.4, \$35.8, and \$27.5 billion respectively (Thomson Reuters, 2012). For the rest of 2012, power and energy, and healthcare are expected to lead the U.S. M&A market.

Federal healthcare legislation is an opportunity for the U.S. healthcare industry to improve its performance by expanding operations and increasing efficiencies, often through cost cutting and consolidation. In 2011, U.S. healthcare M&As reached 86 deals, an all-time high for the industry (Boulton, 2012). Some analysts say that ¾ of U.S. healthcare organizations are considering potential M&A deals (Roney, 2012). PwC predicts that M&A activity will increase in late 2012, as potential deals announced during the first half will close in the second, and with significant activity in the middle market (PwC, 2012).

The U.S. middle market has slowed in 2012, but it is still dynamic. Middle market deals accounted for \$123 billion, with a total of 3,788 deals for the first half of 2012, compared to \$152 billion and 4,505 deals in the same period in 2011. Overall sentiment remains positive as smaller deals seem to be preferred (PwC, 2012).

Despite the European fiscal crisis, M&A activity in the first half of 2012 fell just 3 percent compared to the same period in 2011, with a deal volume reaching \$553.3 billion.

Growth in emerging market countries was sluggish in late 2011 and early 2012. For the first half of 2012, emerging market M&As accounted for 28 percent of worldwide M&A value, falling 12 percent with a total deal volume of \$315.3 billion (Thomson Reuters, 2012). M&A activity in Asia Pacific (except Japan) in the first half of 2012 decreased by 5.9 percent with a total deal volume of \$205.2 billion. Despite slow macroeconomic growth in the region, the Asian market is still a top destination for M&A investment because of higher growth potential. Japan is one of a few Asian countries on a buying spree, encouraged by an appreciating yen and strong corporate balance sheets. Japan's M&A activity increased by 8.2 percent with a total of 1,458 deals in the first half of 2012, compared to the same period in 2011. Japan closed several mega-deals, such as the $12.6 billion acquisition of TEPCO, Itochu Corps' $1.7 billion acquisition of Dole Food Company Inc., and Marubeni Corps $5.6 million acquisition of the U.S. company Gavilon (Kim and Erman, 2012).

GLOBAL M&A ACTIVITY IN 2011

During the first half of 2011, global M&A activity rose almost 50 percent compared to the same period in 2010, then fell during the last six months of 2011 (R.W. Baird, 2012). Overall, 2011 global dollar volume of M&A decreased by 4.3 percent, from $2.05 trillion in 2010 to $1.96 trillion. Global deal count increased by almost 10 percent from 30,347 to 32,891 deals, suggesting that a greater number of smaller, middle market deals were made. Japan conducted the highest deal volume in 2011, growing nearly 70 percent from $80.9 billion to $137.3 billion in 2011. The only other country with a positive growth rate in deal volume is the United States. The rest of Asia, Europe, and Africa/Middle East declined by almost 10 percent each. Central and South America declined most, by over 50 percent in deal volume, although the number of deals increased substantially, from 980 to 1,251.

US M&A ACTIVITY IN 2011

Despite challenges of high unemployment, slow economic growth, and the downgrading of U.S. credit, U.S. M&A activity outperformed other countries in 2011. U.S. deals grew by almost 10 percent from $944 to $1,026 billion and total number of deals increased from 11,034 to 11,612, nearly matching the 2007 all-time high of 11,716 deals (R.W. Baird, 2012). Almost half of deals were in the middle-market, and only 164 deals were above $1 billion. Exhibits 2 and 3 show the most active industries in 2011. The healthcare industry was the most active sector measured by value with almost $170 billion in deals, followed closely by utility & energy with $132 billion, and technology with $131 billion. Technology, professional services, and healthcare industries were the top three sectors for total U.S. M&A activity by number of deals, contributing almost 50 percent and 5,267 transactions to total U.S. deals.

M&A OUTLOOK

M&A specialists are generally positive about the outlook for deals in 2012 and 2013, with some caveats. KPMG and Knowledge@Wharton (2012) report that U.S. M&A activity is likely to be flat, with a slight increase in sight. As of this writing in late September 2012, the U.S. stock market is at a four-year high, but some specialists say that a lack of confidence in the ability of government to correct the current state of the economy is constraining M&A activity. They believe that companies may be holding off on mega deals until after the November 2012 U.S. presidential election (Liu and Spears, 2012). But companies with large cash reserves have two choices: buy, or give returns back to shareholders. In lieu of big, mega-deals, they may seek opportunities in the middle market (PwC, 2012).

Those companies may find that it is a sellers' market, with more interested buyers than there are sellers with quality assets. Middle-market sellers want certainty that the deal will close, and if they have strong assets they can demand it. So buyers looking for top-tier assets are willing to pay skyrocketing multiples for them, and sellers want to complete the deal quickly. Even firms that expect to use debt financing might pay cash to complete the deal, and shop the debt after the deal has closed. These buyers have enough cash to bridge the loan until they can sell the debt or, as is frequently the case, they have a commitment letter for the financing before they bid. Further, middle-market sellers may not want to partake in tax-free deals. Given the chance that U.S. tax law could change, many sellers want to complete taxable transactions to pay any gains at 2012 rates rather than risk paying higher tax rates later.

ACQUIRING A COMPANY IN A FOREIGN COUNTRY: CONSIDERATIONS FOR MIDDLE-MARKET FIRMS

A cross-border M&A – that is, acquiring a firm in a foreign market – is different from acquiring a domestic firm. First, less information is available about international markets, competitors, and financial stability of customers. Second, international business involves many specialized transactions. Third, cultural and institutional differences affect the way business is done in other countries. A middle-market company, defined as a company with revenues of approximately from $50 million to $1 billion, may want to increase sales and spread its R&D costs over a larger volume of products, and entering international markets is one avenue to do that. But are acquisitions a good way for a middle market company to begin? Aren't cross-border search, valuation, and deal making processes complicated? Does a firm need past experience in foreign markets to execute a successful cross-border acquisition?

WHY SHOULD A COMPANY ACQUIRE A FIRM IN A FOREIGN COUNTRY?

An international acquisition may allow a middle-market company to access new, often large, markets, balance slow domestic growth, and gain global awareness of their products relatively quickly. Established companies in foreign countries generally have a reputation and a customer base which, if positive, new owners can leverage. A firm may consider an international acquisition when import duties or other rules discourage it from exporting, or because its customers require it to produce in a location that is closer to them. See Exhibit 4.

WHEN IS A COMPANY READY TO ACQUIRE A FIRM IN A FOREIGN COUNTRY?

To execute an international acquisition, management must be willing to commit significant money, personnel, and time to the project. There is financial risk – and potentially significant return – from a cross-border acquisition, and the project will require the company's leadership to travel frequently to, and possibly live in, a foreign country.

IN WHICH FOREIGN COUNTRY SHOULD WE ACQUIRE?

Before considering an acquisition in another country, a buyer should be sure the country and the target company's customers have a risk-return profile that fits the buyer's strategy and product. Start by analyzing the target country. Search the U.S. Department of Commerce's online resources (www.export.gov), or visit globalEDGE (www.globaledge.msu.edu), for current reports on the political, legal and economic environments of foreign countries. Exhibit 4 lists some factors that are important for business success. Is the currency stable? Is the government stable? Will upcoming elections affect the business? Is contract law well developed? Consider the country's natural, human, and physical infrastructure. Is there sufficient energy to run your factory, or ports and harbors to dispatch your goods? Are there skilled people to hire at appropriate wage levels? Are the roads, airline service, phone systems, and Internet access good?

Analyze your competition, if you can, although competitive information about foreign markets is often difficult to get. You may need to rely on information from the potential target company, but you should consider this critically. The U.S. Department of Commerce Commercial Service has staff in most countries that research business information for the benefit of U.S. companies (see www.export.gov). They may be helpful, because they research industries and have insight on the business climate, trade leads and products sought by foreign companies and governments.

Transaction costs, such as permits, fees, licenses, paperwork, and documentation, are often higher in foreign countries. Consider whether environmental rules, labeling, testing requirements or product specifications, could complicate your acquisition project. U.S. Food and Drug approvals, ISO 9000 +, the European Union's CE Mark, and national requirements that all products sold be labeled in the native language, are examples of added transaction costs.

HOW DO WE FIND A POTENTIAL ACQUISITION IN A FOREIGN COUNTRY?

Finding an appropriate cross-border acquisition can be challenging, but there is advice for potential buyers. First, buyers interested in acquiring a company abroad should seek advice from trusted advisers – their accounting firm, law firm, and investment banking firm. These service providers, especially large firms with national and international offices, can leverage their relationships with sell-side advisers, private investment companies, professional services firms, business intermediaries, industry associations, alumni networks and other sources to help buyers identify feasible international targets. Make sure you are adequately advised and represented by law and accounting firms with a presence in the foreign market.

Second, buyers can consult with their industry and professional organizations for cross-border acquisition targets. International trade groups, corporate growth organizations, and industry associations can provide contacts and networking for buyers interested in purchasing companies in foreign markets.

Third, buyers can browse offerings provided by business brokers. Business brokerage firms identify companies that are being bought and sold. Some brokerage companies let clients search for targets online. Others offer a full range of acquisition services including company search and identification, preliminary valuation, acquisition process assistance, due diligence planning, strategic and operations consulting, and management services for buyers post-acquisition. Any quality service provider will tailor its search to the buyer's industry, revenue range, cash flow, location, valuation, management capabilities, and other criteria. Good advisers will provide short lists of potential companies relatively quickly, so the buyer does not waste time and resources reviewing deals not suited to its needs.

WHAT ADVICE DO I NEED AS I CONSIDER A CROSS-BORDER ACQUISITION?

Legal, tax and accounting advice

Law is practiced differently around the world, and understanding this is critical to your acquisition's success (Sánchez and Goldberg, 2005). In common law countries, such as the UK, the U.S., India, and most former British colonies, law is based on tradition, precedent and custom such that courts interpret and may overturn laws. In civil law countries, such as Japan and countries in Continental Europe and South America, law is organized into detailed sets of codes that are rarely revised or interpreted by courts. Everything is spelled out in the code. For example, contracts written in civil law countries tend to be shorter because codified law incorporates all of the issues of concern in a contract. Contracts in common law countries are longer because they tend to cover contingencies that might not be covered by existing law. How your contract will be interpreted in the foreign country has implications for you and your business, and it is important to understand that it may be different from what you are used to.

Some U.S. laws govern U.S. companies doing business overseas, including those that own cross-border acquisitions. The Foreign Corrupt Practices Act (FCPA) forbids U.S. companies from bribing foreign officials to obtain or keep business. Embargoes forbid companies from selling to restricted countries such as Cuba and North Korea. Export controls prohibit the sale of certain products, such as chemical and biological materials, that could be used in weapons manufacture. The U.S. Department of Treasury's Office of Foreign Assets Control lists Specially Designated Nationals, or individuals with whom it is forbidden by law to do business, even if your company is located in a foreign country. If you violate these laws, whether you know about them or not, you and/or your company may be prosecuted.

It is challenging to protect your intellectual property outside the U.S. U.S. IP law protects your intellectual property only in U.S. territory. You may want to obtain patents for the products manufactured by your cross-border acquisition. Some multilateral patent agreements allow you to file in one country and obtain protection in another or a region. Nevertheless, intellectual property law is complex and you should seek help from your legal advisers.

Currency and exchange risk

All business has risk, but international business has added economic risk. Consider credit risk, political risk, and foreign exchange risk. Credit risk is the possibility that your customers will not be able to pay when payment is due. Political risk is the chance that government action will restrict your ability to do business or collect payments. So, to assure your foreign company gets paid for its products, arrange payment terms based on your assessment of your customer's credit risk (as best you can), and the country's political risk. The higher the risk, the more you need to use secured payment terms.

Exchange risk is the chance that the exchange rate between the foreign currency and yours will change, resulting in a loss or gain in home currency. If the products manufactured in country are sold locally, you are somewhat protected against this risk. But if you sell products in other countries, if you expect to invest dollars into the acquisition, or if you expect to repatriate profits to the home country, exchange risk matters. You may hedge exchange risk with buyers through a forward exchange contract. On the date of the sale, the seller enters into a contract with a bank to exchange the amount of foreign currency that the seller expects to receive at a future date, say, 60 days out, for dollars at the 60-day forward rate. The forward contract is a binding agreement to deliver a fixed amount of one currency in return for a fixed amount of another currency at a future date. Consult with your international banker to learn about other risk- reducing hedge alternatives such as currency options or exchange-traded-futures contracts. Your payment management should reflect your tolerance for risk and your desire to be competitive. The best payment method will consider national political risk, credit worthiness of the buyer, your relationship with them, the competitiveness of your product, and how much credit risk you are willing to assume.

Cross-cultural differences

When managing your cross-border acquisition, you may find significant differences in people's attitudes and behaviors regarding time, authority, risk, status, social groups, family – among other things. Attitudes and behaviors transcend social niceties, and affect business transactions too. For example, a purchase order decision may require authorization from several managers of a German firm, compared to just one in the U.S., if the German company is more centralized than the U.S. firm. If you tend to delegate broad responsibilities to your subordinates, some Southeast Asian workers may find your delegation difficult. They may be used to receiving specific, detailed instructions from supervisors, and may not be accustomed to having extensive decision-making authority. If you prefer a first-name basis with your employees, you may embarrass your Mexican workers by asking them to call you "Bill," because they may be more comfortable addressing authority figures with formal titles. The U.S. culture emphasizes values such as competition, professional status, power, and material rewards. Swedish workers may place more value on affiliations, family, and quality of life. So, your compensation and reward system for Swedish workers may look very different than the one you design for U.S. workers. Exhibit 5 summarizes these points. For more on cultural differences, read Hofstede (2001).

CONCLUSION

In this paper, we have reviewed the state of M&A activity in 2011 and the first half of 2012. While there is some caution about the state of the world economy, the greatest potential for M&As in 2012/13 is expected to come from activity in the middle-market. Healthcare, power, and energy industries should continue to lead M&A activity in 2013, as large and small firms seek opportunities to consolidate or access new markets. Finally, we suggested considerations to hopefully provide insight to help middle-market managers decide why, when, and how to begin thinking about an acquisition in a foreign country. Middle-market firms may find new growth opportunities by exploring acquisition targets in foreign markets. Managers should consider a number of factors, and consult with trusted advisers, to assess the risk and reward trade-off before beginning as well as throughout the cross-border acquisition process.

Exhibit 1

Global M&A Activity Years 2011 and 2010

	M&A Value of Deals (in Billions, US Dollar)			M&A Number of Deals		
Region	**2011**	**2010**	***% Change***	**2011**	**2010**	***% Change***
North America	$1,114.3	$1,032	*8.0%*	13,488	12,795	*5.4%*
U.S.	$1,026.1	$944.6	*8.6%*	11,612	11,034	*5.2%*
Central/South America	$76.7	$168	*-54.3%*	1,251	980	*27.7%*
Japan	$137.3	$80.9	*69.7%*	2,264	2,036	*11.2%*
Asia Pacific (ex Japan)	$278.1	$308.5	*-9.9%*	5,974	5,453	*9.6%*
Europe	$638.1	$708.5	*-9.9%*	12,130	10,853	*11.8%*
Africa/Middle East	$56.4	$62.5	*-9.9%*	852	824	*3.4%*
Global Total	$1,963.3	$2,050.9	*-4.3%*	32,891	30,347	*8.4%*

Exhibit 2 U.S. Most Active Industries in 2011 (by Number of Deals)
1. Technology 2. Professional Services 3. Healthcare 4. Real Estate/Property 5. Finance

6. Oil and gas 7. Utility and energy 8. Mining 9. Construction/Building 10. Consumer Products *Source: Robert W. Baird & Co. Incorporated (2012, January).*

Source: Robert W. Baird & Co. Incorporated (2012, January).

Exhibit 3 **U.S. Most Active Industries in 2011 (by Dollar Value)**
1. Healthcare 2. Utility and energy 3. Technology 4. Oil and gas 5. Real Estate/Property 6. Telecommunications 7. Finance 8. Chemicals 9. Mining 10. Professional Services *Source: Robert W. Baird & Co. Incorporated (2012, January).*

Exhibit 4

Why Acquire a Company in a Foreign Country

- Access new or large markets
- Balance domestic competition & growth
- Get global brand awareness
- Be closer to customers
- Lower production costs

Exhibit 5

What advice do I need to consider a cross-border acquisition?

- Finding a firm to acquire
  - Your trusted accounting, legal, and investment banking advisers
  - Business brokerage firms
- Political and economic risk
  - U.S. Department of Commerce Commercial Service staff in the foreign country
- Legal issues
  - US law
    - FCPA, embargoes, export controls, Homeland Security
  - Local law
    - Contract law
    - Common law versus civil law
    - Intellectual property law
- Taxation
  - Advice from international tax accountants
- Currency risk and payment terms
  - International banking experts
- Cultural and institutional differences

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