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Inbound US M&A: decline of the dollar attracts foreign buyers

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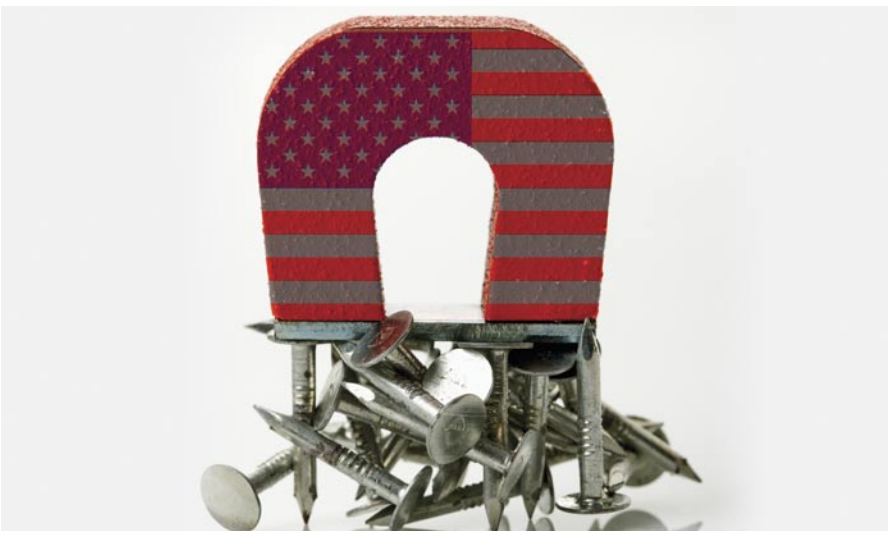

The decline of the US dollar, emphasised by the subprime crash, has led to a surge in foreign investment in the US. According to data compiled by Thomson Financial, none of the ten largest merger related bids in the US in Q4 2007 had a US acquirer. US investment has been high on the European agenda with the UK topping the global list. The euro and pound are soaring, but with the ramifications of the credit crunch stretching to Europe, buyers from the Middle East and pivotal Asian economies are very much in the race for US assets. Furthermore, the rapid rise of cash rich sovereign wealth funds (SWFs) has added another asset class to the mix which, in the current financial climate, has recently bought stakes in leading US banks. The US economic slump brings with it a wealth of opportunity for the foreign investor but also strict regulations that could hinder investment from certain regions and buyers.

The picture may seem bleak for most US buyers, but some are in a position to capitalise. With private equity funds far less likely to drive up deal values as they have done over the past couple of years, the door is open for strategic buyers to acquire assets at a cheaper price. US sellers are agreeing to lower prices and focusing on a buyer's ability to pay cash or obtain financing. "An investor must have cash on its balance sheet or at least ready access to cash through existing credit facilities," says W. Hunter Holliday, a partner at Alston & Bird LLP. "In the current environment the seller will likely be seeking cash rather than equity – in depressed equity markets, a buyer's equity may simply be too expensive to use as currency. Also, the buyer's business must be insulated against the forecasted chill in the US economy. For example, a buyer with a strong balance sheet and ample cash may think twice about pursuing even a bargain acquisition if its business is overly dependent on consumer spending or housing."

The huge impact of the credit crisis on liquidity and the ability to arrange leveraged financing has hit US private equity firms hardest. With large, highly leveraged transactions fading from the market, private equity players have been left with little choice but to turn to the middle market. As a result, deal flow particularly in the lower middle market remains strong, according to David Lonsdale, president and managing director at Allegiance Capital. "The credit crisis has not stopped transactions in the lower middle market, which is almost regarded as a safe haven. A significant amount of the money that was designated for larger transactions is coming down the chain. Although banks are conducting their own thorough due diligence exercises and have tightened up lending criteria, private equity groups have increased their equity stake and company valuations have dropped by 10 percent compared to the second quarter of last year. So while acquirers are modifying the way they structure a transaction, deals are still being consummated."

Although private equity has been hit globally, European based private equity players have an advantage: the exchange rate. With a strong euro and pound against a weak dollar, some experts suggest that European based investors can purchase US companies at around 30 percent less than two years ago. A savvy investor that picks up a handful of good US companies, and prepares for an exit in four to five years, could capitalise twice – once on a rising dollar value and again on the improved performance of the company. In addition, if trends continue, competition from strategic buyers is unlikely any time soon.

The increased buying power of SWFs has shot into the limelight following investments by Middle Eastern and Asian funds in top US banks including Citigroup, Merrill Lynch and Morgan Stanley. SWFs, which currently have around $3 trillion at their disposal, may surpass $10 trillion by 2015 according to Merrill Lynch and Morgan Stanley. But intense scrutiny over their political motivations, and calls for greater transparency, could hinder future activity by SWFs. But most observers expect that funds from fast growing emerging markets will be keen to gain a foothold in the US. "The emerging market economies that will be best positioned to acquire US assets in the period ahead will be those that enjoy a trade surplus with the US and those that benefit from high commodities prices – particularly oil and natural gas. Under these criteria, Middle Eastern sovereign wealth funds seem extremely well placed to acquire US assets," says Mr Holliday.

China is expected to capitalise on the low dollar, using the US economic slump to recycle its huge foreign exchange reserves, expand its business interests and boost its market knowledge. Chinese manufacturers, for example, see compelling reasons to make acquisitions in the US, as Mr Lonsdale explains. "These companies want three things: brand, distribution and technology. At present, most of the design work is happening in the US. The product is then manufactured at a low cost in China, before being passed back to the US where the marketing and distribution takes place. But Chinese manufacturers are eager to compete along all parts of the spectrum. Current economic conditions give lower and middle market companies the perfect incentive to acquire the design, distribution and marketing capability which they currently lack."

However, corporate Chinese acquirers may suffer delay in the deal process through additional scrutiny off the back of general fears in the US surrounding Chinese investments. "There seems to be paranoia in the US, that is being politicised by elected representatives in the US congress, about investments by SWFs from China in particular, which may impede some of the investments they would otherwise make," says G. Michael O'Leary, a partner at Andrews Kurth. "Some of this fear may be justified but the majority are probably not. Nevertheless, the fear is real. But now that other sources of capital have dried up or been eliminated, it is a good opportunity for these countries to invest. Given more time, and if China is willing to work with the US government and adopt more transparency, they may find that the door is opened more widely to them."

The backlash against foreign investment from certain countries puts European acquirers in an even stronger position. Cultural similarities between Europe and the US are a tremendous advantage over more opaque, unfamiliar emerging markets. Also, in contrast to the strength of the euro and pound, many emerging markets have rising commodity values but their currency is pegged to huge stores of dollars. European investors also have an advantage when acquiring a controlling interest in sensitive or strategic US assets. Perhaps as a result, there are general differences in the way assets are targeted and deals are structured, as Mr Holliday points out. "European investors and investors from emerging markets are, in many cases, pursuing different types of investments in the US. Financially savvy European strategic investors are acquiring US businesses or assets in medium sized transactions to enhance the value of their existing businesses or operations. In contrast, many emerging market investors seem to be making more passive investments, such as acquiring minority stakes in large US companies, like investment banks, or even investing in or partnering with US private equity funds."

Although Europe has felt the ripple effect of the credit crunch from across the Atlantic, and the availability of debt is restricted, the strength of the euro means opportunities in the US will be too attractive for top European investors to ignore. "Although some European financial institutions were caught in the credit crisis, there remains access to capital for well placed European buyers," says Wayne N. Bradley, a partner & co-chair of the corporate department at McKenna Long & Aldridge LLP. "Furthermore, as investments by private companies in public projects continue to make their way through the US economy, it will become more likely that there will be European entrants into that space due to European governments and consequently companies, having an established history of such public private partnerships."

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Attractive opportunities for the foreign investor

There is interest in US businesses across the board, but some sectors are leading the field. The US financial sector has recently made headlines due to foreign investments in top-tier banks. Other active sectors include oil and gas and commodities. "Oil and gas is a broad sector that covers new technologies, construction, preparation work and drilling infrastructure, therefore offering a wealth of diverse opportunities. It is also being boosted by high oil prices. In terms of commodities, there is a growing appetite in China and other places for raw products. Anything in the scrap metal, aggregates and precious metals arena, including recycling, is proving hugely attractive," says Mr Lonsdale. With many state governments looking at ways to improve infrastructure across the US, this sector also provides scope for investment inflow. "A significant amount of infrastructure in the US needs to be either newly built or replaced, so there is plenty of opportunity for foreign investors to involve themselves in infrastructure financing. Already we are witnessing growth in the number of international infrastructure funds providing sources of capital in this space," says Mr O'Leary.

Distressed companies, either in bankruptcy or on the verge of insolvency, are also attractive to foreign investors. But, as Mr Bradley points out, these deals require a higher level of legal and business sophistication and a close relationship with advisers who are comfortable working with distressed companies. "Investing in distressed companies is one area that non-US investors have traditionally shied away from. However, the opportunities for bargains here are amplified, and a shrewd investor with knowledge of the US legal system and US markets can take advantage of these opportunities. Similarly, the US infrastructure is generally in need of a vast overhaul, and many state governments will attempt to deal with these issues through public private partnerships. The pace of such investments is expected to quicken substantially."

Legal and regulatory issues

When pursuing transactions, foreign investors have to exercise an increased level of transparency and be willing to face scrutiny from the Committee on Foreign Investment in the US (CFIUS). In addition, the recently enacted Foreign Investment and National Security Act (FINSA), affecting non-US entities seeking to acquire, merge with, or make an investment in a US business, may involve a governmental review and investigation of such transactions. As a result of FINSA, CFIUS will likely become more active, and the reviews and investigations it undertakes more numerous. "Not only will transactions in traditional defence sectors be reviewed, but FINSA makes clear that national security concerns may be implicated as well by investments in 'critical infrastructure', such as transportation, energy and technology. Furthermore, the application of FINSA and involvement with CFIUS is not only a regulatory process, but a political process too, where thoughtful navigation can mean the difference between success and failure," says Mr Bradley. Non-US investors must also be aware of US antitrust laws including those governing pre-merger filings, pre-closing conduct and post-closing operations. Such laws, not always familiar to foreign investors, can play an important role in determining the success of the transaction.

Some of the concerns from US officials on foreign investments are justified, but in the main investments are commercially and legally sound. Similar concerns were raised about foreign investment back in the 1980s, when the Japanese bought several 'trophy properties'. The weak US dollar has prompted a recurrence by encouraging foreign investors to flood in. A wave of media and political commentary is stoking the fires of fear towards foreign investors. Yet most experts hope such fears will subside. "People will eventually realise that foreign investors are just like any other economic investors – they typically have the same motivation, which is to make good investments and generate returns," says Mr O'Leary. "Everything goes in cycles; the US has had great opportunities to invest abroad in the past, and now the tables have turned. While there are some legitimate causes for concern about countries that may not necessarily respect property laws, or trademark and patent laws, for the most part this is a positive trend. The US needs capital, and while regulators should certainly be keeping a close eye on investment, we hope this does not discourage sound transactions."

Looking ahead

Foreign investment is expected to accelerate, predominantly down to the low cost of US investment for European investors due to the soaring euro and pound. On a global scale, as long as the outflow of US dollars to foreign countries continues, there is no end in sight for foreign investors to re-invest that money back into the US, especially when there are bargains available. Strategic investors will remain the first choice for sellers in a liquidity-starved environment, due to synergies with the target and access to cash. SWFs will have to play the US regulatory game in order to capitalise on low priced US assets. Private equity players, for now, will target the lower to middle market, but when US buyout houses come up against their European counterparts, the strength of the euro and pound will put them on the back foot. Ultimately, economic decline in the US has created a market awash with opportunities for savvy buyers with cash in hand and a willingness to navigate a potentially tricky regulatory process. ■

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