BARINGS VIEWPOINTS

February 2018

CROSS-BORDER ORIGINATION: TAX REFORM & OTHER CONSIDERATIONS

PRIVATE EQUITY SPONSORS ARE INCREASINGLY INTERESTED IN PURSUING CROSS-BORDER DEALS BUT FEW HAVE THE LOCAL PRESENCE AND EXPERTISE NECESSARY TO DO SO. THE RIGHT FINANCING PARTNER CAN BE KEY TO ACCESSING THIS ATTRACTIVE OPPORTUNITY SET, PARTICULARLY AS SPONSORS TAKE INTO ACCOUNT THE IMPLICATIONS OF THE RECENTLY PASSED U.S. TAX REFORM.

In recent years, private equity firms have begun casting a wider net, looking outside of their core markets in an effort to find attractive opportunities. In many cases, this means targeting larger (or smaller) transactions or new geographic regions. The increasing prevalence of cross-border transactions is a result of multiple factors including intensified competition in local markets—largely a result of the industry's record amount of global dry powder—as well as the fact that many businesses now maintain a global presence.

While foreign markets may offer accelerated growth at attractive valuations, cross-border deals are not without challenges. In this paper, we discuss the inherent complexities and seek to illustrate how the right financing partner can play a critical role in helping private equity sponsors access the increasingly wide set of cross-border opportunities.

The Complexities of Cross-Border Deals

The potential benefits of pursuing cross-border opportunities are fairly well known among private equity firms and a key reason many funds are looking to expand their reach. As mentioned above, many sponsors are finding increased competition in their domestic markets fueled by record fundraising in the private equity asset class combined with lofty valuations. Looking beyond their domestic markets can give sponsors access to a larger universe of deals, potentially enhancing their ability to deploy funds and capitalize on opportunities that generate attractive returns. Also, private equity managers increasingly look to create value by transforming domestic businesses into multinational platforms with enhanced ability to compete in global markets.

What may be less clear to private equity funds are the complexities and challenges inherent in pursuing cross-border deals. For one, M&A process dynamics and intracompany structuring have become significantly more complex, and it can be challenging to secure financing on a global basis. Due to the limitations of most banks and institutional lenders, U.S. acquirers often fund foreign deals in U.S. dollars, and as discussed below, such transactions are often executed through use of intracompany transactions, exposing companies to FX and tax inefficiencies.

CASE STUDY

MULTI-CURRENCY
FINANCING SOLUTIONS

2016

In 2016, the Barings Global Private Finance team supported a private equity sponsor's initial refinancing of an existing portfolio company. During this primary transaction, Barings co-arranged the senior facilities, providing financing denominated in Swedish kronas and Swiss francs.

2017

In 2017, highlighting our team's ability to structure transactions and lend across multiple geographies, Barings worked with the same sponsor, this time to provide incremental capital to support the purchase of an add-on acquisition. The target, located in the French market, was acquired through the provision of an incremental euro-dominated facility. Barings is now the largest lender to this business, with exposure across three different currencies, and continues to be a reliable financing partner to both the company and the sponsor.

The above case study is being shown for illustrative purposes and are not necessarily indicative of future private transaction deals.

CASE STUDY

EFFICIENT, CROSS-BORDER EXECUTION

2016

In 2016, Barings Global Private Finance team was engaged by a U.S.-based sponsor to consider financing an off-market acquisition of a U.K.-headquartered manufacturing company. Barings' established relationship with the sponsor, and demonstrated ability to conduct internal due diligence in a timely and efficient manner, resulted in a mandate to deliver the buyout financing for the acquisition.

After the original transaction closed, the same sponsor completed two additional acquisitions, including a deal that more than doubled the size of the overall group. Barings acted as a sole arranger and agent of senior financing for each of these three transactions, which were denominated in three different currencies (USD, GBP and CHF). The sponsor's platform now has facilities in the U.K., Switzerland, France, U.S. and the Netherlands.

The above case study is being shown for illustrative purposes and are not necessarily indicative of future private transaction deals.

"Without the ability to fund efficiently, a sponsor may be at a significant competitive disadvantage on a potential opportunity."

The Implications of U.S. Tax Reform

Today, when transactions involve U.S. companies, private equity firms must consider the implications of the recently passed U.S tax reform. While the full impact of the tax reform on cross-border structuring remains to be seen, certain changes are worth noting. For example, U.S. companies may repatriate funds to the U.S., where this liquidity may now be used to repay debt or for other purposes that may have required funding through incremental borrowings. In addition, the new law significantly limits the deductibility of interest expense (in the U.S.), restricts deductible payments to non-U.S. affiliates, and denies deductions for arrangements that involve so-called "hybrid" entities.

WHAT DO THESE CHANGES MEAN FOR A U.S.-BASED PORTFOLIO COMPANY LOOKING TO COMPLETE A CROSS-BORDER DEAL?

A U.S.-based portfolio company acquiring a German company, for instance, may be required to fund the acquisition through payment in euros to a German operating company. Prior to the passing of the tax reform, a private equity firm may have approached the portfolio company's U.S. lenders to provide incremental euro-denominated debt to the U.S. portfolio company and then, via an intracompany note, downstream funds to a German holding company, allowing the acquisition to be consummated. Today, in the context of tax reform, the private equity fund must take into account several key questions:

1. *Is the use of an intracompany note still a viable mechanism to repatriate German cash flow?*
2. *What is the after-tax cost of the debt when factoring in the U.S. (21%) income tax rate and effective German tax rate of 30 to 33%?*
3. *Can the U.S. portfolio company deduct the additional interest expense, or is it more favorable, after tax, to place the debt in Germany?*
4. *What structure best mitigates foreign exchange risk?*
5. *What are the key differences in financing terms between the U.S. and Germany?*

Securing foreign capital can be a burdensome and complicated process, and without the ability to fund efficiently, a sponsor may be at a significant competitive disadvantage on a potential opportunity. Further, without access to financing partners that understand the options available regarding financing structures, a sponsor may receive suboptimal financing for foreign buyouts.

The legal framework around structuring cross-border transactions is complex and varies from region to region. Whether a private equity firm is pursuing a deal in the U.S., Europe or Asia, each region has its own rules, tax regimes and regulatory requirements that must be taken into account. In order to successfully pursue a cross-border deal, a private equity sponsor must also take into account the underlying dynamics of a particular region's M&A process. Purchase price adjustments, indemnification and tax liabilities/benefits are just three areas where significant differences exist between the U.S. and Germany alone, for instance. Understanding these nuances is critical, particularly given the pressure to execute deals in a timely and efficient manner.

The Right Financing Partner is Key

Given the challenges of executing cross-border transactions, finding the right financing partner can have key benefits and ultimately play a critical role in unlocking this large potential opportunity set. In particular, there are several key capabilities that private equity sponsors may want to consider when choosing a financing partner to assist in a cross-border acquisition, including:

- THE ABILITY TO PROVIDE FINANCING IN THE NATIVE CURRENCY OF THE REGION TO A DOMESTIC COMPANY
- A LOCAL PRESENCE AND NETWORK OF TRUSTED ADVISORS WITH LEVERAGED LENDING EXPERIENCE
- EXPERTISE IN THE REGION'S NATIONAL AND LOCAL REGULATIONS, INCLUDING STRUCTURING IMPLICATIONS
- FLUENCY IN LANGUAGE TO COMMUNICATE EFFECTIVELY WITH LOCAL COUNTERPARTIES
- AN UNDERSTANDING OF THE REGION'S CULTURAL NUANCES AND MARKET DYNAMICS, PARTICULARLY RELATING TO M&A PROCESSES

Opportunities tend to come and go quickly, underscoring the importance of working with a global financing partner that has the ability to execute seamlessly across jurisdictions.

Conclusion

As private equity firms look to deploy record amounts of committed capital, competition has intensified, made even more challenging by higher-than-average asset prices and record-setting private company valuations. In search of more attractive returns, private equity sponsors have begun targeting deals outside of their domestic markets, although many face challenges when it comes to raising financing and structuring deals. The process is made even more complicated by the recently passed U.S. tax reform, particularly when it comes to the implications of leverage. For these reasons, finding the right financing partner can play a critical role in capitalizing on cross-border opportunities as they emerge across the global landscape.

THE BARINGS TEAM

Barings' global private finance team, as part of a $304+ billion global asset manager, has the ability to execute transactions in geographies across North America, Europe and developed Asia. Our experience and local presence across these three regions allows us to offer multi-currency solutions, enabling us to support private equity managers as they look to expand their investment theses and platform companies in multiple regions across the world.

$12 BILLION invested in **600** PLATFORM COMPANIES

CLOSED DEALS IN **20+ COUNTRIES** and **9** MAJOR CURRENCIES

10 LANGUAGES spoken: CATALAN **CANTONESE** ENGLISH RUSSIAN KOREAN **SWEDISH** **FRENCH** GERMAN **MANDARIN** SPANISH

70 PRIVATE FINANCE INVESTMENT PROFESSIONALS located in **7** COUNTRIES on **4** CONTINENTS

Barings Global Private Finance Team has been investing since 1992.

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