KEYNOTE INTERVIEW

Trade war threats and opportunities

As protectionist trade policies impact supply chains of mid-market American businesses, private equity firms are both winners and losers. Baker McKenzie partners Michael Fieweger and Mark Mandel discuss the impact on pricing and portfolios

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Q What impact is the US protectionist legislation having on mid-market private equity transactions today?

Mark Mandel: The trade war began last year when the President responded to the huge trade deficit with China by imposing tariffs on billions of dollars' worth of Chinese products. He also opened a now completed renegotiation of the North American Free Trade Agreement by imposing import tariffs on both Canadian and Mexican goods as part of that renegotiation.

The number of goods and businesses impacted is staggering, and those private equity portfolio companies that are buying products from China as part of the supply chain have seen costs go up, while those that source goods in Vietnam, India or neighbouring nations have gained an advantage as a result. There are no clear winners or losers, it simply depends what the supply chain of each business looks like. If you're a private equity firm that owns a company that manufactures in China you are having issues, but if you own a portfolio company in a neighbouring country it's a bonanza while trade negotiations continue.

Michael Fieweger: There are two competing goals behind US foreign trade policy. One is the promotion of the President's mercantilist America First trade policy, and includes the imposition of tariffs, the reopening of NAFTA and termination of participation in multi-lateral trade talks.

The other is national security, which is manifested in increased scrutiny of and acquisitions of technology companies and increased scrutiny of IP transfers, particularly in areas like 5G. It is not always clear what goals the administration is pursuing and, as a result, it is not clear as to what may or may not be an acceptable solution to the trade sanctions imposed by the administration.

Trade sanctions driven by the promotion of trade policy and national security interest have differing effects on private equity investments. Enhanced national security reviews for example are impacting mid-market deals, largely removing Chinese buyers from the market and creating concern from other foreign buyers and limiting the market for the services provided by high tech companies.

That impacts the calculus as you go into technology deals in areas like software or software services, because one has to consider whether there are aspects of the business that could be subject to limitations on the transfer of technology, which maybe were not an issue in the past. Or, are those businesses likely to be the focus of potential backlash legislation from other countries in the future?

Q Which sectors and types of portfolio company are feeling the greatest impact, and why?

MF: There are some sectors that are seeing less activity. A client was looking at a deal where the end markets are tied to the agricultural markets. Interest in the target was very low, because US farmers are being hit badly by the tariffs being imposed in China. Sectors hit hard by the trade war like agriculture are a tough place to play these days.

Across industrials it has not been easy, because notwithstanding the intent to benefit US manufacturing, the supply chains of even heavily US-centric companies are being negatively impacted. Most middle-market US industrial companies have supply chains which are heavily dependent upon trade with China, Mexico and Canada.

The presence of existing tariffs and constant threat of new tariffs creates significant risk when looking at a US manufacturer. Clients are looking carefully in those situations at how much pricing power the companies have and their ability to pass on the increased input costs to customers.

Technology is being impacted in certain segments, but overall that market remains pretty strong, particularly in the middle market where a lot of investments in technology-enabled services do not see a lot of impact from the tech transfer focused sanctions.

On a macro level, we are seeing a decline in cross-border investment and people are putting money to work closer to home. Asian investments into the US have really dropped off. A lot of that can be attributed to the trade war, but it is also really expensive to come into the US at the moment as a foreign fund and outbid local players.

Q How do you see the policies creating opportunities?

MF: If you are a private equity fund that is operationally-focused and used to working with companies with complex supply chains, there may be some value to be added by repositioning supply chains moving production and sourcing out of China into other South-East Asian countries. If the fund and management are willing to put in the work there may be opportunities where the targets have been negatively impacted by the trade wars.

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MICHAEL FIEWEGER
Baker McKenzie

There is also a calculation to be made about whether this all dies down through the hold period. In some of those sectors being hit hard, there is a buying opportunity because this will hopefully be resolved by the end of your hold period.

MM: These policies have created opportunities but they are not without risk. We are in a period of transition, because it is likely that the policies are going to change. The trade wars could be resolved like with NAFTA or they could expand in intensity and scope.

Nevertheless, we are still seeing some private equity firms purchasing companies that manufacture in these neighbouring countries. They are betting in the medium term the tariff wars will be resolved favourably.

Q What can private equity firms active in the market do to mitigate the impact of protectionism and regulatory uncertainty?

MM: In the context of private equity funds buying companies that are lower-cost producers because they are not subject to higher tariffs, we have crafted provisions that provide that if a tariff were to be imposed on a product, the seller would have to pay damages to the buyer. The parties negotiate a formula that applies to determine damages.

Either the parties can share the pain or the seller can bear all of it. We have seen this in the form of indemnification on purchase price provisions. We have used these provisions a lot since the beginning of the trade wars.

Right now, private equity firms are trying to get to a view on what is the new normal, and once they feel comfortable, they will start to operate their businesses under that construct. It may affect how they put money to work. In the short term, until the trade wars are resolved, they may shy away from businesses that have more exposure to tariff risk. However, deals are still getting done and private equity funds still have money to deploy, so they can price the risk into the deal or negotiate the indemnification or purchase price adjustment provisions to limit the risk.

Q What advice would you give to any mid-market firms that are concerned about this?

MF: The protectionism and the trade war are not going to go away any time soon, so the advice is to be thoughtful about their impacts when you are making investments and when you are addressing issues with your portfolio companies.

There are both negative and positive impacts, and that discussion needs to be an item on the board agenda.

Attention needs to be paid to the impact on supply chains, earnings, contracting with customers and suppliers, and how acquisition and partnering opportunities might be created. Some of the best private equity firms are looking at this as an opportunity, a way to distinguish and a way to use thinking around these challenges to create and unlock value.

Companies need to be thinking about how they plan for a prolonged trade war and what the knock-on effects might be, not just in the US but also elsewhere in the world. The political circumstances that have resulted in us getting to this point are not unique to the US, so we should not necessarily expect this to blow over resulting in free and open markets everywhere. ■