

Valitas Insights: Cross-border M&A: The Critical Role of Due Diligence

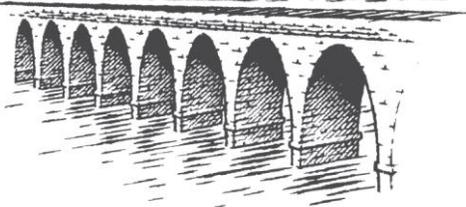
Dealmakers are reaching across borders, seemingly undaunted by political uncertainty. In Q2 2017, global cross-border deal value was up 49% over the previous year, accounting for 47% of total global value and 36% of volume.¹ In Canada, cross-border transactions accounted for more than half of total activity by both value and volume².

As deal makers accelerate their cross-border activity, the due diligence process becomes more critical than ever in addressing risks inherent in those transactions. We spoke with [Michael O'Neill](#), a Director at [Stone Arch Capital](#), about his experience with U.S./Canadian cross-border deal making, and the unique concerns that need to be addressed during the due diligence process.

Valitas: In your opinion, why are we seeing an increase in cross-border activity, given the global environment and political uncertainty?

Michael: Both the number of U.S. PE firms and the capital base has increased over the last two decades. That increase has been driven by two things, amongst others: an increase in the number of experienced professionals as the industry matures; and increasing L.P. allocations towards alternatives, as those investors look for yield. With increasing competition in the U.S. market, firms are looking towards Canada to deploy capital, with a focus on similar businesses and fundamentals

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that have been successful for them in the U.S. Investors certainly consider the political environment, but most are focused on business and macro fundamentals, which would include an evaluation of existing and potential legislation.

Valitas: Do you expect this level of cross-border activity to be sustained?

Michael: I do expect interest in cross-border activity to be sustained. As our industry matures, firms and professionals are gaining experience investing across borders. In addition, there is more sharing of knowledge about cross-border deal making, which is helping investors become comfortable with the investment opportunities and how to structure them. Speaking for our firm, we made our first Canadian investment in a manufacturing business in 2006. That experience was important for us, as we learned quite a bit during the deal process and working alongside the management team helping grow the business. PE firms can say they are comfortable with a cross-border deal, but not every firm is ready for the diligence hurdles that are unique in a cross-border deal.

Valitas: What are some of the unique due diligence issues in a cross-border transaction, and what is the most challenging aspect?

Michael: Significant issues include currency, legal/regulatory, and cultural differences. Currency is a big issue, but it is more complicated than simply the exchange rate on dollars invested. Over the last few years we have seen some Canadian manufacturers selling into the U.S. benefit from the currency change. It's important to understand how much of a company's margin is attributable to a lower

¹ According to the [Baker McKenzie Cross-Border M&A Index](#)

² Valitas Capital [Q2 2017 Canadian M&A Review](#)

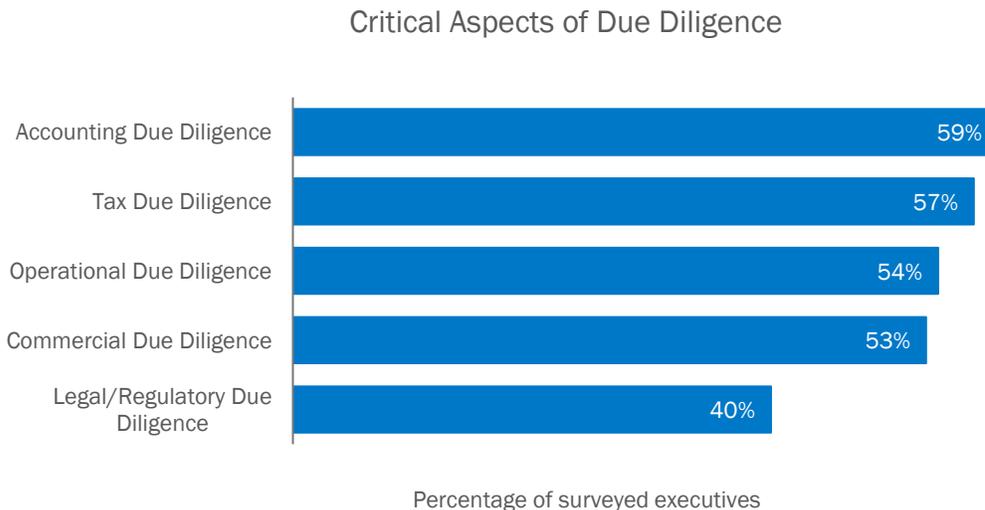


Canadian dollar, i.e., cost of goods sold, but more importantly, how much revenue is attributed to the lower Canadian dollar, and whether that revenue and profitability can be sustained if the Canadian dollar strengthens.

Legal differences are also very important to understand, as laws and their interpretations vary across borders, states and provinces. It's essential to retain good legal counsel experienced in cross-border deals to mitigate risk associated with this issue.

Another unique challenge is working with an unfamiliar diligence team. For example, if we are investing in Canada, we will be using the Canadian team to do the Quality of Earnings report. While they may be part of the firm that we use in the U.S., we aren't necessarily familiar with the individuals, which can make things more cumbersome.

A Deloitte's cross-border M&A [survey](#) conducted on almost 500 executives from a variety of regions and industries supports and adds to Mr. O'Neill's insights. Respondents to the survey identified their cross-border due diligence concerns, and the report describes the top five:



Source: Deloitte cross-border M&A survey

Accounting and Tax Due Diligence

Accounting and tax due diligence were considered the most significant sources of risk in a cross-border M&A deal. An understanding of tax differences increases the likelihood of reaching the best deal outcome for both companies from a tax perspective. In addition, under different accounting systems, parties to a transaction need to understand and agree on issues that might include valuation metrics,



costing method (LIFO vs FIFO), or the reporting of line items such as pensions and employee benefits. And as Mr. O'Neill highlighted, currency differences also add to the complexity of accounting due diligence.

Operational and Commercial Due Diligence

Operational and commercial due diligence are not unique to cross-border transactions, but are certainly ranked as one of the more important facets of cross-border due diligence. While conducting these types of diligence, it is particularly important to pay attention to cultural differences, as diverse backgrounds, communication styles, and business practices can impede the post-merger integration process.

Legal and Regulatory Due Diligence

Legal and regulatory due diligence play a significant role in the successful outcome of a cross-border merger. In Baker McKenzie's article, [Managing Risk in Cross-Border Deals](#), the authors suggest that dealmakers should consider the "whole spectrum of regulatory requirements" when embarking on an overseas transaction. They warn that "failing to identify applicable foreign regulatory in a timely manner" can have severe consequences, ranging from delays to a failed transaction. This brings Mr. O'Neill's recommendation to mind: companies should retain legal counsel with extensive experience in cross-border transactions.

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With indicators suggesting that cross-border activity will at least be sustained and likely increase, buyers and sellers need to understand the unique due diligence issues related to cross-border transactions. Michael O'Neill offered us one last piece of advice, applicable to all M&A transactions, but definitely relevant for cross-border dealmakers:

"Do your homework, and spend time qualifying and validating people that can help you [in the region where you are investing]. Find people that have actually done work cross-border, not just spoken about it. And don't be reluctant to pay for an excellent due diligence team. When you're doing a cross-border deal, it's not the time to be penny wise but pound foolish..."

If you would like to speak to Mr. O'Neill about his experience investing with Canadian business owners and managers, please contact him at moneill@stonearchcapital.com or 612-317-2978.