GLOBAL TARIFFS PERSPECTIVE

LINCOLN INTERNATIONAL

Tension and tariffs drives Chinese M&A activity to markets outside the U.S.

Mounting tension between Washington, D.C. and Beijing are top of mind in the dealmaking climate. As tariffs continue to dominate headlines, U.S. – China deals have cooled, while China casts its sights on more fruitful alternatives around the globe. To help dissect and digest implications across sectors and geographies, eight Lincoln advisors share their True Perspective:

3 STRATEGIES FOR CONSUMER BRANDS TO COPE WITH TARIFFS

Christopher Stradling, *Managing Director, Mergers & Acquisitions, Consumer, Chicago*

When consumers look to make purchases, they might not realize how tariffs impact the goods on their shopping list. But in an internet age with informed consumers searching for the best price, keeping prices low is paramount. Here are three ways we're seeing consumer brands mitigating the financial impact of tariffs to stay competitive:

1 Stockpiling essential inventory

Should businesses go long on inventory or keep stocks light? The answer depends on how mission-critical the item is for their customers. For example, for parts that go into heavy machinery, it may be wise to keep a heavier stockpile in order to ensure service during turbulent times. However, keeping low inventory of highly discretionary items may be superior to remain competitive if prices go up, or to prevent loss if prices go down.

2 Diversifying supply chain geography

Engaging suppliers from multiple regions is a prudent strategy for the mid-term. While it generally takes time to establish supplier relationships, such diversification insulates against trade volatility in any particular region. Also, working with suppliers closer to the business can decrease the supply timeline significantly, which provides greater agility and usually lowers working capital requirements.

3 Squeezing existing suppliers

Most Chinese suppliers will be somewhat threatened by large customers seeking alternative sources. Therefore, they could work with customers to provide price concessions to partially offset tariffs. Furthermore, historically, the Chinese government has responded to tariffs by devaluing their currency. As such, U.S. buyers should benefit from the increased purchasing power of the dollar and a wise buyer will renegotiate pricing to reflect the current currency exchange rates.

WITH CHINA-U.S. BREAKUP, CHINA LOOKS FOR OTHER PROSPECTS

James Fang, *Managing Director, CEO China, Mergers & Acquisitions, Beijing*

The acceleration of trade tensions between the U.S. and China caused a severe drop in both inbound and outbound M&A activities in the country. While this caused some difficulty for business in China, we are not pessimistic because there are other opportunities—including cross-border deals in other markets.

The drop in Chinese outbound investments was the result of a significant decrease in the volume of Chinese investments into North America. Chinese acquisitions of U.S. companies have sunk 95 percent from the height of activity, from $55.3 billion in 2016 to a mere $3 billion in 2018, according to Mergermarket. Interestingly, at the same time, Chinese outbound M&A in Asia and Europe increased because the tension with the U.S. diverted attention to other markets.

In recent years, a wave of manufacturing facilities moved from China to adjacent, less developed countries such as Vietnam and Cambodia. Higher tariffs will strengthen and catalyze this movement. As a result, Chinese investors will conduct more cross-border M&A deals in Asian markets–especially ASEAN countries.

Automotive, electronics, healthcare, automation and artificial intelligence (AI) sectors led the charge with the highest number of China-U.S. cross border deals in the past couple of years. With Chinese investors highly interested in these sectors, they are now turning their attention to seek out acquisition targets in Japan, Israel and European countries.

CHINESE ACQUISITIONS OF U.S. COMPANIES

95%

JAPAN, ISRAEL AND EUROPEAN COUNTRIES WILL BECOME NEW ACQUISITION TARGETS FOR THE AUTOMOTIVE, ELECTRONICS, HEALTHCARE, AUTOMATION AND ARTIFICIAL INTELLIGENCE (AI) SECTORS

ISRAELI TECH PRIMED FOR SUCCESS, BUT GLOBAL TECH CHALLENGED BY TARIFFS AND CFIUS

Chaim Lubin, *Managing Director, Mergers & Acquisitions, Energy, Power & Infrastructure | Technology, Media & Telecom, Chicago*

Jack Calderon, *Managing Director, Mergers & Acquisitions, Technology, Media & Telecom, Chicago*

Learning how to navigate CFIUS will become critical to success

The U.S. and Israel are powerhouse technology innovators. While China has invested in both countries for a long time, their interest in Israel has now increased as the tariffs shut the door to the U.S. and activity accelerates in Israel, a hotbed for advanced technology.

From a competitive standpoint, tariffs might drive the price of technology in Israel higher. Nonetheless, for Chinese and U.S. buyers alike, we still see ample opportunity to invest in Israel.

From a global perspective, tariffs also impact the supply chain. Countries manufacturing in China are now setting up plants in Vietnam and other places in Southeast Asia. Even though moving manufacturing removes the tariff risk, it creates inefficiencies as manufacturing is dislocated.

The tariffs have stalled M&A activity between the U.S. and China, however, CFIUS poses a potential long-term impact on the technology industry. CFIUS has made international deals more complex and elongated the time horizon it takes to complete a deal. Anything that is related to semiconductor and related device manufacturing is now tasked with a mandatory filing requirement that prolongs the process. Learning how to navigate CFIUS will become critical to success—especially as deal activity in the technology sector is more challenging because of the combined impact of tariffs and CFIUS.

SOME LENDERS STEER CLEAR OF TARIFF-IMPACTED BUSINESSES

Natalie Marjancik, *Managing Director, Debt Advisory, Chicago*

From a debt perspective, many lenders are wary of the uncertainty that surrounds the tariffs and the full impact that they'll have on a borrower's operations and financial performance.

For a number of lenders, tariffs are a deal breaker. The decision whether to provide financing to a company impacted by the tariffs is a binary one—even at conservative leverage levels and lender-favorable terms they are uncomfortable providing financing to these businesses.

For the lenders willing to consider financing such companies, it's critical that the borrower demonstrates that it has already taken significant measures to mitigate the potential impact of the tariffs (e.g., plans to move production capabilities outside of China are detailed and well underway and expected to be completed in the near-term, or a significant portion of a company's third-party supply chain has been re-sourced with vendors located outside of China).

TIGHTENING CFIUS REGULATION AND TARIFFS SOUR U.S.-CHINA MEDTECH M&A

Brian Bock, *Managing Director, Mergers & Acquisitions, Healthcare, San Francisco*

The current political climate has driven a noticeable drop in cross-border U.S.-China M&A activity for emerging technology companies—such as medical devices and biopharma.

Interestingly, had it not been for the politically driven tension, the M&A outlook for cross-border activity between China and the U.S. would likely be robust. The advancement of the healthcare sector in China over the past decade, combined with limited R&D infrastructure and cash rich acquirers has been driving strong demand by Chinese strategics and investors to seek out cutting edge technologies outside of the country. Meanwhile, the rise in mega mergers and subsequent integration between large-cap MedTech players in the U.S. has moderated the amount of activity by several of the large U.S. domestic buyers. In turn, U.S. emerging technology companies had been casting their sights overseas in search of potential buyers and were receiving strong interest prior to the tightening regulation.

However, this phenomenon is not slowing China's appetite to consummate transactions; it is simply shifting where Chinese buyers and investors look to find innovative technologies. There is a growing number of non-U.S. geographical alliances and partnerships between China and countries like Israel, Australia and Germany, which are attracting significant investment dollars and acquisition activity. Another example of this activity Lincoln has observed is growing dialogue between China and other technology-advanced countries like Japan, where historical tensions are subsiding in the interest of business and trade, setting the stage for valuable economic alliances in the coming years. Solidifying these mutually beneficial economic partnerships will serve to boost innovation in these regions, and perhaps could lead to greater technological competition for U.S. companies down the line.

Although China and U.S. activity has slowed, it is not to say it has completely ceased, however. We still see and participate in active interest from Chinese strategics and investors in reviewing M&A and investment opportunities, or interest in pursuing alternatives to M&A, such as joint ventures and China distribution structures. Absent an escalation in tensions, as time passes since the recent CFIUS reforms and the market is able to gain greater clarity around the definition and the application of the to-be-defined "emerging and foundational technologies" to life science transactions, we'll begin seeing cross-border M&A activity pick-up a bit from these current levels.

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BORROWERS TURN TO EUROPE, DRAWN TO FAVORABLE RATES

Xenia Sarri, *Director, Debt Advisory, London*

Progress on U.S.-China trade talks earlier this year, combined with a more accommodative monetary policy environment globally and improving macro indicators, supported an environment of low volatility and strong demand for credit in Q1'19.

Cross-border loan issuance has remained robust but diverging monetary policies between the Federal Reserve and the European Central Bank (ECB), have made Europe increasingly attractive for borrowers over the last four years.

Case in point, cross-border loans syndicated in Europe have grown by a whopping 99% since 2015, when the Fed first started raising rates in the U.S. Meanwhile, cross-border loans syndicated in the U.S. have only grown by 4% during the same period. For the first time ever, cross-border loan issuance was almost equally split between the U.S. and Europe last year – contrary to historical trends where the larger, more liquid U.S. market always dominated.

The average yield to maturity for the euro or sterling tranche of a cross-border deal was 4.31% in Q1'19, compared to 7.44% for the dollar portion. The spread between these two measures was 310bps, the widest it has ever been.

With FOMC officials paying close attention to trade as an important risk factor for the US economy, the widening spread in borrowing costs may soon start to reverse, [leaving Europe trailing behind once again]. While the ECB announced earlier this month that it would delay its first hike to interest rates since the crisis until the second half of 2020 (leaving rates at record lows), the Fed has also hinted at a potential rate cut, aimed at mitigating the growing risk of damage from uncertainty over trade negotiations.

CROSS-BORDER LOANS SYNDICATED IN EUROPE HAVE GROWN BY

SINCE 2015 AMID RISING U.S. RATES

CROSS-BORDER LOANS SYNDICATED IN THE U.S. HAVE ONLY GROWN BY

4% DURING THE SAME PERIOD

TARIFFS A BUZZ KILL FOR INDUSTRIAL M&A

Thomas Williams, *Managing Director, Mergers & Acquisitions, Industrials, Chicago*

The issue of tariffs taking a toll on industrial companies is not a new one. Many companies have felt the impact from the first two rounds, but this latest round is hitting consumers more directly.

Our industrial clients believe the tariffs will not solve the problems with China regarding trade, with many looking for an end. The latest negotiations have been miscalculated by both sides leading us to believe that this climate may now drag on longer. In fact, a recent study from the Association of Equipment Manufacturers (AEM) measured the huge impact China-U.S. tensions are having in lowering GDP, reducing jobs and raising prices. We expect this will be a recurring issue for manufacturers with global supply chains.

Despite this, deals will continue to get done (as they have since tariffs have been implemented), but investors and lenders will keep their eyes on the impact of the mounting tensions. While we have completed deals with a significant level of tariffs on producers, it is not without challenges. With this in mind, Industrial companies are rethinking their sourcing strategies.

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Importantly, M&A takes place when CEOs and boards are confident and can see the near-term outlook in their markets; tariffs can really shift the mood and dampen the enthusiasm given the unpredictable nature of these programs. Hopefully negotiations to resolve the trade disputes will find some resolution and restore confidence and M&A deal activity with China.

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