

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

TRADE WAR & TARIFFS MANUFACTURE A NEW NORMAL FOR PRIVATE EQUITY

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The U.S.-China trade war has added new levels of instability to conducting business worldwide. Between nations' clashing foreign policies, the resulting peaks and valleys of their markets, and fears of sparking or accelerating the arrival of a recession, an environment of certainty seems a distant hope.

Such uncertainty is anathema to the confidence needed for investment capital to flow freely. For private equity funds with portfolio companies that have operations in or are exposed to a China-based supply chain, the trade war has presented new challenges. It has had a particular impact on industrial companies that have relied on China as a key source of parts and materials. For those who have been relying on China as a sole supplier or trading partner, the impact has been felt far more keenly.

Much has already been said about the trillions of dollars in dry powder that private equity has on hand to put towards new investments. How are PE funds responding to such geopolitical

uncertainty? Are investment strategies changing in response to the trade war? Is capital being deployed or are investors in "wait-and-see" mode?

FOR PRIVATE EQUITY, TARIFFS PRESENT RISK AND OPPORTUNITY

Since the start of the trade war in 2018, the United States has imposed tariffs on more than [\\$375 billion](#) worth of imports from China and is slated to impose tariffs on another \$160 billion worth come December 15, at which point the tariffs will touch essentially every product China exports to the United States. For its part, China has imposed \$110 billion of tariffs on U.S. exports. The trade war has dampened global economic activity as companies and consumers contend with the anxieties of more instability. The U.S. Federal Reserve has estimated the trade war will reduce global economic output by \$850 billion.

At the beginning of November, the Institute for Supply Management (ISM) reported that the U.S. manufacturing industry in October continued to contract, after seeing in September the biggest monthly contraction since the end of the Great Recession.

"Global trade remains the most significant cross-industry issue," the ISM said. "Food, Beverage & Tobacco Products remains the strongest industry sector and Transportation Equipment the weakest sector. Overall, sentiment this month remains cautious regarding near-term growth."

For many private equity funds, the trade war and increased tariffs present an unpalatable risk. Manufacturing and distribution comprise about 30% of private equity's industry investment portfolio. Though there are ways to circumvent the impact of the tariffs on China-based manufacturing—for example, by relocating factories or facilities to countries other than China—like Vietnam or, because of favorable tariffs under NAFTA, Mexico—these efforts can be costly or completely cost-prohibitive.

The extent to which the trade war is having a material impact on PE in large part depends on where portfolio companies' operations reside. While portfolio companies with China supply chain exposure may be juggling how to manage rising costs, their counterparts in the neighboring countries to which companies are moving parts of their operations are seeing an [influx](#) of new business opportunities. In fact, some private equity funds have acquired companies in those countries, perhaps indicating they anticipate tariff turmoil to continue in the near- to medium term.

Prospective investing in companies with potential exposure to China-based supply chains carries concerns about extended lead times and the potential disruption inherent in having to find alternatives that meet specification, design and quality requirements. Private equity firms are either pricing exposure to China supply chains at a material discount or avoiding such exposure altogether.

However, where one fund may see too much risk, another may see ripe opportunity. If valuations for potential targets are coming down as a result of a target's exposure to China-based supply chains, now could be an opportune time to invest. Indeed, some funds are doing just that, with the expectation that trade turmoil will abate during a five-to-seven-year hold period.

HAVE TARIFFS HAD THEIR INTENDED EFFECT?

One question being asked is whether the tariffs have had their intended effect of encouraging onshore investment and the purchase of domestic products. Reports vary on the impact of the steel and aluminum tariffs on imports from almost all countries (not just China) on domestic manufacturers. But because U.S. businesses have become much more strategic in sourcing steel and aluminum globally at competitive prices, they have found themselves at a competitive disadvantage as they negotiate

12 industries reported contraction in October. From greatest to least, they are:



- ▶ Primary metals
- ▶ Apparel, leather and allied products
- ▶ Textile mills
- ▶ Transportation equipment
- ▶ Plastics and rubber products
- ▶ Machinery
- ▶ Chemical products
- ▶ Petroleum and coal products
- ▶ Electrical equipment, appliances and components
- ▶ Fabricated metal products
- ▶ Miscellaneous manufacturing
- ▶ Paper products

5 industries that reported growth are:



- ▶ Furniture and related products
- ▶ Printing and related support products
- ▶ Food, beverage and tobacco products
- ▶ Wood products
- ▶ Computer and electronic products

Source: October 2019 Manufacturing ISM® Report on Business®

replacement sources. The United States is not the only significant importer of China's output. For other countries, importing steel and aluminum from China is business as usual.

Aside from reduced tariffs, moving operations abroad is largely motivated by savings in international logistics and labor costs. Reshoring, or moving operations back to the United States, is likely to happen if tariffs continue to rise, pushing up costs; if foreign wages rise; or if domestic sources become comparable in cost to, if not par with, foreign ones.

CHINA-U.S. RELATIONS: A NEW STATUS QUO

There has been speculation that the election in 2020 could impact the future of trade tensions, and thus alter the investment climate further. However, a change in administration is not likely to yield a return to the status quo. The United States' stance toward China, while evolving during a Republican administration, in fact has bipartisan support. In September, for example, Sen. Chuck Schumer (D-NY) was one of two senators who asked the Federal Communications Commission to review two licenses that give Chinese telecommunications companies China Telecom and China Unicom the right to use U.S. networks. Schumer, who was joined by Tom Cotton (R-AK), voiced national security concerns.

FIVE INITIAL STEPS PRIVATE EQUITY FIRMS CAN TAKE TO NAVIGATE TRADE UPHEAVAL

ASSESS IMPACT



M&D fund managers may need to seek expert advisors to assist them in reviewing the full text of Executive Orders imposing increased tariffs and well as exclusion orders issued by the Office of the U.S. Trade Representative and the U.S. Commerce Department. These documents include highly technical language concerning, e.g., specific tariff codes under the Harmonized Tariff Schedule of the United States (HTSUS) and specific exemptions in Chapter 99 of the HTSUS based on narrow product descriptions. Fund managers also need to measure the specific impact of the tariffs and any exemptions on product lines for each company within a portfolio to gauge the holistic effect on the bottom line of these companies. Private Equity firms may wish to advise companies to submit product exclusion requests, which, if approved by the government, can save high volume importers millions in tariffs. General Partners (GPs) should be prepared to communicate with investors about the potential impact of tariffs or free trade agreement changes (such as the pending US-Mexico-Canada Free Trade Agreement) on their returns.

ASSEMBLE A TEAM



While the heaviest burden may fall on accountants, individual companies and their finance teams will all have an important role to play to gather and evaluate all the necessary information.

For private equity firms with significant investments in manufacturing and distribution, trade tensions could create a sea change in the way companies do international business. These developments have the potential to impact PE throughout the fund lifecycle entirely, as deal valuation hinges in part upon the predictability of future cash flows. As the effects of each remains uncertain, fund managers are relying on a “wait and see” approach to deal making as they brace for the comprehensive impact of trade tensions.

The Committee on Foreign Investment in the United States (CFIUS) has also ramped up scrutiny of China, specifically its technological and economic ambitions in the United States. CFIUS's concerns precipitated the sale, executed in September, of Hong Kong-based Orient Overseas' entire interest in Long Beach Container Terminal, the second largest container port in the United States and part of a project that, when complete, will make it the largest automated terminal on the West Coast.

For its part, Chinese investment into the United States has fallen precipitously, as Chinese buys of U.S. firms decreased by 94.6% to \$3 billion in 2018, down from a record \$55.3 billion in 2016, according to MergerMarket's 2018 global M&A report.

DIG INTO THE DATA



Assessing the impact of trade tensions requires a substantial amount of data to be readily available, mainly concerning the tariff code for all product lines. GPs can use this data to begin modeling how trade changes within certain areas of the world will affect their portfolio companies' businesses.

ESTABLISH PRIORITIES



When considering which aspects of trade tensions to tackle first, focus on the areas that could have the greatest impact on companies within your portfolios. For portfolio companies that are drastically affected, it may be worth prioritizing a reassessment of the supply chain network to unearth potential savings.

INITIATE CONVERSATIONS WITH YOUR TAX ADVISOR



Trade tension of this magnitude is the biggest disruptor to international M&D we've seen in several years and will require intense focus to understand not only how the changes apply at a federal level, but also how to navigate the ripple effect this is likely to have on the fund lifecycle as well.

The new normal for years to come may contain geopolitical unpredictability. Unless private equity funds emerge only to conduct business when economic conditions are salutary, an environment of uncertainty is one that investors of all stripes will likely need to adapt to. The adage “necessity is the mother of invention” seems appropriate here. With money burning a hole in private equity's pockets and deal valuations having been driven up in recent years by intense competition, firms are reevaluating the ways they invest. In demonstration of this new normal, the trade war and tariffs are likely to reshape how, where and when private equity ultimately deploys capital.



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