CLIFFORD CHANCE

Cross-border M&A:
Perspectives on a changing world

Including analysis from

Economist Intelligence Unit The Economist

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About this report

This report is published by Clifford Chance LLP and written by the Economist Intelligence Unit, with the exception of the foreword, the Clifford Chance perspectives and those quotes which are attributed to Clifford Chance. The EIU would like to thank the Clifford Chance global M&A team for their invaluable insights. The views expressed by the Economist Intelligence Unit do not necessarily reflect those of Clifford Chance LLP.

Foreword from Clifford Chance

Although the worst of last year's market turmoil may be behind us, the macroeconomic and political uncertainties of 2012 continue to create an unstable environment for M&A. There are clear signals, however, that at a company level confidence is rising for many and M&A forms a key part of strategic plans.

Against this backdrop, I am delighted that we have commissioned the Economist Intelligence Unit to undertake research for us around the opportunities and challenges in cross-border M&A. The research explores the strategies, priorities and concerns of major companies across all regions, their views on the key opportunities for inorganic growth, and their perceptions of the risks and barriers to cross-border M&A. The survey findings validate our own experiences with our clients. They also provide valuable insights into the perceptions of opportunity and risk across the globe, and the alternative strategies for managing and mitigating those risks.

Looking forward, I am cautiously optimistic. We are six years on from the heights of the M&A market in 2006, and after several years of relatively low deal activity, many global businesses are currently enjoying favourable balance sheet conditions, having amassed healthy reserves of cash; they also have access to debt at historically low interest rates. Importantly, many have the appetite and confidence to pursue the right M&A opportunities to strengthen and grow their core businesses. Given a stable market environment, I expect that this boardroom confidence will translate into an upturn in M&A activity in due course – particularly cross-border activity focused on those markets offering the greatest potential for growth, in what are now truly global markets for many sectors.

The new era for cross-border M&A will be characterised by a shift in the approach to deal-making, as the cross-border environment becomes increasingly competitive and complex. In order to deliver a successful M&A growth strategy, businesses must assess and navigate legal, financial, political and cultural risks with a flexible approach, informed by the insights of an experienced team of advisers.

It is clear that we are in a unique period of opportunity – one where complex cross-border transactions can deliver significant benefit for companies seeking growth and opportunities to achieve significant competitive advantages.

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Executive Summary

"Insurance is pretty stodgy business," began an article in *The Economist* in March 2010. But the article went on to describe a deal that was anything but stodgy. AIA, the Asian business of US insurer AIG, had accepted a US$35.5bn takeover offer from Prudential, the UK insurer, which would provide, *The Economist* continued, "a closely-watched test of what can and cannot be done by financial firms as they try to build Asian franchises."

And so it proved. The announcement of the deal caused a 20% drop in value of each company's shares. A core of shareholders, believing the US$35.5bn offer was far too big, forced Prudential to put the deal to a vote, which it lost. AIG refused to lower the purchase price and the deal collapsed, leaving Pru shareholders with a £450m bill.

The demise of this deal highlights the risks and barriers regularly encountered by would-be deal-makers as they brave a volatile M&A market to seek opportunities outside their home markets. In addition to increasing shareholder scrutiny of deals, the antitrust environment in many developed markets appears to be tightening. New entrants into high-growth, emerging markets must also get to grips with new, increasingly sophisticated and yet untested regulatory environments.

M&A is being made more difficult by the speed at which the economic and regulatory environment is changing – the twists and turns of the market mean that buyers and sellers need to be well-prepared, have flexible strategies, and react quickly to the latest challenges. Buyers and sellers who develop creative solutions – to bridge valuation gaps, for example, or circumvent regulatory difficulties – will have an edge on success in the new era of cross-border M&A. Existing practices for risk assessment also need to evolve to the developing environment. Equally important is the need to overcome language, cultural and management challenges that are inherent with expansion into new markets and geographies.

Overcoming these challenges is a necessity. Cross-border deals can be a source of significant value creation, and can present attractive opportunities for companies to seek growth in new markets or accelerate expansion where they already have operations. The opportunities for these investors are plentiful and significant, and in many cases represent an essential part of the long-term strategy of the business. Now may be a good time to embark on cross-border activity – evidence is mounting to suggest that deals executed during periods of high volatility offer greater long-term value to shareholders than those undertaken in steadier market conditions.

This report, which is produced by the Economist Intelligence Unit and commissioned by Clifford Chance, looks at how companies identify, assess and manage the risks and opportunities involved in cross-border M&A. Based on a global survey of senior executives from companies that have conducted deals in the past two years, and a programme of interviews with industry experts and commentators, the report explores ways in which companies can achieve successful cross-border deals through preparation, agility and effective risk management in a fast-changing economic environment.

Key findings

Companies are maintaining a cautious approach to M&A activity.
Continuing volatility in the global economy means that most companies are taking a cautious approach to deal-making. Survey respondents are fairly evenly split between those who plan to expand through organic growth (55%) and those who intend to prioritise inorganic growth (45%). Companies also appear inclined to stick to what they know, rather than diversify into new areas: 79% of respondents say their company's current growth strategy is to develop its core business.

M&A opportunities are seen in emerging, high-growth markets.
Respondents may be cautious about the prospects for deal activity, but in general they are more excited about the possibility of M&A in emerging markets than anywhere else. When asked to choose the key focus of their growth strategy, 56% select emerging, high-growth markets, as opposed to domestic or developed markets (both 22%).

Alongside new opportunities, new risks are also emerging.
Companies embarking on cross-border M&A appear acutely aware that they face different risks to those they might have to deal with in their established markets. This group sees protectionist measures and political pressure as key political risk factors, maybe reflecting recent high-profile interference by politicians and regulators in M&A deals. Meanwhile, shareholder scrutiny is also seen by survey respondents as a risk for their M&A strategies, particularly for those focused on cross-border deals. As they seek new markets, companies will need to bear in mind the interests of their key stakeholders at home.

Cash is king for acquirers.
For those that are planning acquisitions, accumulated cash reserves remain the preferred method for funding M&A deals, except for the US where bank borrowing is the preferred financing route.

Shareholders are influencing M&A strategy.
Companies embarking on cross-border M&A increasingly see shareholder pressure as an influence on strategy. Overall, 18% of respondents say shareholder pressure is a main driver for pursuing M&A activity, and this increases to 26% for North American respondents. Many companies, particularly in the US, have come through the crisis with strong balance sheets and deep reserves of cash. Shareholder sentiment over whether such cash should be deployed for new investments, or returned to shareholders, is an increasingly important factor in their strategic planning.

The competitive landscape will be a key barrier to M&A activity, suggesting that, for now, prime M&A targets are scarce and therefore likely to be pursued by multiple buyers.
When asked about the key risks that could derail their M&A strategies, respondents point to increased competition for assets as the leading factor. One reason for this could be a shortage of attractive assets and investment opportunities, combined with a pervasive mood of caution in the market. Continuing economic uncertainty means many vendors conclude that now may not be the best time to sell. A focus on emerging markets is also a likely cause, with many companies courting a limited supply of prime targets in these economies in the absence of growth opportunities closer to home.

Joint ventures are becoming increasingly important as companies seek ways of sharing and mitigating risk in cross-border deals.

The financial, cultural and political risks inherent in cross-border deals mean that many companies are taking a more gradual approach to gaining a foothold in the market. A desire for risk-sharing, and recognition that local partners can play a vital role in smoothing the investment process, means that companies increasingly prefer joint venture arrangements when investing across borders. Investee companies, in turn, often see minority investment by more sophisticated partners as being for mutual benefit. Protectionism and foreign ownership policies are also factors at play in this trend.

Concerns about cultural differences can be an important deterrent to cross-border deals.

Despite the growing need for companies to invest in new markets in order to realise their growth ambitions, more than one-half say that they are discouraged from acquiring overseas because of concerns about bridging cultural differences. This rises to 63% for respondents in the US. Many companies admit that they find the softer side of deal-making challenging, with just 44% of companies saying that they are effective at handling cultural integration as part of the transaction process.

> "People think of cross-border deals as risky, but my view is that it is more risky for the long-term health of the business not to pursue these deals. Yes, there are short-term risks with moving into new markets, particularly emerging economies, but companies face a much bigger strategic risk from not being there at all."

Don Mulligan, Chief Financial Officer, General Mills

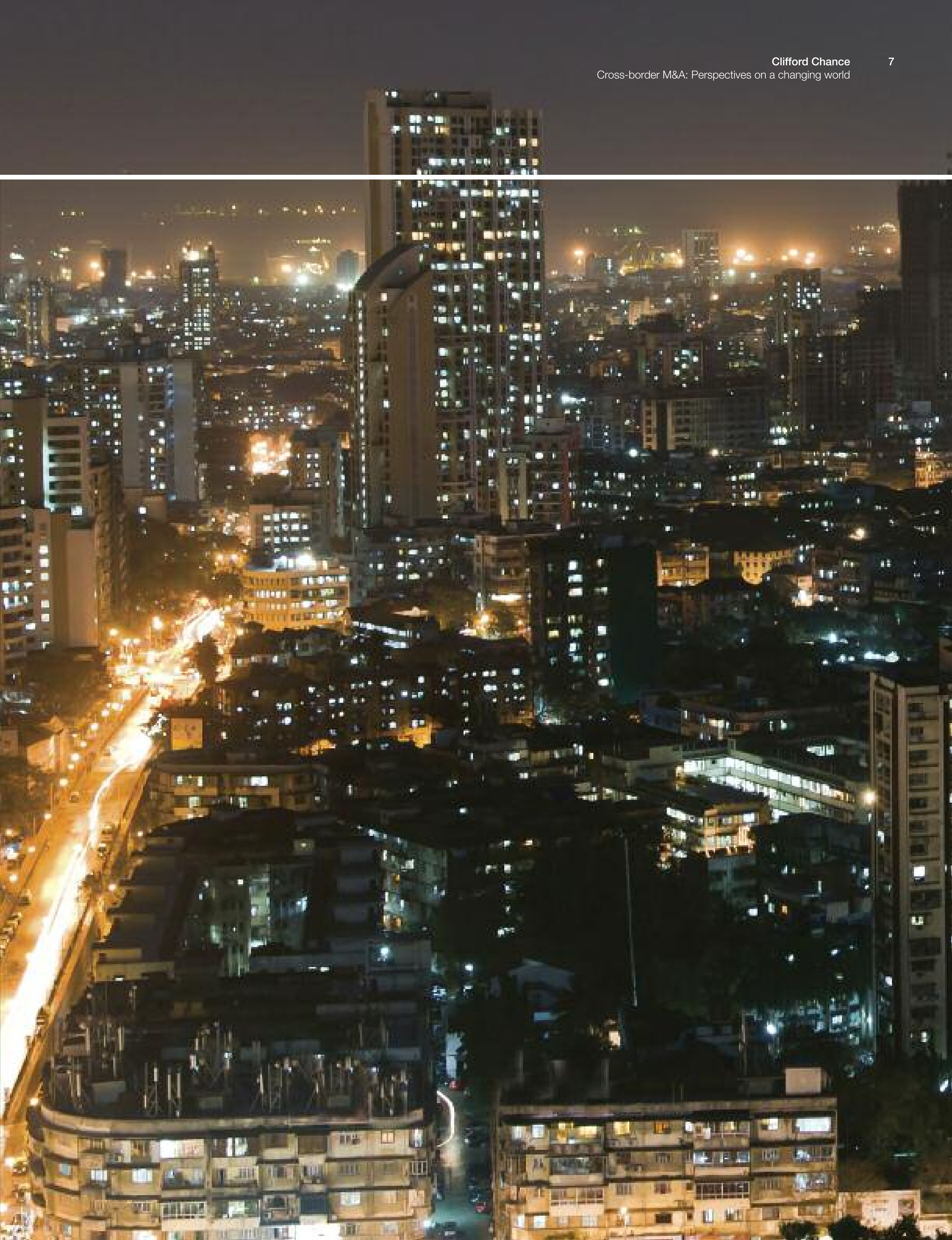
New opportunities, new markets: regional viewpoints

In many places in our survey, looking only at the overall response data does not always offer the best insights. Throughout the report, we will draw attention to regional or sectoral differences between responses.

Some stand out immediately. For example, European respondents appear much more likely to pursue organic growth (67%) than their North American (54%) or Asia-Pacific (49%) counterparts. However, they are more likely than their counterparts from the US to focus their M&A efforts on high-growth markets (57%, against 49% from the US).

Responses to our survey suggest that:

- There is more caution in the US than in Europe regarding M&A in emerging high-growth markets. US respondents overwhelmingly see their domestic market and other developed markets as offering the most attractive opportunities for M&A.
- Europeans appear cautious about embarking on M&A activity at the present time, reflecting underlying concern about the ongoing crisis in the Eurozone, but they also see opportunities arising over the next two years. They identify the high-growth markets of China and India as presenting prime M&A opportunities.
- Companies in the Asia-Pacific region see the prime opportunities as being almost exclusively within their own region, ahead of North America, the Middle East and Brazil.



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Strategic M&A in an uncertain deal environment

Sharp decline in global activity levels

Ongoing sovereign debt woes and concerns about the strength of the economic recovery continue to create a muted environment for global M&A activity. Global activity levels in 2011 actually increased by 2.5% year-on-year, according to a year-end round-up by Mergermarket, an M&A analyst, with 12,455 deals announced[1]. However, this headline increase for the year masks a strong underlying downward trend in the second half of 2011. The size of deals has also shrunk. In 2009, mega-deals (those valued at more than US$10bn) accounted for 29.6% of the total global deals value. That figure fell to 15.1% in 2011. In fact, last year was marked by the collapse of a number of headline deals, including the AT&T/T-Mobile USA transaction.

Meanwhile the downward trend has continued into 2012, with first-quarter M&A volumes down 9.8% from the final quarter of 2011 and 31.2% down on the first-quarter of 2011, according to Mergermarket[2]. This is despite a handful of sizeable transactions being put on the table this year, including Glencore International's proposed merger with Xstrata and its proposed acquisition of Viterra.

Changing growth strategies and M&A drivers

Companies are adapting their growth strategies to the current economic and regulatory environment. When asked how they intend to grow their businesses, the executives surveyed for this report – all of whom represent companies with revenues greater than US$1bn – are split fairly evenly between those who plan to focus on organic expansion, and those who will take the M&A route (see figure 1).

The vast majority (79%) of respondents to our survey intend to prioritise their core business, rather than diversify into new areas of activity (see figure 2). A similar story emerges when looking at the reasons why organisations divest assets. More than one-third (35%) of our respondents cite the need to focus on core business

1 Mergermarket M&A Round-Up for Year End 2011
2 Mergermarket M&A Round-Up for first quarter 2012

Figure 1: Which of these options corresponds most closely with your organisation's current growth strategy?

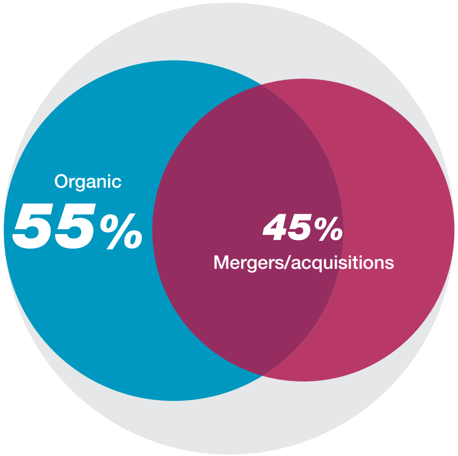
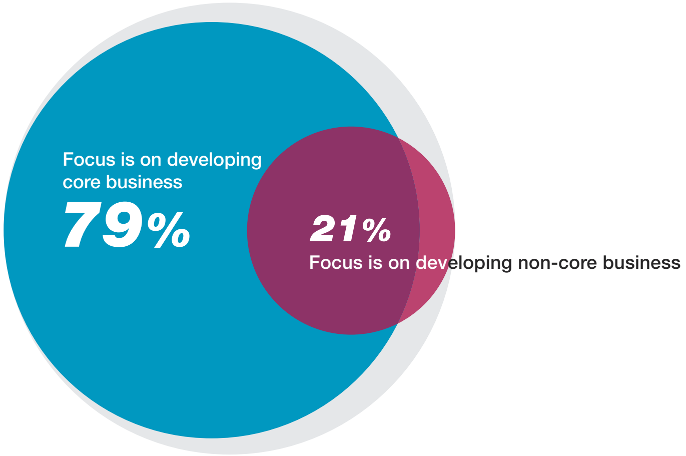


Figure 2: Which of these options corresponds most closely with your organisation's current growth strategy?



as the key driver for M&A activity over the next two years, and that is also identified as the principal cause for divestitures expected over the same period. This suggests that balance sheet pressures, and demands on management time and resources are leading many companies to stick to what they know rather than exploring new business lines in order to grow their business. Financing and balance sheet pressures are identified as key drivers for M&A by respondents located in the US and in Asia-Pacific.

Spotlight on emerging high-growth markets

Although overall M&A deal volumes may be sluggish, certain pockets of the market remain in better health. Mergermarket's analysis found that growth in cross-border M&A is a continuing trend, comprising 40% of global M&A activity (based on deal value) in 2011. This is up from 38% in 2010 and 28% in 2009. Deals between regions were up by 19.6% in 2011 as compared to 2010.

More specifically, cross-border deals involving emerging markets have become the engines of global M&A, as companies capitalise on the growth opportunities they represent. Between 1997 and 2003, just 4% of global M&A investments involved an emerging market company. But between 2004 and 2010, that proportion rose to 17%. In 2010 alone, more than one-half of all cross-border M&A deals involved an emerging market company either as a buyer or seller[3].

The Clifford Chance view:

"After the macroeconomic uncertainty over the last few years, it is not surprising to see that the appetite for risk is low. Companies and their investors are focusing on what they do best – typically their core businesses – albeit with an interest in accessing new markets for these activities."

Roger Denny, Head of Corporate, Asia Pacific, Clifford Chance

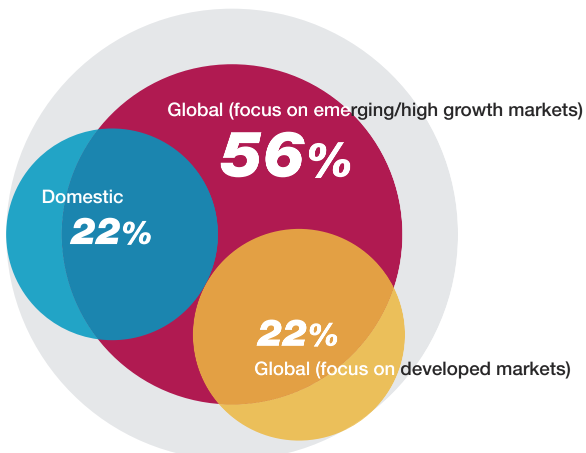
3 Multipolarity: The New Global Economy, World Bank 2011

This focus on emerging markets is one that resonates with the executives surveyed for this report – both from an inbound and outbound perspective. When asked to choose the key focus of their growth strategy, 56% select emerging, high growth markets, as opposed to domestic or developed markets (see figure 3). True, only 23% say that they plan to increase their levels of M&A transactions in overseas emerging economies, but this is considerably higher than the proportion who plan to ramp up their deal-making activities in either domestic or overseas developed markets (see figure 4).

High-growth markets feature prominently on the list of attractive destinations for M&A. When asked which markets are considered to be prime targets for M&A opportunities, China, Brazil and South-east Asia all appear in the top six (see figure 5). Where the emerging market opportunities lie is perceived differently depending on where a company is located. The results of the survey suggest that:

- Asia-Pacific companies identify the emerging markets in their own region – China, South-east Asia and India – as presenting the greatest opportunities.
- US companies identify Russia and Brazil, followed by the rest of Latin America, as key high-growth market destinations.
- Europeans see prime opportunities in China, India and Brazil.

Figure 3: Which of these options corresponds most closely with your organisation's current growth strategy?



The Clifford Chance view: Engines of growth for 2012

We are expecting cross-border activity to continue to represent a high proportion of total M&A activity for the remainder of 2012. The current volatile macroeconomic environment makes M&A more difficult, but by no means impossible – and we are seeing an active pipeline of deals where clients are looking to seize M&A and investment opportunities, particularly in overseas markets. Cautious expansion is the name of the game in 2012.

Looked at from an M&A perspective, the world is increasingly one globalised market – with major corporates as likely to be doing deals in far-flung places as they are domestic transactions. The emerging and high-growth markets are likely to be the engines of growth for 2012. We are seeing clients from Europe and the US looking, in particular, at opportunities in China, South-east Asia, Africa, Russia and Latin America. M&A between emerging markets is also a key trend at the moment, with LatAm companies increasingly looking to cross borders in their own region, and China looking at outbound investment into India and South-east Asia in particular.

The high growth markets often present (or are perceived to present) the highest risks, both in terms of deal execution and in terms of cultural integration. The results of the EIU survey support this view – China and South-east Asia being named by respondents as the countries whose regulatory regimes are most likely to deter them from embarking on M&A activity. But the "risky" regions are often the ones where the highest rewards are to be reaped – so clients need to continuously assess the "risk versus reward" conundrum.

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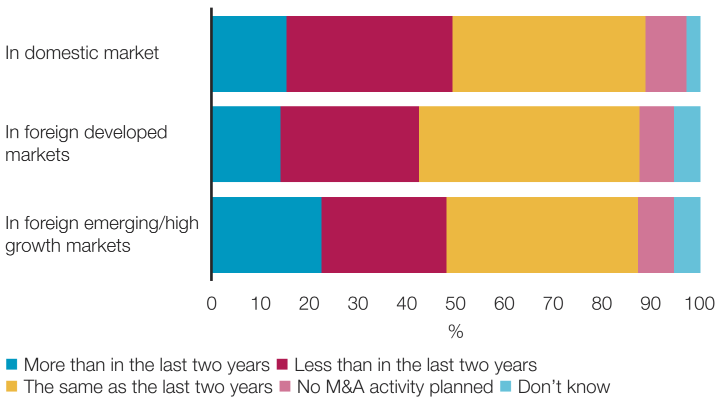
Figure 4: What do you expect of your organisation's M&A activity over the next two years?

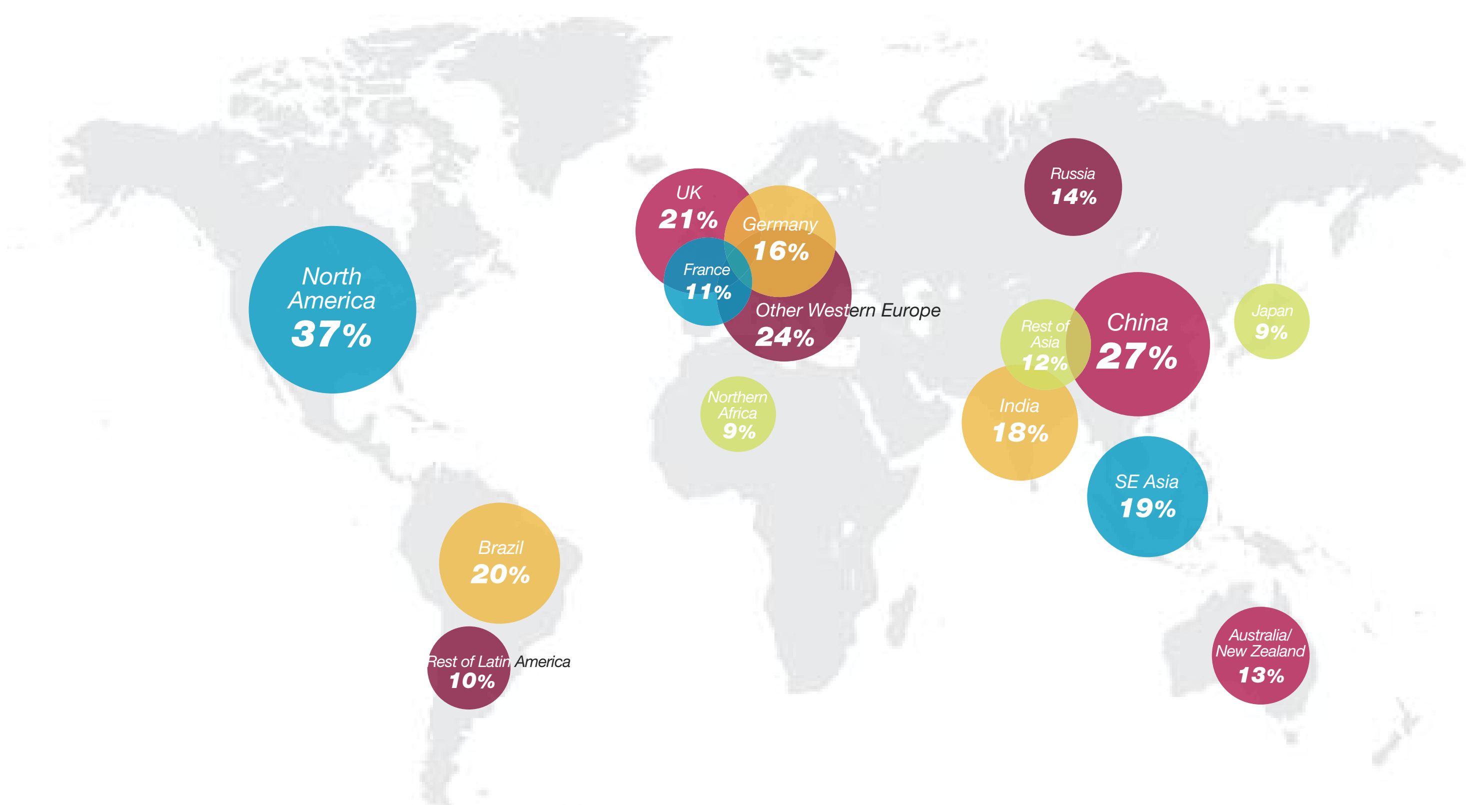


The Clifford Chance view:

"Across most sectors, the leading businesses are operating in global markets. The key messages coming from our survey reflect what we are seeing from our own businesses and those of clients."

Matthew Layton, Global Head of Corporate, Clifford Chance

Figure 5: Top 15 countries and regions that are considered prime opportunities for M&A activity



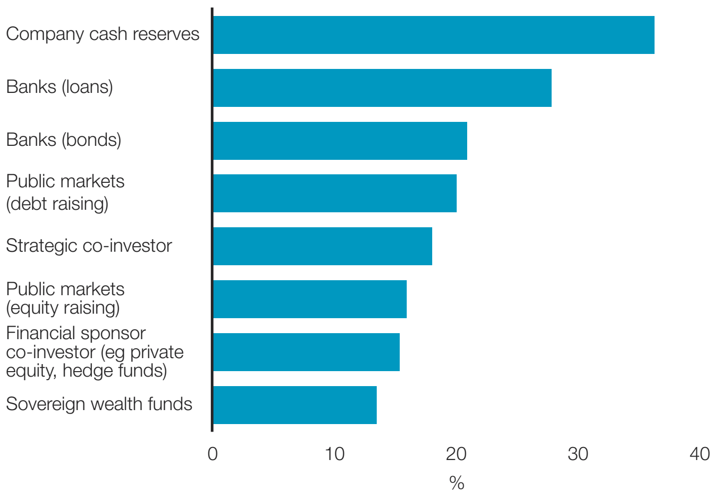
Reversing the flow: where are the emerging markets investing?

As companies in emerging markets grow in size and stature, they are themselves looking overseas for growth opportunities. Around 60% of outward foreign direct investment from these economies is flowing into other emerging markets, and the remaining 40% into developed markets[4].

But the approach that emerging market companies take to overseas investment varies significantly according to the maturity of the destination market. These companies may prefer greenfield investments when accessing other emerging markets, owing in part to the tax breaks, subsidies and other types of incentives available. However, when expanding into developed markets, they are far more likely to favour an outright acquisition, joint venture arrangement or a minority investment. According to the World Bank, 85% of all investments by emerging market companies into developed markets between 2003 and 2009 were M&A transactions[5].

There are compelling reasons for this preference when entering developed markets. Emerging market companies and investors are often cash-rich but need to access brands, technology or expertise in order to further their growth ambitions. Developed markets present a ready supply of targets that will help them to achieve this. In particular, taking a minority stake in a global business gives the emerging market investor a unique opportunity to learn the business and practices of the investee business and gain valuable insights into the operations of these global players. And, despite their economic problems, many developed countries offer huge markets with friendly investment climates, stable tax regimes and lots of wealthy consumers.

Figure 6: What are your preferred methods of financing for M&A deals currently?



Strategies for financing M&A in unpredictable global markets

Using cash for M&A activity is an increasingly popular financing method: in 2009, 59% of global M&A deals were financed with cash; in 2010, the figure had reached 68%, and 70% in 2011. As a result, fewer deals are financed solely with equity (22% in 2009 and 19% in 2011)[6], perhaps reflecting buyers' reluctance to use undervalued stock as acquisition currency. Many companies are sitting on substantial cash reserves which over time will need to be deployed or the pressure to return it to shareholders will increase. In the US alone, non-financial companies were estimated to be holding some US$1.24trn in cash, with much of this being held overseas[7].

Faced with growing demands from shareholders that cash on balance sheets is put to work, it is unsurprising that our respondents see cash reserves as the preferred method of financing M&A deals (see figure 6). In addition, cross-border deals can be an effective way to put profits earned in local markets to more productive use, where repatriating it would incur a large tax hit.

Low interest rates have also kept bank-lending a preferred source of funding for M&A deals, particularly in the US and in Europe, although the banking crisis has meant this is not a source available to all buyers. Thirty per cent of survey respondents say that availability of financing is a key concern for them over the next two years.

4 http://blogs.worldbank.org/prospects/node/831
5 Multipolarity: The New Global Economy, World Bank 2011
6 Mergermarket database, April 2012
7 Moody's Announcement, 14 March 2012

The Clifford Chance view: Financing M&A in the new world order

Where's the money? An active M&A market needs financing to fuel activity. Even with sufficient cash reserves on hand, many acquirers seek to tap external finance sources. With recent market volatility, windows of opportunity to access liquidity have been brief, with geographical variances. In order to manage risks and maximize opportunities, we have increasingly been working with clients to explore multiple financing options, either individually or in combination. In addition to enhancing flexibility, this approach can create competitive tension among alternate sources of financing. Looking ahead to the emergence of the so-called "shadow banking" market, the financing landscape is only going to become more complex as we are already seeing corporates looking to access this liquidity in the form of approaching sovereign wealth funds, credit funds, etc.

Equity – Despite difficult conditions there have been a number of 'share for share/stock for stock' transactions (e.g. proposed Glencore and Xstrata merger). Recent volatility in equity markets in the wake of the Eurozone currency crisis has posed significant valuation challenges for bidders and targets alike and has increased the challenges in using an equity issue (such as rights issue) to fund acquisitions in whole or in part. Using equity to fund M&A transactions also affects the timing of transactions - due to documentation requirements – and adds a level of public and regulatory scrutiny, and bidders need to be able and willing to address the implications this raises. This is particularly true of those transactions that are more significant in size.

High Yield – Whilst often associated with private equity sponsor transactions, there is an established track record of corporates in the US, Europe and Asia successfully using high yield bonds for M&A financings. In the US, the history is the longest and we have seen countless examples of M&A event-driven corporate high yield issuances. In Europe, we saw a creative example when BASF and INEOS used high yield bonds to finance their new joint venture, Styrolution. In Asia, we have seen a number of Chinese property companies tap the high yield market to fund the acquisition and development of properties. These transactions are frequently combined with some form of bank facility, a revolver for liquidity for example, and are often associated with complex capital structures. Within the M&A context, where sellers often focus on certainty of funds, using a bond to help finance an M&A transaction generally requires cooperation between parties.

Bank Loans – Whilst equity and high yield markets open and close, the loan market tends to be a constant and is generally open for high quality borrowers and assets. Corporate borrowers can potentially raise sizeable facilities albeit often as a bridge to an equity or debt capital markets take out. Recently we worked on Sanofi-Aventis' US$15bn syndicated loan facility to partially finance its public tender offer for Genzyme. The transaction showcased a highly rated corporate borrower choosing to access the bank market for ease of execution and flexibility with a view to then refinancing in the debt capital markets. In connection with the Glencore and Xstrata merger and ancillary to the M&A transaction, US$6bn of liquidity facilities were put in place to satisfy the working capital requirements of the merging entities, notwithstanding the existing multiple credit lines and double exposures of the relationship banks.

As a corollary to the buy-side's efforts at keeping all financing options open, vendors are taking a multi-track approach when trying to realize a liquidity event with respect to a company, subsidiary or asset by considering some combination of an IPO, refinancing or M&A disposition. The refinancing may include a spin-off and the M&A sale process often includes staple financing (including high yield), providing the terms of a loan/bond financing and a high yield offering memorandum to bidders. A multi-track exit allows a seller to keep its options open, maximise value whilst enjoying flexibility if one of the exits is no longer feasible. An excellent example was the work we performed on the sale of Securitas Direct where the seller considered multiple exits and, although it ultimately settled on an M&A disposal, the competitive tension, as well as the availability of a full financing package for the acquirer, secured a successful exit.

Michael Dakin, High Yield Partner, London – Clifford Chance: Tel: +44 20 7006 2856 Email: michael.dakin@cliffordchance.com

Accessing the public markets (equity and debt) to raise funding for M&A activity remains a popular option amongst Asian respondents, but less so for their US and European counterparts.

Using cross-border M&A as an effective hedge

It is striking that, when asked about the key financial concerns associated with their overall M&A strategy, currency fluctuation is the number one issue (see figure 7). Cross-border deals can help to minimise the risks of currency exposure, because companies can either raise money in the local currency or divert cash reserves already in the market into acquisitions. Either way, the outcome can be an effective hedge against currency movements in the company's core markets, matching operating revenue with costs in local currency.

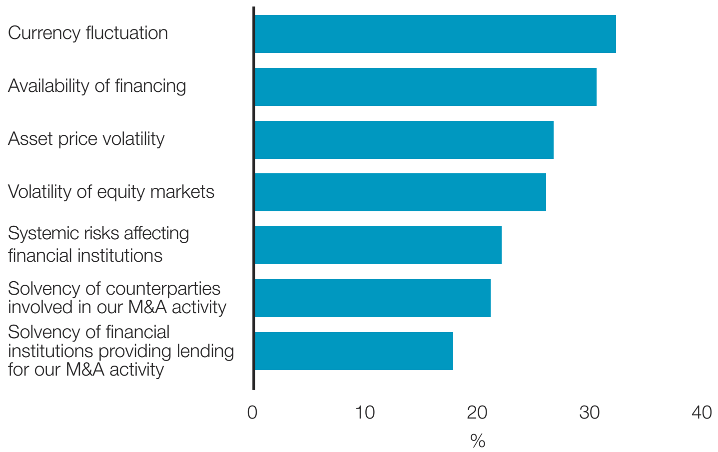
"It's part of our risk management strategy that we want more exposure outside of US dollars," says Nick Gangestad, Corporate Controller at 3M. "As a company, we have a mismatch today between our revenues that are non-US dollar based and our costs that are non-US dollar based. So the more that we can add to our cost structure in non-US dollars, the better that balances and gives us a natural hedge."

Playing by the rules

Regulatory constraints – whether in the form of antitrust, competition and foreign investment rules, anti-corruption rules, or regulations affecting particular industries – continue to have an impact on M&A activity. Our survey suggests that the risk of regulatory interference, unpredictability, delay and complexity is certainly influencing cross-border M&A decision-making.

In industries such as mining, power, healthcare and TMT, large companies are increasingly finding that their efforts to grow, whether at home or abroad, are being impeded by antitrust rules. At the time of publication of this report, Google's buy-out of Motorola Mobility – which has already won regulatory approval in the US and EU – had hit a roadblock in the form of Chinese antitrust regulators. Figures indicate that such high-profile examples actually run counter to current enforcement trends in a number of key antitrust regimes. Nonetheless, companies in highly-concentrated sectors may find that their cross-border deals are coming under increased scrutiny from regulators – particularly in emerging markets, where once-friendly antitrust and foreign investment environments have been toughened up.

Figure 7: When considering your organisation's M&A activity over the next two years, which of the following financial factors are of greatest concern?



Protectionism

Protectionism and other political pressures are a major source of concern in cross-border M&A activity. Recent history is littered with warnings for the unwary, such as the blocked BHP Billiton/PotashCorp bid of 2010 and the Singapore Exchange's bid for its Australian equivalent in 2011.

While protectionism is not seen by our survey respondents as one of the top five barriers to cross-border M&A overall, it is certainly regarded as presenting the leading legal and regulatory risk, ahead of employment and tax laws and financial regulation.

Regulatory black-spots

Our survey shows that executives in Europe see over-regulation as the leading political factor that causes concern for M&A. It also ranks highly as a concern for executives in Asia-Pacific and the United States. General concerns about over-regulation may reflect a wide range of specific issues, including antitrust and foreign investment regulation, anti-corruption laws, as well as financial regulation and industry specific regulation.

The survey suggests that:

- For Europeans, China and North America are seen as the regulatory black-spots, ahead of Russia. Meanwhile, 28% of European respondents say the North American regulatory environment would stop them from embarking on M&A activity there.
- US companies appear not to have a reciprocal fear of Europe. They identify China, Japan, South-east Asia and the rest of Asia as the most risky regulatory environments.
- China, Russia, Brazil and Germany are viewed as the key regulatory danger zones by those in Asia-Pacific.

South-east Asia is also identified by 40% of mining sector respondents as the place where regulatory issues are likely to get in the way of M&A activity. China tops the list for TMT and healthcare respondents – although (perhaps in the wake of the T-Mobile/AT&T decision) TMT is also wary of North America.

Unsurprisingly, however, many of the regions seen as presenting major regulatory risks – such as China and South-east Asia – are also seen as offering the greatest opportunities for M&A.

The Clifford Chance view: Spotlight on protectionism and political scrutiny

What acquirers fear most is not so much protectionist sentiment, but the lack of predictability that it creates, both for closing the deal and for the commercial prospects of the target post-acquisition. Our advice to clients is three-fold: First, you need to identify early in the process all of the regimes in all the jurisdictions which apply, such as merger control, foreign investment, regulatory and anti-corruption. Clients are often shocked to learn how many regimes they have to grapple with, often in jurisdictions that are peripheral to the deal being done. Many emerging markets are introducing new rules, which can be complex and time-consuming to navigate. For example, Brazil recently imposed new restrictions on foreign ownership of land, and the filing requirements under India's new merger control regime can be very burdensome. This proliferation of regulation means there's an ever greater risk of adverse and inconsistent decision-making, so it is more important than ever to be well-prepared and well-advised. Second, focus on your public affairs strategy - some high-profile deals which have collapsed recently, attracting the "protectionist" rhetoric, have really resulted from acquirers being insufficiently prepared for the public backlash. Third, it is difficult to predict how jurisdictions will make decisions on matters that they perceive to be in their national interest – few saw Argentina's move to renationalise YPF coming, for example – so having advisers who understand the wider dynamic on how countries exercise sovereignty over deals is key where this is likely to be a concern.

Clients are often over-alarmed about the hurdles they may face in this area, particularly when entering countries that are perceived as "high-risk". But the reality is that if you are well-advised and well-prepared you can get most deals through. For example, more than 400 transactions have been notified under the China regime since 2008, but fewer than 3% have been cleared subject to remedies and only one has been blocked outright.

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Sector Focus: Telecoms, media and technology (TMT)

What exactly do you do when your company has US$100bn on its balance sheet? It may seem a nice problem to have but Apple's CEO, Tim Cook, has come under scrutiny from both the media and anxious shareholders as he tries to rationalise his company's enormous mountain of cash.

One option available to Apple is acquisitions. The firm historically shies away from mega-deals, preferring to buy small companies with promising technology. Apple and other TMT companies are placing a lot of hope on cloud. Might Apple and these companies seek to use their cash to invest in the infrastructure for the deployment of cloud to their customers?

In our survey, nearly one-half (45%) of telecoms, media and technology (TMT) sector respondents say that company cash reserves would be their preferred method of financing M&A, compared with 37% of respondents overall. This tallies with an estimate by Moody's, the ratings agency, that US non-finance companies were sitting on US$1.24trn in cash holdings by the end of 2011. Fully 60% of TMT respondents also say that shareholder influence has increased over the last two years – a much higher proportion than the 43% average, and perhaps one reason for Apple's decision to pay out a US$10bn dividend, its first since 1995. Could others, such as Google follow suit?

Greater scrutiny by shareholders

It is clear that shareholders are playing an increased role in M&A in the current economic environment – both as key drivers of M&A strategy and, in some cases, as obstacles to getting the deal done.

Pressure from shareholders is a driver for M&A activity in all regions, particularly in North America.

However, the success of shareholder resistance during the recent period of market volatility is also reflected in the results of the survey. About 18% of respondents regard shareholder resistance as a key risk to cross-border M&A (see figure 8). Indeed, shareholder scrutiny can be (and has been in several high-profile deals) a significant hurdle to effective execution of cross-border M&A, as highlighted by the Prudential/AIA example from the Executive Summary.

More recently, security group G4S was forced by shareholders into an embarrassing retreat from its US$8.2bn bid for Danish cleaning services firm ISS. G4S shareholders worried publicly that the deal was too big and complex, and represented a diversion from the company's core businesses. In the subsequent public fall-out, G4S's chairman stood down, and its advisers were also replaced.

Figure 8: Top eight risks and/or barriers organisations believe they will face in terms of cross-border M&A activity in the next two years

1	Increased competition
2	Political uncertainty
3	Currency fluctuations
=4	Regulatory issues
=4	Rising costs
6	Limited growth prospects
7	Integration/cultural issues
8	Shareholder resistance

High risk, high reward

Cross-border M&A poses increased challenges over and above those encountered on domestic deals. However, the challenges should not blind companies to the potential benefits that can be derived from well-planned and well-executed transactions, as cross-border deals can be powerful accelerators of growth ambitions. Our survey shows that, very often, the countries and regions which are seen as being the most risky to enter (such as China, South-east Asia or Africa) are the ones which can offer the greatest rewards.

Investors who are well-prepared and have flexible strategies and insights into local regulatory and cultural practices will be best placed to carve their way through the risks and challenges. Best practice norms for investing in more developed markets are often not effective when entering some emerging markets, for example.

As growth rates diverge between the developed and emerging world, the rewards to be gained through cross-border M&A into high-growth markets increase. The bigger risk may be to remain too geographically constrained. “People think of cross-border deals as risky, but my view is that it is more risky for the long-term health of the business not to pursue these deals,” says Don Mulligan, Chief Financial Officer, General Mills. “Yes, there are short-term risks with moving into new markets, particularly emerging economies, but companies face a much bigger strategic risk from not being there at all.”

The Clifford Chance view:

“Shareholder activism is a particular feature of the US M&A environment. However, it is clear that shareholders everywhere are becoming more active. In most cases, dialogue is a company’s best defence – open communication with shareholders is critical – as well as being able to demonstrate that the company has corporate governance best practices and a strategy known to all investors.”

Sarah Jones, M&A Partner, New York, Clifford Chance

The Clifford Chance view:

“Various techniques can be employed to minimise risks on emerging market M&A: should a buyer tie up with a local partner and has due diligence on that partner been conducted? What is the applicable regulatory framework and can bilateral investment treaties or insurance protect against discriminatory changes to it? Directors also need to consider minimising risk of exposures under legislation like US FCPA and the UK Bribery Act.”

Kem Ihenacho, Partner and co-head of Africa Practice, Clifford Chance

Sector Focus: Healthcare

Healthcare companies face increasing pressure in their established markets. Rising healthcare budget deficits have put pressure on pharmaceutical and medical device companies to reduce prices on existing products. Regulatory constraints have raised the bar for reimbursement for new therapies. R&D pipelines are drying up, and patents on former "blockbuster" products are expiring. Meanwhile, new markets are opening up, and new technologies such as biologic products are offering new opportunities, but healthcare companies need to ensure that they are in a position to take advantage of these developments.

Our survey shows that healthcare companies see M&A activity as an avenue to overcome the challenges facing the sector, and to benefit from new opportunities. More than one-half (52%) of healthcare respondents say they will look for growth through M&A. The main drivers of their M&A strategy will be to develop their core business, as well as diversify their risk portfolio.

For 72% of healthcare respondents, emerging/high-growth markets – with their increasing living standards and spending on health – will be the focus of their growth strategy, as opposed to domestic (14%) or developed foreign markets (14%). Given the significant differences in terms of regulatory framework and legal certainty in these economies, it is perhaps unsurprising that "risk exposure" is named as the most important due diligence criterion for healthcare respondents (43%) and that cultural and integration issues are named on the list of possible barriers to successful M&A.

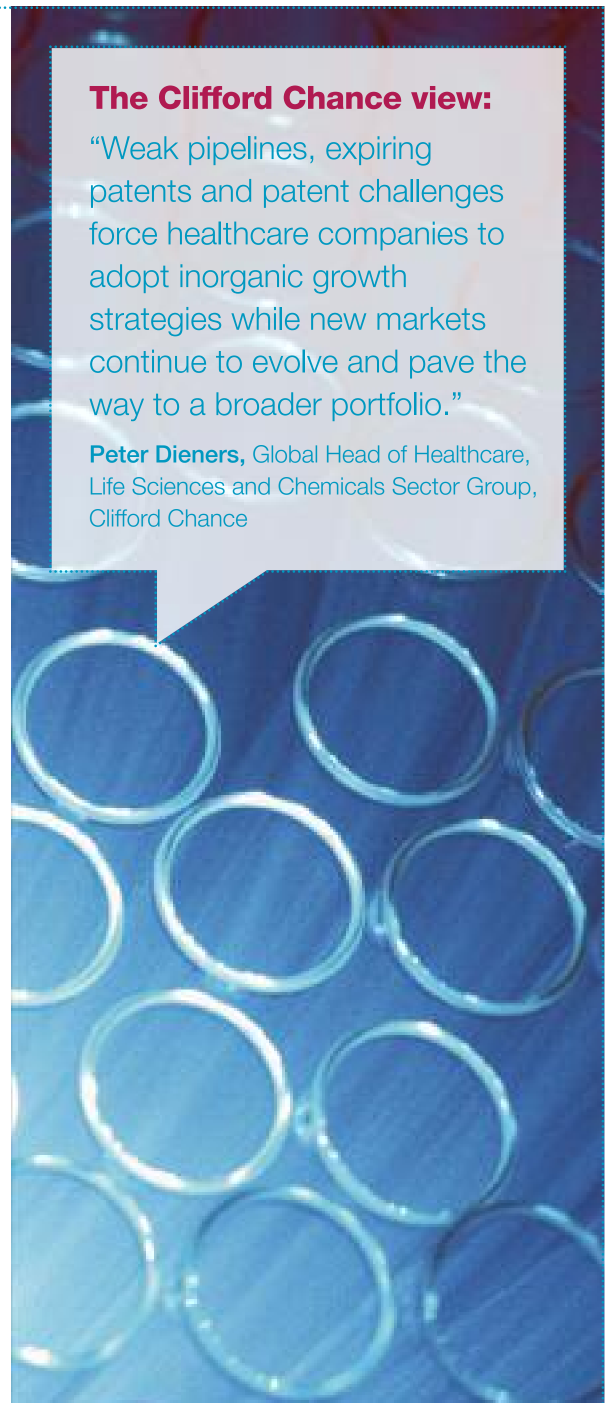
According to our survey, healthcare firms are much more likely to take up a minority investment in a local company, compared to other sectors. These minority participations are an increasingly popular alternative to traditional joint venture and partnership structures – they are seen as a useful vehicle to get initial access to new markets in times of limited availability of financing and asset price volatility.

Investors and analysts predict a surge in M&A activity in the healthcare sector, driven by biotech firms and smaller, generic drug-making companies. Biotechs will benefit from larger companies' shift away from internal R&D, and generics companies will be looking to create synergies and achieve economies of scale in increasingly competitive landscapes, especially in emerging markets. The reach and marketing expertise of larger players, who are looking for ways to plug their revenue holes, will then come into play.

The Clifford Chance view:

"Weak pipelines, expiring patents and patent challenges force healthcare companies to adopt inorganic growth strategies while new markets continue to evolve and pave the way to a broader portfolio."

Peter Dieners, Global Head of Healthcare, Life Sciences and Chemicals Sector Group, Clifford Chance



Having knowledge on the ground is very important

Norikazu Tanaka, Head of copper investment for Mitsubishi Corporation, discusses the key risks and success factors for cross-border M&A

What are your top tips for ensuring the success of a cross-border deal?

"For me, the most important key to success is having a global network, internally and also externally. Mitsubishi started off as a trading company, and so it has over 200 bases of operations around the world. Their main responsibility is to nurture and expand our networks in each region. When doing cross-border deals, having knowledge on the ground is very important – we need to engage with our local stakeholders from our internal global network. And we also need to use our relationships with our joint venture partners. There are two reasons for this: first, it helps us mitigate risk, especially monetary exposure; second, we can collect even more information from these partners and add it to our internal network.

The second factor to success is having full knowledge of the sector you operate in. This includes anything from understanding what the future holds, what the likely trends in demand and supply are, to analysing competitors and profiling customers.

Cultural integration is definitely something we need to bear in mind – it's a very important factor. We need to work together with our investment partners to overcome the cultural gap. But it's not something that can be done in a day – we need to acknowledge that it can take a few years for all cultural differences to be smoothed over.

Finally, you need to make sure you've put together a good deal team. This isn't just about the internal deal team, but also about making sure you have the right investment partners as well as tax, finance and legal advisers. Together they ensure we have the right intelligence to make a success of our investment."

In your opinion, what are the key risks of cross-border M&A?

"Cross-border deals are certainly more risky. One such risk is currency fluctuation – what makes this particularly difficult is that it is near impossible to manage.

One other risk of cross-border deals, especially when going into an emerging market, is overpaying for assets as a result of increasing competition in these markets. But an even bigger risk, at least in the copper mining industry, is the boom that the natural resources industry is experiencing. This has had some tangible effects on the cost of capital and operations, so that the total cost of acquisition is much higher than it was ten years ago.

That's not to say that cross-border transactions don't also represent great opportunity. In the sector I operate in, at least, most of our business is conducted across borders. It's very much our job to cross over [borders]."

Where do you see M&A in the natural resources and mining sector taking place over the next two years?

"The hot spots for M&A, in my opinion, will still be Chile and Peru, if not over the next two years, then over the next five years. This is mostly because of the amount of natural resources available in these countries and the quality of the copper. To the list of M&A opportunities, I would also add Central Africa, for example Zambia, and parts of Asia, including Cambodia and Papua New Guinea for the next decade.

In my view, North America is likely to see a decline in M&A activity [in the sector]. This is because as a region it is not only a production area, but also a consumption area. So, their appetite for export is quite limited compared to other regions. Another reason is that North America has very strict regulations for extraction."

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Before and during the deal: Managing risks in cross-border transactions

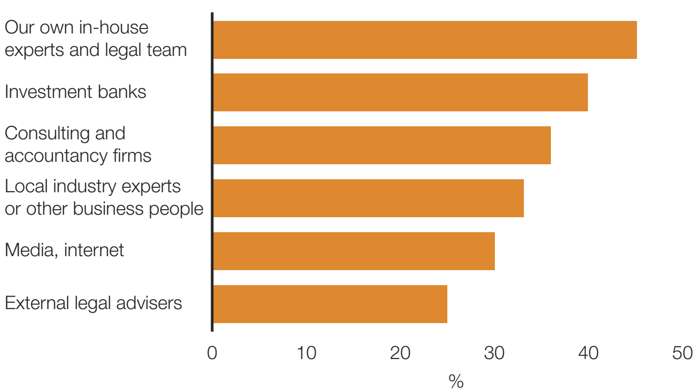
Cross-border M&A – a risky business

The success of any M&A transaction often hinges on the identification and mitigation of risk. Acquirers need a detailed understanding of the macro environment, including the political, economic and regulatory risks that might affect the viability of the deal. At the same time, they must also amass a deep knowledge of the target company, including its financials, management, culture, goals and operations.

"Experience of dealing with a company as a customer or supplier gives us confidence in how a company operates, and knowledge of where its strengths and weaknesses lie," confirms Nick Gangestad, Corporate Controller at 3M. He points out that 3M would not consider an M&A deal without having some level of operations already in place in the target destination. "There isn't a case where we've acquired a company and it's in a green space in terms of geography for us," he explains. "This means that we already understand the country risks and this gives us some level of internal capability to support that operation once 3M acquires it."

In situations where this is not possible, the process of due diligence and risk assessment becomes significantly more complex. A large company may have its own M&A deal team, but if it has no experience of the target market, it will need to draw on expertise from external advisers on the ground. Respondents to our survey say their own in-house experts and legal team are their most important sources when gathering intelligence on their proposed M&A targets, followed by investment banks, consulting and accountancy firms, local industry experts, and external legal advisers (see figure 9).

Figure 9: What do you consider to be your organisation's most important sources of intelligence on potential M&A targets?



Casting the net widely may be costly but, in a cross-border context, it is essential to seek out a broad range of inputs to the due diligence process. "What we tend to see now is that companies are well-advised and spend a lot of time looking at the territory issues that could potentially cause the deal to fall over," says Daniel Max, senior vice-president in the Private Equity and Mergers & Acquisitions team at Marsh. "People have got a lot more sophisticated in their view of the underlying risks through taking a substantial amount of advice from different parties."

The Clifford Chance view:

"Joint ventures have long been used to access emerging, high-growth markets. These structures are increasingly being considered by companies in China and other emerging economies to invest in the US and Europe."

Robert Masella, M&A Partner, New York, Clifford Chance

Risk sharing when entering new markets

The mode of entry that an acquirer adopts can make a significant difference to the level of financial, cultural and political risk to which they are exposed. Outright acquisitions, particularly in a market with which the company has limited experience, will be risky. Instead, a joint venture, partnership or minority investment may limit the acquirer's exposure to risk while it gets to know its partner – and, more importantly, the partner's local market. Local investee companies are often supportive of collaboration too. Companies in emerging markets, for example, may benefit from collaboration with global partners who can bring their international expertise to the local operation for mutual benefit.

Another factor driving the trend towards joint ventures and partnerships is the increasing number and complexity of the world's antitrust and foreign ownership regimes. In certain Middle East jurisdictions, for example, it is not possible to acquire more than 49% of a local corporate, which means investors need to structure investments as joint ventures, minority investments or collaborations, or use trust arrangements to address foreign ownership restrictions. Measures such as these are becoming increasingly widespread as governments and regulators take steps to protect local business interests against foreign investment.

Our survey also illustrates this increasing preference for joint ventures and partnerships as a mode of market entry. When asked about the deal structures they would have been most likely to pursue two years ago, respondents point to traditional M&A as the leading method. But asked how they would structure a deal today, they are most likely to choose a joint venture. As well as joint ventures, partnerships with local companies and minority investments in local companies are popular ways of entering new markets (see figures 10 and 11 overleaf).

This is not to say, of course, that joint ventures are free from risk. As with an outright acquisition, it is critical to perform extensive due diligence to get to know a potential partner and ensure that there is both strategic logic to the arrangement and a good fit with the partnering company. Clear parameters and responsibilities for each partner are also essential for success.

A recent paper from the Mergers and Acquisitions Research Centre at Cass Business School concluded that joint venture activity increases in the recovery period after a major economic downturn by over 20% compared with the average[8].

8 Sharing Risk: A Study of Corporate Alliances, Cass Business School, 2009

Figure 10: Thinking about M&A opportunities abroad, which of the following deal structures would your organisation most likely pursue?

Two years ago **Now**

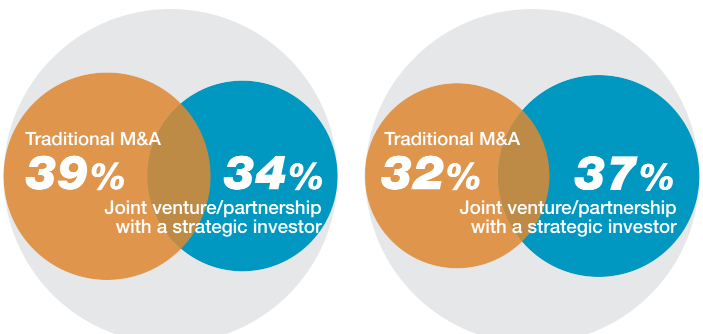


Figure 11: Top eight deal structures to be pursued on cross-border deals

1	Joint venture/partnership with a strategic investor
2	Traditional M&A
3	Minority investment in a local company
4	Partnerships with local companies
5	Asset deals
=6	Incorporating a local company to grow organically
=6	Partnership with a financial investor
8	Greenfield investments

Due diligence and deal breakers

The due diligence process in any deal comprises several important elements. Companies must scrutinise financial accounts in order to gain a thorough picture of historic performance and cash flows, and challenge the forecasting assumptions made by management. They must ensure that there are robust financial controls in place, assess the potential for operating synergies and check that the business does not present any problems from a legal or tax perspective.

By gathering this information, the potential acquirer should be able to build up a picture of the future value of the business and identify any "black holes" that could impact their assessment of value or identify any unacceptable risks. Legal due diligence is seen by many as critical in identifying such risk factors and potential deal breakers: US respondents identified legal due diligence as being the leading factor in deal failure in the last two years, above other causes of deal failure such as being outbid by others, valuation issues, and antitrust issues.

Among our respondents, scrutiny of the financial accounts is seen as the most important aspect of due diligence, followed closely by risk exposure and tax scrutiny (see figure 12).

Yet despite recognising the importance of financial due diligence, this is an area where many companies say that they struggle. Less than one-half of respondents think that their organisation is effective at managing financial risks in a cross-border context.

Figure 12: When thinking about due diligence associated with M&A, which areas are the most important for your organisation?

Case study: Eden Springs

In the 15 years since its launch, the Switzerland-based company Eden Springs has made 77 acquisitions, all in Europe and most outside Switzerland. To deal with this volume of transactions, the company, which sells water-coolers and related technology, has established a team that identifies risks and works through a standard due diligence checklist. "Good preparation saves a lot of mistakes," says Ranaan Zilberman, Eden Springs' CEO. "We know exactly what we are going to check when we carry out due diligence on cross-border acquisitions."

To conduct its due diligence, Eden Springs uses a mix of global advisers and local experts who understand the language and the nuances of the business environment. "When you are acquiring a target in a different market, you have to assume that you don't understand everything and take the position of a student for a while," says Mr Zilberman. "There are many factors to consider, including labour laws, regulations, benefit schemes, antitrust issues, unions and transparency in reporting. In a cross-border context, these issues are even more complex."

Eden Springs has made several acquisitions in Eastern Europe, which have posed specific challenges from a reporting perspective. "If I look at the books of a company in Western Europe, there is a good chance that the auditors have reflected the situation on the ground relatively well," explains Mr Zilberman. "When you work in Eastern Europe – with entrepreneurs, rather than with corporates – they have their own way of reporting and you need to take that into account."

One approach that Eden Springs has used to reduce the risk in a cross-border deal is to avoid making a full acquisition. "Sometimes we strike a deal of 51/49 or 60/40 equity stake, and we give the local entrepreneurs an incentive plan to run the business for a few years with the potential to exit," says Mr Zilberman. "That creates a win-win situation: we have the time to learn about the company and the market, and the seller also derives benefits."

Although none of the company's acquisitions have been failures, there have occasionally been mistakes, such as lower-than-expected growth, or reported data that did not match the reality. A key pitfall to avoid, according to Mr Zilberman, is the "sin of pride": acquiring a company in the belief that you can run it better than the existing management. An acquisition has to be made on the basis that it will provide some kind of leverage, whether in terms of operational excellence, IT systems or access to new customers.

Many transactions go wrong after the deal has been signed because of difficulties in integration. The key here, believes Mr Zilberman, is speed. "Uncertainty is the enemy of any acquisition," he explains. "We try to finish all the changes in less than 90 days. In order to do that, everything needs to be prepared in advance. Before we finalise the acquisition, we know more or less how the integration plan is going to end."

"Sometimes we strike a deal of 51/49 or 60/40 equity stake, and we give the local entrepreneurs an incentive plan to run the business for a few years with the potential to exit.That creates a win-win situation: we have the time to learn about the company and the market, and the seller also derives benefits."

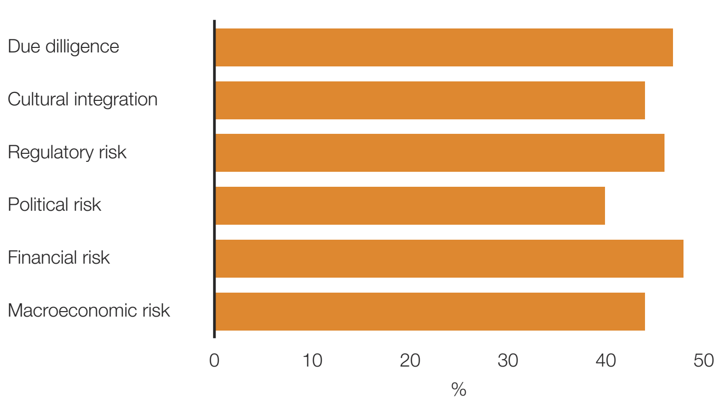
Ranaan Zilberman, CEO, Eden Springs

More generally, just 47% of respondents (and only 17% in the US) say that they are effective at handling due diligence (see figure 13). This highlights the need for many companies to rely on advisers with local expertise and experience to provide them with a knowledgeable, on-the-ground assessment of the risks. "If you're an overseas buyer, you need to engage a specialist in your target market, not ship some ideas in based on your hometown experience," says Chris Thorne, technical director of the International Valuation Standards Council.

In a cross-border context, a key problem with due diligence – particularly financial due diligence – can be poor transparency or availability of data, particularly in emerging markets or in transactions where the target is relatively small. Companies may also need to take into consideration differing accounting practices and corporate governance requirements in the destination country.

Our survey suggests that commercial and legal due diligence are the primary cause of deals failing before completion – ahead of pricing and valuation volatility, financing falling through and a general breakdown in negotiations. Due diligence findings do not have to kill a deal, but they may affect the valuation that the acquirer is prepared to place on the asset. "There will be times when there is such poor information that we need to factor that into how we value an asset," says Nick Gangestad of 3M. "It may not be enough to prevent us from doing a deal but it will encourage us to discount more aggressively the cash flow and reduce the amount of value that we are willing to assign to it."

Figure 13: Respondents who rated themselves as "effective" at managing the following aspects of M&A risk in cross-border deals



Integrity due diligence and political risk

Thorough due diligence requires more than simply an assessment of the financials and the legal and tax positions of the target. To gain a better understanding of a target, how it operates, and the culture of its management team, acquirers also need to conduct detailed integrity due diligence. This will give them a better understanding of the target, including its reputation, political connections, the track record of its management team, and its approach and procedures in respect of key areas of risk management, such as anti-corruption policies and practices.

The Clifford Chance view:

"Emerging, high growth markets – carrying the highest integrity risks, but often the highest rewards for M&A – require tailored due diligence to deal with data privacy, statutory restrictions, and often target pushback. Where these limitations make detailed due diligence difficult, the key is to know what information is critical to accurately assess the risks, any alternate means to obtain that information, and when (or if) to move forward without it. That knowledge comes with experience of those markets and the applicable regulatory regimes, and most importantly, experience with the regulators."

Wendy Wysong, Litigation and Dispute Resolution Partner, Hong Kong, Clifford Chance

One important driver of the current increased focus on integrity due diligence has been legislation such as the US Foreign Corrupt Practices Act and the UK Bribery Act, both of which have effective extra-territorial reach. Under the US legislation, acquiring companies must demonstrate that, as part of due diligence, they have evaluated the target's anti-corruption and anti-bribery processes.

Corrupt practices in a target company not only present legal and reputational risks, they can also affect the financial viability of a deal. If the target derives a proportion of its revenues from sales that are generated through corrupt means, and the acquiring company puts a stop to that activity as a result of the due diligence process, then this could have a significant impact on the future cash flows of the firm.

Integrity due diligence should also explore the extent of political links between the target company management and government officials. Strong links with the government can be an asset but, if there is a change in political leadership, they can also become a liability. Among our respondents, leadership uncertainty in government is seen as the key political risk that they face in cross-border M&A (see figure 14). This finding may also reflect current fears about the possibility of politically-motivated investment policy and related tax decisions following events in 2012 such as the US and French presidential elections and the impending leadership transition in China.

For respondents who indicated a focus on high-growth markets for their M&A strategy, two key political risks are the poor protection of foreign investors' rights, and bribery and corruption.

Figure 14: Top five biggest political risks when considering cross-border M&A opportunities within the next two years

1	Political leadership uncertainty
=2	Protectionist measures/political pressures
=2	Bribery and corruption
4	Over-regulation
5	Poor protection of foreign investors' economic rights

The Clifford Chance view:

"We clearly saw the effects that leadership uncertainty can have on M&A appetite and activity in Russia in the first quarter of 2012. We generally saw activity levels slow in the lead-up to the election in March. Clearly this had little to do with the personnel involved - but investors were concerned to understand the policy changes that may be introduced and the effect they may have on the economic environment in which deals are being done."

Nicholas Rees, M&A Partner, Moscow, Clifford Chance

The Clifford Chance view: Accessing new markets

One key trend that we are seeing, as reinforced by the results of our survey, is an increasing appetite to take advantage of the higher growth potential found in emerging markets. This is not only evident among organisations in developed economies like Europe and the US, but also on a regional level with a clear rise in intra-emerging market activity.

Clients who are moving into a new market, particularly an emerging market jurisdiction, often find themselves out of their comfort zone, so take this step with some trepidation. Again this comes across in the results of our survey, where political uncertainty, protectionism, restrictions on levels of foreign ownership, corruption, antitrust and tax laws all rank highly as areas of concern. We find that even on intra-regional M&A there is still a degree of nervousness when crossing borders.

It is clear that investment in emerging markets carries with it increased risk, whether through cultural differences, language issues, regulatory hurdles, unknown legal frameworks or even, in some areas, corruption and the mistreatment of outside investors. But in nearly all cases, some political angle comes into play on deals in a way that is unfamiliar to clients entering the emerging markets for the first time.

So while a key responsibility for us when advising on these transactions is to guide the client through the law and regulation of the target country, our role is in reality so much broader. We need to prepare clients for the local political, cultural and regulatory issues they are likely to encounter, for example the uncertainties of the local legal system, the difficulty in predicting regulatory processes, the frustrations of operating in unfamiliar markets, different standards of corporate governance, and often a surprising unavailability of the type of information they may be used to relying upon in home markets. Our job is to show clients the best way through these challenges so they can get their deal done as safely and swiftly as possible. It's really about demystifying issues and finding solutions.

Being sensitive to the local political and cultural issues in regions like the Middle East, South-east Asia, or Latin America can be critical. And here, respect is key – it's very important to deal with local culture and processes in a cooperative and inclusive way and to adapt international practices to those of the target country. Emerging markets can be very different from developed markets. The increasing complexity of regulatory, financial, political and cultural challenges means there is a need for advisers to have a different range of specialist skills and a flexible mentality – international quality and expertise, local knowledge and contacts, and of course the resources and technical ability to get the deal done.

Guy Norman, Head of Corporate, Middle East – Clifford Chance: Tel: +971 43620 615 Email: guy.norman@cliffordchance.com

Sector Focus: Mining

According to investment software specialist Dealogic, January 2012 saw the slowest start for M&A since 2003. But a look at the mining sector paints quite a different picture. In early 2012, Glencore approached Xstrata with a US$61.9bn all-share takeover that would combine the world's largest commodities trading house with one of the world's largest mining groups. Many see the Glencore-Xstrata merger as the latest evidence that strong M&A activity in the mining sector will be a hallmark of 2012, continuing the trend of the last two years.

In our survey, responses from the mining industry stand in contrast to overall trends. For one, there is significant sovereign wealth fund and state-owned enterprise investment for financing deals (32% of mining sector respondents see this as their preferred source of financing, against 14% overall – cash reserves top the figures for everyone else). And while financial accounts are the most important due diligence consideration for respondents generally, corruption and tax top the list of due diligence concerns in this industry. Mining sector respondents also report over-regulation and financial regulation as key risk factors in cross-border deal-making.

Our respondents' concerns can be easily mapped onto recent developments. There is a continuing trend towards "resource nationalism" globally, with recent examples including Indonesia's plans to ban the export of raw minerals by 2014, Australia's pending Mineral Resource Rent Tax and Zimbabwe's plans to force miners to retain export earnings in local banks. And pressure is mounting against China's practices in the rare earths market, with the recent lawsuit by the US, EU and Japan at the World Trade Organization.

Stories like these perhaps also, in part, explain why a minority investment in a local company is a more popular growth strategy in the mining sector (41%) than in others (30% on average). There are a number of other reasons for the preference for minority investments in local companies, including offtakers locking in minority investments to underpin relationships, trading houses seeking to track underlying commodity price movements, and investors requiring local expertise to execute projects. Foreign investment restrictions also play a role in this preference.

"Those who are looking to cross borders need to keep an eye on risks. In the natural resources and mining sector, in my opinion, environmental and social risks are the ones that tend to be underestimated during transactions. This is on top of rising costs as a result of a boom in the sector – labour, energy, water, steel and pipes costs have all hiked considerably over the last ten years."

Norikazu Tanaka, Head of copper investment for Mitsubishi Corporation

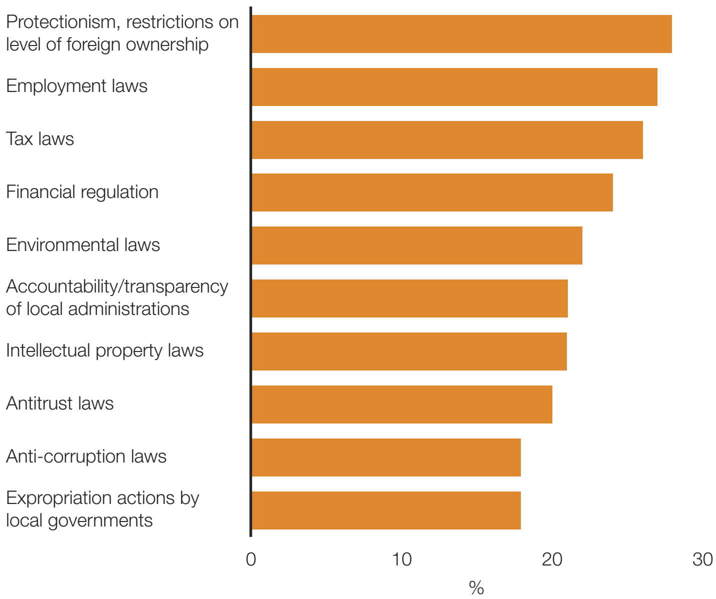
Taxing issues

Around the world, tax authorities are becoming more aggressive in their efforts to collect revenues from corporate taxpayers. Information is being shared across borders to an unprecedented extent and tax administrations are tightening their enforcement. According to recent research, 78% of the world's largest companies say they are already experiencing greater risk or uncertainty around tax legislation, and this figure increases for those in emerging markets[9].

Among our respondents, tax laws are seen as the most severe legal and regulatory risks associated with domestic transactions and the third most severe in a cross-border situation (see figure 15).

The costs of getting tax wrong can be considerable. Following its 2007 acquisition of the Indian company Hutchison Essar, the telecoms giant Vodafone has been embroiled in a five-year legal battle over a US$2.6bn bill for capital gains tax that the Indian authorities claimed was payable. Even though Vodafone eventually won the case when the Indian Supreme Court over-ruled an earlier decision by the High Court in Mumbai, the issue continues to rumble on, with the Indian government proposing retrospective legislation which would effectively overturn the Supreme Court's decision. This episode illustrates the scale of the risk that acquirers can face, particularly in emerging markets where tax policy may be less developed or tested.

Figure 15: When considering cross-border M&A opportunities over the next two years, which of the following do you see as the biggest legal or regulatory risks for your organisation?



The Clifford Chance view:

"The trend towards tightening up on tax enforcement is not limited to emerging markets. The UK government is set to introduce a "general anti-abuse rule" into UK tax legislation and recently has even resorted to retrospective legislation of its own to clamp down on perceived tax avoidance. Such actions create a great deal of uncertainty and governments run a real risk of deterring inward investment as a result."

Nicholas Mace, Tax Partner, London, Clifford Chance

9 2011–12 Tax risk and controversy survey: A new era of global risk and uncertainty, 2011 Ernst & Young

4

After the deal: The importance of effective integration

Cultural integration

There are few projects that are as complex and prone to error as post-merger integration. Once a deal has been completed, management teams must move quickly to integrate functions, consolidate accounting and reporting systems, implement risk and controls frameworks, impose new processes and realise expected synergies. They must do so under the watchful eye of management and shareholders, and they must execute this project at the same time as their normal business responsibilities. No wonder that academic literature estimates that one in two post-merger integrations fares poorly[10].

Among our respondents, just 44% say that they are effective at cultural integration. Looking at the geographical split of our respondents, it's worth noting that those from North America are much less confident about their ability to manage cultural integration (22%) compared to their Asia-Pacific (57%) and European (52%) counterparts.

There are numerous dimensions in which cultural gaps between target and acquirer can pose a problem. In addition to the obvious differences of language, religion and other local differences, the two companies may have very different styles of decision-making. For example, a US multinational may take a very analytical, process-driven approach, whereas an Asian company may have a greater tolerance of ambiguity and rely more on "gut feeling". There may also be hierarchical differences, with one company adopting a flatter approach in which dissent of senior management is encouraged, and the other reliant on a more compliant or command-and-control approach to decision-making.

10 Johannes Gerds and Gerhard Schewe, *Post Merger Integration* (Berlin: Springer Verlag, 2009), 3rd edition.

Speed of integration, sensitivity of approach

The speed with which a company integrates the target company will depend on the type of deal being conducted. In transactions where the benefits are heavily dependent on synergies, it will be important to move quickly. But in deals where growth is the priority, integration can proceed gradually because it is more important to retain the target's management team and customers.

Speedy integration risks causing problems, though, if not managed sensitively. It risks alienating the management that the acquirer is seeking to retain, or simply overwhelming the target with too many projects and responsibilities to fulfil. "You need to be sensitive to how the integration process will affect the target company," says Don Mulligan, Chief Financial Officer of General Mills. "There's a risk that, when acquiring an asset in another market, you focus on the hard assets but don't do enough to nurture the soft assets. You can siphon off a lot of value if you don't manage that risk appropriately."

One way of ensuring that integration proceeds at the right pace is to put in place a senior executive who can serve as the intermediary between the acquirer and target. "You need someone close to the target business who understands where the value is being created," explains Mr Mulligan. "You don't want the corporate machine to overwhelm the target and undermine the softer, intangible assets that you have purchased. Having someone in the middle helps the target company understand why certain processes need to be added but also helps the acquirer to phase the integration process at an appropriate speed."

Integration that happens too slowly can also create problems. Having completed the transaction, the acquirer may delay starting the integration process, perhaps because they are worried about destroying the value that they have acquired.

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Case study: Hinduja Global Solutions

In recent years, the Indian business process outsourcing provider Hinduja Global Solutions (HGS) has conducted a series of cross-border acquisitions in North America, Europe and Asia. So familiar has the process become that Partha Desarkar, CEO of the company, describes M&A as a "core competency" of the firm.

According to Mr Desarkar, a key reason for the success of the company's transactions has been that it does not have a stand-alone deal team. "The people who run the business get to do the deals," he explains. "They can't walk away and go onto the next deal – their credibility rests on the fact that the deal was worth every penny they said should be paid for it."

HGS uses a standard checklist to evaluate the risks of an acquisition and tries to structure the deal in a way that mitigates those risks. When it acquired the Canadian company OLS in 2011, it deferred some of the payment on the basis that the target would need to retain its client and ensure continuity. "A part of the acquisition proceeds will only go to the sellers after 18 months if the target continues to grow," says Mr Desarkar. "This reduces the risk of any client leaving because of this acquisition."

Mr Desarkar acknowledges that there is extra work to be done in a cross-border acquisition. With the OLS deal, human resources due diligence has been particularly thorough because employment law varies between states in Canada, and the company has had to make sure that it is familiar with the nuances.

Valuation can also be harder in a cross-border deal, but Mr Desarkar argues that, if the price gets too high, it is important to be able to walk away from a deal. "Acquiring companies often lose their financial prudence and discipline just to do a deal, and try to rationalise it by saying that the synergies of this acquisition justify the huge price they are paying," he explains. "The synergies turn out to be more theoretical than real, and then you're straddled with a company that is eating value."

Mr Desarkar agrees that cultural differences can be a challenging part of the integration process, but believes that they can be addressed partly by retaining key employees in the target firm and recognising that they have the business expertise and client knowledge to do the job well. For example, OLS employees who have been in client-servicing roles will stay after the acquisition. "We have retained the CEO and the core executive team," he says. "So as far as clients are concerned, they see no risk of an Indian company acquiring a Canadian asset and then stripping it for profit, putting in Indian management and risking client relationships."

> "Acquiring companies often lose their financial prudence and discipline just to do a deal, and try to rationalise it by saying that the synergies of this acquisition justify the huge price they are paying."
>
> **Partha Desarker,** CEO, Hinduja Global Solutions

5 Conclusion

With the global economic recovery still proceeding at a slow pace, M&A activity is likely to remain below the highs of 2005 and 2006 for some time to come. But as companies in developed markets look further afield for growth, and as emerging market firms venture overseas in search of new markets, resources and expertise, cross-border transactions are likely to comprise an increasingly large proportion of overall M&A volumes.

Although M&A deals have often been seen as being highly susceptible to failure, there is an emerging body of academic work that suggests that those who engage in M&A activity tend to outperform those who do not. In a cross-border context, transactions can be significant value creators. They can help companies to diversify their geographical exposure, develop new markets, and share expertise and resources across borders.

But any company that downplays the risks associated with cross-border deals would be foolhardy. Geographical and cultural differences magnify the risks of getting a deal wrong. All too often, companies can over-estimate the benefits of a deal or the value of an asset, and underestimate the high degree of complexity associated with bridging divergent regulatory, reporting and political environments. Deals that look good on paper can quickly flounder as these issues bubble to the surface.

Ultimately, there are a number of factors that separate those cross-border deals that succeed from those that fail. Most critical of all is the commitment of resources and time, and careful preparation.

When considering or planning deals, companies must adopt a rigorous approach to identifying risks. In this context, due diligence takes on even greater importance. Financial due diligence is just one aspect that requires investigation – acquirers should also assure themselves that they are comfortable with how the target operates, the experience and relationships of the management team and the integrity of its business practice.

Companies must also be willing to draw on pools of both internal and external expertise, particularly local experts in the target market. Appointing advisers adds to the costs of a transaction, but can create significant value if the process identifies problems that may later turn out to undermine the success of the deal. The guidance of external advisers can also be invaluable in assisting newcomers to navigate the cultural, political, regulatory and legal frameworks of new markets.

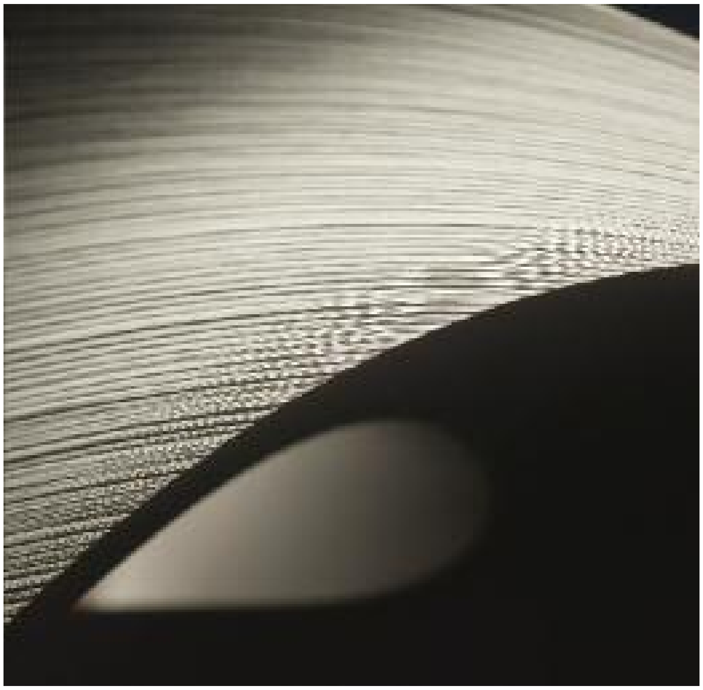
Finally, there must be a realistic, well-resourced and well-planned integration programme. Acquirers must be realistic about the revenue and cost synergies that they will be able to deliver, and set a pace for integration that enables benefits to be derived but that does not unsettle the target.

The capabilities required for successful cross-border deals are becoming increasingly critical as international diversification and expansion become keys to long-term success. Not every company will want to conduct cross-border deals, and many will be deterred by the associated risks. But those companies that are willing to grow by cross-border acquisition, and can manage those risks effectively, will find themselves with more options to grow their business and take advantage of international opportunities.

The Clifford Chance view:

"The research study conducted by the Economist Intelligence Unit on our behalf provides many insights into the current mindset of companies considering M&A, demonstrating that today's global M&A market is diverse and complex. Drivers of M&A strategy and the perceptions of barriers and challenges to deal-making vary dramatically around the world. As the world begins to re-shape following the crisis, companies need to acknowledge and understand these risks in order to successfully grasp the much sought after new market opportunities."

Matthew Layton, Global Head of Corporate, Clifford Chance LLP



About the research

In the first quarter of 2012, the Economist Intelligence Unit carried out a global survey on behalf of Clifford Chance to assess current approaches to risk management in cross-border mergers and acquisitions. It explored current and future plans for M&A activity, and key barriers that might get in the way of successful cross-border deals.

The Economist Intelligence Unit surveyed 377 respondents from a wide range of industries and regions. Approximately 30% were based in North America, 29% in Asia-Pacific, 27% in Western Europe, and the remainder in the Middle East, Africa, Eastern Europe and Latin America. All respondents represented companies with annual revenues in excess of US$1bn, and 50% were C-level, or board-level, executives. The vast majority of respondents had responsibility for strategy and development, and finance.

To supplement the survey, the Economist Intelligence Unit conducted a series of in-depth interviews with senior executives and industry specialists from a number of major companies:

- Norikazu Tanaka, Head of copper investment, Mitsubishi Corporation
- Partha Desarkar, CEO, Hinduja Global Solutions
- Nick Gangestad, Corporate Controller, 3M
- Daniel Max, senior vice-president in the Private Equity and Mergers & Acquisitions team, Marsh
- Don Mulligan, Chief Financial Officer, General Mills
- Chris Thorne, technical director, International Valuation Standards Council
- Ranaan Zilberman, CEO, Eden Springs

The following experts were also interviewed, but are not quoted in the research:

- Almira Cemmell, director in the global risk and investigations practice at FTI Consulting
- Emma Codd and Peter Maher, partners in the Forensic and Dispute Services practice at Deloitte
- David Furniss, a partner at Livingstone Partners
- Rhys Phillip, head of M&A in UK and Ireland for Ernst & Young

We are grateful to all the interviewees and survey participants for their valuable time and insights.

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