Navigating global challenges
Helping you succeed in a world of business uncertainty

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Guiding M&A and tax
Through a volatile global market
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Agenda

Purpose

To up-skill us all on the impact of macro-economic and geopolitical factors

Core themes

- informing board conversations
  - the regional and sector specific trends impacting collective thinking
- consequences for Global M&A terms
  - tax response
  - technology
  - spin-offs
  - specific deal terms

Future-proofing your approach to M&A

Q&A
Informing board conversations
Macro trends

As M&A advisors, key trigger-points from David and Robin’s observations are:

- Thinking outside national borders against a protectionist backdrop. Trade used to leverage foreign policy.
- Rise of national security (e.g. CFIUS and China generally), Brexit and ongoing trade-wars.
- Implications of AI, automation and disruptive technology.
- New markets paramount (customers, suppliers and people). Life and business go on.

To navigate global M&A in the short-term, familiarity with macro drivers is key.
Europe

- **continued convergence**
  - mergers between European financial services and industrials sector businesses, in particular, remain a key driver of M&A
  - consolidation of European companies is already underway and will likely pick-up speed in 2019
  - in particular in the consumer sector, as corporates reshape portfolios in response to changing consumer behaviours

- **digital transformation**
  - the continued rise of innovative and disruptive e-commerce platforms throughout Europe fuels M&A

- **shareholder activism**
  - deploying capital on core businesses by disposing non-core operations that can fit better with a more suitable owner

- **rise of alternative sources of capital across and into Europe**
  - more than 5,300 family offices globally hold approximately $4 trillion of assets

- **international tax reform measures**
  - derived from the OECD and EU are disrupting common multinational business structures
  - increased importance of business substance for tax purposes driving investment and M&A
  - uncertainty and double taxation risks created by unilateral reform steps taken by individual countries

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*Helping you succeed in a world of business uncertainty*
The new Foreign Investment Law

- promulgated on March 15, 2019 and effective on January 1, 2020
- unifies the old foreign direct investment laws and harmonizes the differences in treatment between domestic Chinese and foreign invested enterprises
- how open will China be?
  - all domestic markets are open to foreign investments except for those on the “Negative List”
  - in response to the US/China trade war

Impact of US/china trade war

- 74.9% of 250 respondents cited increases in US and Chinese tariffs and a negative impact on their business
- 20% said they have experienced increased inspections and slower customs clearance
- greatest impact is decreased demand for products followed by increased manufacturing costs
- RMB depreciated by 3% in May heading towards the ‘7 mark’
- newly set up ‘unreliable entity list’
**China**

**Forex control regulations**
- China has a strict foreign exchange regulation regime
- all funds inflow and outflow require SAFE approval
- this type of “cross-border guarantee” requires SAFE registration and in practice registration success rate varies significantly across different locations

**Shifts in outbound Chinese investment**
- deal value has fallen over the past three years
- technology and consumer related deals continue to be dominant sectors
- Europe attracts biggest deal value while sharp decline in the US
- increase in investments in Belt and Road projects
China Deal values

Outbound M&A deal value by region of destination 2014-2018

*US $43bn ChemChina-Syngenta deal is included in 2016 outbound value

Source: Thomson Reuters, China Venture and PwC analysis
regulatory and geopolitical headwinds and macroeconomic uncertainty, but M&A activity remains strong
- tariffs, protectionism, CFIUS
- shareholder activism
- pressure for divestitures
- renewed focus on core business
- digital transformation/new technologies
- drive M&A across all sectors
- role of private equity, sovereign wealth funds, family offices and non-traditional funds
- Akorn:
  - material adverse change definition
- cyber-security and privacy due diligence and compliance

- tax reform
  - historically the US had a high corporate tax rate (35%), few limits on the ability to deduct interest expense and a worldwide tax system
  - key features of the Tax Cuts and Jobs Act:
    - reduction of the US corporate tax rate to 21%
    - new limits on the ability to deduct interest expense
    - a new incentive (FDII)
    - still a worldwide tax system... but with better acronyms (GILTI and BEAT)
Understanding Global M&A terms
Overview

- having anticipated what boards are focused on for the short to medium term, let’s now turn to how we are advising our in-house counsel teams to respond to those board pressures

- centered around four key themes:

  1. **tax response**
     - revisiting existing principal company structures and supply chains in light of changes in tax rules and new tariffs

  2. **technology**
     - the pressure of all businesses becoming technology businesses (even law firms!)

  3. **divestitures – focus on spin-offs and split-offs**
     - avoiding the conglomerate discount, focus on core business

  4. **specific deal terms**
     - price is king but without paying top-$, how to compete in global M&A processes
Tax response
The international tax system has undergone dramatic change in response to international measures, like the OECD’s BEPS project, and as a result of legislation in individual countries, such as the Tax Cuts and Jobs Act.

What does it mean internationally?

- New information reporting regimes give tax authorities greater visibility than ever before into the operations of multinationals.
- There is increased importance on substance in jurisdictions, which is causing a re-examination of traditional principal company and holding company structures.
- What comes next?
  - Taxing the digital economy?
  - An international response to US tax reform?

What does it mean for US multinationals?

- US tax reform was generally a boon to purely domestic corporations. For US multinationals, the impact was less clear.
- US tax reform changed several features of the US tax system that historically made US multinationals attractive targets for non-US acquirers and that made ‘inversion’ transactions attractive.
  - Fewer acquisitions of US multinationals and ‘inversion’ transactions.
- Will 21% US corporate tax rate bring companies home?
  - So far, not many.
  - But, choice of entity decisions are being re-examined in light of the lower corporate rate (e.g. Blackstone, KKR and Apollo converting management companies to corporations).

Limits on the ability to deduct interest expenses are causing a reexamination of capital structures

- US taxpayers generally limited to net interest expense up to 30% of adjusted taxable income.
- Need to consider financing for deals in light of limitations and existing capital structure.
- New limits on hybrid arrangements.
Technology
**Drivers for technology M&A**

- **sector focused**
  - DI and E&I - accepted logic is that manufacturers must digitize, using technology to remain relevant in the future or risk becoming obsolete
  - TMT and FS - acquiring other technology is a major deal driver (but just one example)
  - all - using technology to keep up and grow their market and to develop new markets

- **arguably this dynamic is not new - industry has always adapted to technology; society copes and evolves**
  - e.g. the launch of Excel cost 400,000 accounting clerk roles but generated 600,000 new accountant roles over the same time period (since 1980)
  - the rise of ‘FANG’ and ‘BAT’

- **what is arguably shocking and potentially disruptive is the pace of change**
  - e.g. struggles in the retail and airline industries; signs of stress in the automotive industry

- **what is driving technology focused M&A in all sectors:**
  - sophisticated consumers demanding customized experiences
  - availability of data
  - price-point of technology
  - better production driving investment
  - also impacted by increasing cyber-security fears

- **B2B spending on such technology is tipped to reach $280bn next year**

- **technology investment will be a huge driver for M&A (despite other macro-economic headwinds!)**

- **add to this a nationalist sentiment to re-shore manufacturing and develop flexible supply chains**

- **technology, rather than labor costs, becomes a main driver of profit**
Spin-offs
Why our focus on spin transactions?

- such transactions are becoming more common
- they are a symptom of some of our macro-economic themes
  - e.g. pressure on earnings and shareholder activism
- smaller businesses speak to the agenda of flexibility and the desire for nimbleness
- demonstrate the valuations placed on technology

Spin-offs

Why spin? The theory

- some companies want to get rid of a weak or low-margin division that is detracting attention from the parent
- some companies seeking buyers for parts of their business are not getting good offers from other firms, or from private equity, and so choose to Spin (i.e. Foster’s Group spinoff of Treasury Wine Estates)
- shareholder activism and the concept of the ‘Conglomerate discount’ (the Economist) – “stockmarkets value a diversified group at less than the sum of its parts”
Spin-offs

Why spin? The facts

- since 2003, the Bloomberg Spin-Off Index has generated a total return of 1,030% versus 194% for the S&P 500 Index

- for the 10-year period, the Bloomberg Spin-off Index has appreciated 342% (versus 154% for the S&P 500 Index)

- over the three years to 2018 the spin index is up 60% versus 35% for the S&P 500
Spin-offs

Common issues

- **initial scoping**
  - structuring a spin-off
  - transaction structures (jurisdictional specific issues)
  - historic liabilities
  - valuations
  - gathering the underlying information
  - incorporating the skeleton structure

- **progressing to ‘spin’ and the ‘curveball’**
  - third party consents:
    - landlords
    - regulatory (i.e. permits, operating licenses)
    - lenders
    - customers/suppliers
    - employee representatives and labor authorities

- **global and shared agreements, interdependencies and shared assets**
- **employee consultations and benefits**
- **value, consideration and “distributable profits”**
- **treasury and finance issues**
- **IT issues/ IP issues**

- **delivering**
  - project management
  - data volume
  - execution issues:
    - logistics
    - powers of attorney
    - notaries/apostiles
    - electronic execution
Spin-offs: high level US tax considerations

- if certain requirements are satisfied, a spin-off may be tax-free to both the distributing corporation and the shareholders receiving the distribution
  - these requirements include, among others, that the distributed stock constitute “control,” that both corporations be engaged in active trades or business and generally that the distributed stock has been held for at least five years
  - corporations often seek private ruling letters from the IRS (where available) and regularly rely on opinions of law firms that these requirements are satisfied

- if a spin-off does not satisfy these requirements, the transaction would be taxable to both the distributing corporation (at 21%) and the shareholders receiving the distribution (at rates up to 37%)
  - because of these two levels of tax, taxable spin-offs are generally inefficient
Spin-offs

Conclusion

– do not underestimate the time that a spin transaction can take. The more time you can give yourself (and advisors) the better
– prior planning and establishment of systems can be the differentiator between a well-managed spin and timetable extensions
– validate and interrogate the steps plan from every angle
– collate information in a uniform, coordinated manner
– be alive to employee consultation and people dynamics
– curve-balls will arise, but can typically be dealt with provided they are identified with sufficient time
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Specific deal terms

![Document icon]
Understanding global M&A terms

We commissioned research on the theme of understanding global M&A terms. We interviewed our Global Corporate Partnership, analyzed deal information from the 500+ deals we complete each year and analyzed market trends and publicly available information.

Key findings:

- The continued rise of the locked box
- Rep and warranty insurance has changed the M&A landscape
- Convergence of European practices (but less so US)
- Still a seller’s market
Focus on the R&W market

- Zero recourse for the seller (i.e. buy-side policy)
- $1 liability cap
- Policy enhancements: time periods for warranty claims exceeding those in the purchase agreement SPA (offered in 4% of policies); and knowledge scrape (offered in 5% of policies)

Underwriting premium – generally 0.65% to 1.65% of the policy limit (which tends to be around 30% of consideration)
Excess/retention/deductible – 0.5% - 1% of EV (commonly lower) – generally excess only
R&W insurance deductible will generally drive the amount of the basket in a R&W deal
## US vs Europe (continental and UK) comparison

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<th>US</th>
<th>Europe</th>
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<tbody>
<tr>
<td><strong>Purchase price adjustments</strong></td>
<td>Purchase price adjustments are the norm, locked box is much less common</td>
<td>A more even split of purchase price adjustments and locked box deals, with locked box becoming more popular in the last decade</td>
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| **Deal conditionality**              | Risk only passes to the buyer on closing:  
- MAC definition in light of Akorn  
- purchase price  
- reps and warranties materiality accurate at closing | Negotiable (split signing and closing seen in only 43% of European deals, compare to 85% in the US) |
| **De minimis**                       | Much less common in the US (35%) | Used in 72% of deals in the UK                                  |
| **Basket/threshold**                 | Occurs in almost all US deals (98%)  
70% operate as “excess only”  
Tend to be lower than Europe (95% were 1% or less as a % of consideration) | Basket/threshold financial limitation occurs in 68% of European deals  
First dollar recovery/tipping baskets are more common in Europe  
Less consistency in Europe re size of basket |
| **Seller liability cap**             | 95% have a cap of 25% or less of purchase price  
Typically secured by a cash escrow or retention of 10%-15% of purchase price, which is often the same as the cap | 40% of deals in Europe have cap of 25% or less escrows/retentions less common |
| **Disclosure**                       | Specific disclosure schedules   | General disclosure has become common                            |
| **Buyer’s knowledge**                | Buyer knowledge limitations are not common  
Neither are reverse warranties “sand-bagging” is negotiated | Buyer knowledge qualifies the warranties  
Buyers commonly give reverse warranties |
| **Materiality scrape**               | Buyer is entitled is disregard materiality qualifications in the warranties for the purpose of establishing whether the de minimis or basket thresholds have been met | Extremely rare in European deals |
| **Tax**                              | Coverage for tax indemnity? New exclusions? | Synthetic tax indemnity? |

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Future-proof
M&A
Where is M&A headed in 2019 and beyond?

- **impact on deal flow**
  - volumes are stable overall but Europe likely to be down in 2019
  - likely to be down in both inbound and outbound deal values and volumes for China in 2019
  - trend for larger deals (on the basis that risk management within M&A only ever increases so small deals become disproportionately expensive)
  - flight to quality – deal volumes are down but values are going up (due to increased risk and reporting requirements with all deals and so a desire for transformational M&A only)

- still a sellers’ market, valuations remain high
- deals are taking longer due to uncertainty (rather than terms fundamentally changing)

- **divestitures (including spin-offs and split-offs)**
  likely to be a key theme as the shift from conglomerate to core business focus continues (i.e. shareholder activism)

- tax reform was supposed to bring cash back to the US – did that happen?
How is changing M&A likely to impact terms?

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<th>– Europe</th>
<th>– China</th>
<th>– USA</th>
<th>– In general</th>
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<tr>
<td>completion accounts regaining (some) popularity</td>
<td>further opening up domestic markets for foreign investments?</td>
<td>rethinking structure and tax representations in light of tax reform</td>
<td>changes to the MAE definition?</td>
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<td>earn-outs (particularly for smaller deals and as deal values remain at historically high levels)</td>
<td>greater flexibility allowed for structuring foreign investments?</td>
<td>consideration of terms to address trade issues</td>
<td>changes to Reps and warranties?</td>
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<td>greater protection and transparency for foreign investments?</td>
<td>consideration of MAE definition in light of Akorn</td>
<td>hell or high water provisions become standard?</td>
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<td></td>
<td>Chinese buyers becoming more sophisticated in transaction management</td>
<td>additional reps and warranties related to privacy and cybersecurity</td>
<td>other changes to closing conditions?</td>
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<td>increased use of “hell or high water” covenants?</td>
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<td>increased use of R&amp;W insurance</td>
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<td>for manufacturing business, continued focus on changes impacting facilities in Mexico and tariffs to drive structuring and business strategies</td>
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Questions