How Trump's Trade Wars Are Affecting M&A Target Valuation

By **Eric Emerson**

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The recognition of potential liability arising from international regulatory regimes has long been part of a normal due diligence assessment. For many years now, acquirers have included an analysis of exposure under antibribery laws like the U.S. Foreign Corrupt Practices Act and the U.S. Antibribery Act, as well as liability under export control and economic sanctions regimes, when assessing target valuation.

But what is rarely included in this process is an in-depth analysis of the impact of changes to international trade policy on a target company's business — and for good reason. Prior to January 2017, trade policy was stable and predictable. Trade agreements were well-entrenched; tariffs were generally low and trended downwards. Outside the occasional antidumping/countervailing duty case, trade cases were rare.

But the Trump administration has upended all of these expectations — in many cases, dramatically — and this has left companies scrambling to protect their supply lines and manage their duty exposure. As a result, acquirers of companies with substantial involvement with imported merchandise must now take into account the potential impact of these changes in international trade policy when conducting due diligence to value a target, or face the possibility of significantly overpaying.

Consider the following hypothetical: A fund is considering acquiring First Auto Parts Inc., a privately owned national distributor/manufacturer of aftermarket auto parts. First Auto Parts imports most of the merchandise it sells, but also produces its own line of parts in the United States. Through favorable long-term supply and distribution relationships, the company has been able to return an attractive EBITDA in this competitive, price-sensitive market.

Initial due diligence reveals that First Auto Parts has broad exposure to the global marketplace. The majority of First Auto Parts' imported stock of finished products comes from suppliers in China and India. To support its U.S. production, First Auto Parts imports specialty steel from Japan and Korea, and a significant percentage of its U.S. production is exported to Europe.

The deal team has concerns that their normal due diligence process is not designed to identify and quantity the onslaught of changes in international trade on First Auto Parts' business, and wants to add a trade policy component to that review.

The first step is to analyze the impact of recent trade actions on First Auto Parts' ability to obtain supply from its traditional sources. As a result of an investigation conducted under Section 301 of the Trade Act of 1974, the United States has imposed duties on an ever-growing list of products imported from China. Today, $250 billion in goods imported from

China are covered by a 25% tariff, and another $300 billion are threatened with the same.

Given the scope of the products involved, it is almost certain that the cost of most, or perhaps all, of First Auto Parts' purchases from China have increased by 25% within the last several months, or will do so shortly. Assessing First Auto Parts' reliance on imports from China, determining whether alternative non-China sources of supply exist, and making an assessment of the possible trajectory of U.S.-China trade relations will all be critical in accurately assessing the impact of these tariffs on the target's cost of merchandise.

First Auto Parts' India supply is also potentially at risk. Duty-free benefits extended to India under the Generalized System of Preferences program ended last month, as a result of the Trump administration's conclusion that India failed to abide by the terms of GSP eligibility. Once that happened, $5.9 billion in imports from India became subject to normal duty liability. Auto parts are generally not affected by this revocation, but it is possible that some of First Auto Parts' supply could be impacted.

Furthermore, the United States Trade Representative has suggested that India may also be targeted with a Section 301 investigation similar to the one ongoing against China. If initiated, and if duties are imposed, this could increase the cost of First Auto Parts' India purchases.

The acquirer must also consider the impact of the "national security" investigation of autos and auto parts that is being conducted under Section 232 of the Trade Expansion Act of 1962. In this investigation, the U.S. Department of Commerce has investigated whether imports of autos and auto parts have threatened to harm national security. The U.S. Department of Commerce has delivered its report to the president, who was supposed to have issued a decision on the appropriate remedy by mid-May.

The president has deferred his decision for six months, pending negotiations with the United States' major auto trading partners. But should these negotiations fail, the president would have statutory authority to impose additional trade restrictions on imports of the auto parts First Auto Parts sources from abroad.

Finally, a number of auto parts are subject to antidumping and countervailing duty orders — remedies that are designed to offset unfair trade practices through additional duties. Products that are or have been covered by AD/CVD orders include steel wheels, passenger tires and windshields. If First Auto Parts is directly importing goods subject to an AD/CVD order, it could be liable to additional AD/CVD duties in future administrative proceedings conducted by the Commerce Department.

First Auto Parts' U.S. production is not insulated from risk either. First Auto Parts' steel imports from Japan and Korea are likely subject to additional duties due to an entirely separate Section 232 "national security" investigation focused on global steel and aluminum imports. As a result of this proceeding, restrictive annual quotas have been imposed on half a dozen countries, including Korea, and duties of 25% have been imposed on imports from the remainder, including Japan.

For First Auto Parts, its imports of steel from Japan are likely to have become more expensive unless it has been able to obtain an exclusion for its imports, something that should be confirmed preacquisition. By contrast, First Auto Parts' steel purchases from Korea could continue to enter duty-free, but annual quotas might limit the company from obtaining all the steel it needs.

Finally, the company's exports to Europe are at risk. As a result of the long-standing feud between Boeing and Airbus, both the United States and the European Union are on the point of imposing duties on each other's imports in retaliation for subsidies granted to each aircraft manufacturer. U.S. duties could be imposed in mid-2019; the EU is likely to retaliate in late 2019 or early 2020. While auto parts are not currently targeted by the EU, this list could be amended or expanded to include additional items.

Any or all of these actions could have a significant impact on First Auto Parts' profitability. While the target might be able to pass some of this additional cost on to its customers, at least a portion of this additional cost is likely to impact the bottom line. So how is an acquirer to estimate the potential impact on the target's valuation?

The first step is to analyze what the target company has done already to address this risk. It seems likely that a company with as much exposure as First Auto Parts has already started to mitigate its risks, either by seeking exclusions from these special tariffs or by seeking suppliers in alternate countries.

But exclusions are not available in every case — and are not always easy to obtain even when the process is available — and suppliers in countries not subject to these proceedings are under increasing demand. Thus, just like an acquirer would normally review a target's compliance program as part of its due diligence process, an acquirer should determine what steps a target has taken to shield itself from increased liability.

The next step is to analyze the company's "hot spots" — those areas where the company faces the greatest potential exposure to increased cost. For First Auto Parts, that analysis would be both on the purchase side and on the sales side, and would require identifying which material sources and which customers are either the largest or the most strategically important. This analysis would reveal where First Auto Parts would have no choice but to take on additional liability, which could then be quantified in the due diligence process.

As the last step in the due diligence process, some assessment needs to be made of the possible future trajectory of the most significant trade disputes affecting the target. No one has a crystal ball, certainly not in this environment, but seasoned trade practitioners might be able to provide some insights into the possible outcomes of some of these disputes.

Post-closing, the acquiring company will want to pursue actions to improve target's position, particularly if the target has not been active in this area. For First Auto Parts, in addition to commercial considerations like diversifying its supply chain, this mitigation strategy would include determining whether any Section 301 duties paid could be recovered through duty drawback, or whether the company could legally avoid duties through more rigorous country of origin determinations, for example. Not every tool is right for every company, but the range of available options is broad enough that First Auto Parts should be able to find at least some approaches to reduce its liability.

In short, changes in international trade policy over the last two years necessitate adding these issues to the ever-expanding list of issues that must be addressed as part of due diligence in the M&A context. A failure to consider these issues could result in a significant and unforeseen impairment in a target company's profitability, and thus its value.

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