




## So you want to expand into Brazil?

Considerations for US companies pursuing Brazilian targets

Today's presentation begins at 2:00 p.m. (Eastern) / 11:00 a.m. (Pacific)





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## Leading today's discussion



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## Brazil overview



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**So you want to expand into Brazil?**

Considerations for US companies pursuing Brazilian targets

June 20, 2012 2

## Today's agenda

- **The Brazilian economic landscape**
- **Financial and tax due diligence**
- **The M&A process in Brazil**
- **Final thoughts**

We will answer audience questions throughout today's presentation. Please submit your questions at any time.

## The economy and politics of recent

- **Growing steadily, though not brilliantly** – reflex of the European Crisis and the least spectacular recovery of the US
- **Argentina and its regional importance** – its effects in Brazil – the softer spot
- **More technical administration, more complex political environment** – difficult dialogue between Congress and Ministries
- Tendency of increasing non-customs barriers on foreign products that tend to threaten local industries (specific actions)
- Dependence on the behavior of the commodities price

## Taxation

- **IPI:** Tax on Industrialized Products - Recent tax reliefs for local industry – white line, consumer goods and others
- **Tax Reform:** Long shot – Guaranteed superavits and complexity of a congressional negotiation on much needed changes

## Labor and qualification

- Much needed reform on Labor Legislation (CLT) will not pass under the present administration
- Recent changes in legislation reduces payroll costs for exporters and some specific industries

## Environmental concerns

- Sharper environmental consciousness – 1st time in history it does not come majorly from government official actions, but from society
- New bill on use of soil under discussion in congress with distinct tinges of “echo-radical” tone

## Global M&A Transactions – Jan 2012

(\$ in millions)

	Number of Deals – January			Deal Value – January		
	2011	2012	% Change	2011	2012	% Change
North America	1,188	1,320	11.1%	\$107,664	\$60,499	(43.8%)
– U.S.	1,011	1,194	18.1%	\$103,610	\$49,940	(51.8%)
Central / South America	99	114	15.2%	\$9,495	\$3,033	(68.1%)
Europe	1,094	800	(26.9%)	\$37,158	\$45,552	22.6%
– U.K.	246	205	(16.7%)	\$9,016	\$5,603	(37.9%)
– Germany	153	142	(7.2%)	\$3,737	\$8,951	139.5%
Africa / Middle East	87	79	(9.2%)	\$6,709	\$4,007	(40.3%)
Asia-Pacific (ex. Japan)	480	349	(27.3%)	\$26,518	\$10,624	(59.9%)
– China	257	157	(38.9%)	\$16,468	\$5,012	(69.6%)
– India	78	67	(14.1%)	\$2,609	\$887	(66.0%)
Japan	159	197	23.9%	\$4,203	\$16,364	289.3%
Global Total	2,823	2,570	(9.0%)	\$167,967	\$112,074	(33.3%)

Source: Dealogic and Robert W. Baird & Co. Incorporated M&A Market Analysis.  
 Note: Global Total will not equal the sum of the individual regions listed above, as cross-border transactions are reflected in both the target's and acquirer's respective regions.  
 Figures exclude transactions involving minority stakes, stock repurchases, and spin-offs.

## Global M&A Transactions – YTD 2012

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## Global M&A Transactions – Jan 2012 Middle Market ONLY

(\$ in millions)

	Number of Deals – January			Deal Value – January		
	2011	2012	% Change	2011	2012	% Change
North America	471	416	(11.7%)	\$31,828	\$26,883	(15.5%)
– U.S.	370	339	(8.4%)	\$27,774	\$22,411	(19.3%)
Central / South America	36	38	5.6%	\$2,529	\$3,033	19.9%
Europe	276	219	(20.7%)	\$20,650	\$15,025	(27.2%)
– U.K.	81	82	1.2%	\$7,547	\$3,451	(54.3%)
– Germany	26	29	11.5%	\$2,376	\$4,250	78.8%
Africa / Middle East	33	34	3.0%	\$2,249	\$2,757	22.6%
Asia-Pacific (ex. Japan)	318	216	(32.1%)	\$15,140	\$8,142	(46.2%)
– China	197	120	(39.1%)	\$8,831	\$5,012	(43.2%)
– India	30	27	(10.0%)	\$1,401	\$887	(36.7%)
Japan	74	73	(1.4%)	\$2,752	\$3,488	26.7%
Global Total	1,107	901	(18.6%)	\$65,075	\$53,139	(18.3%)

Source: Dealogic and Robert W. Baird & Co. Incorporated M&A Market Analysis.  
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## Brazil leads South American Middle Market M&A Deals

(\$ in millions)

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## Today's agenda

- The Brazilian economic landscape
- Financial and tax due diligence
- The M&A process in Brazil
- Final thoughts

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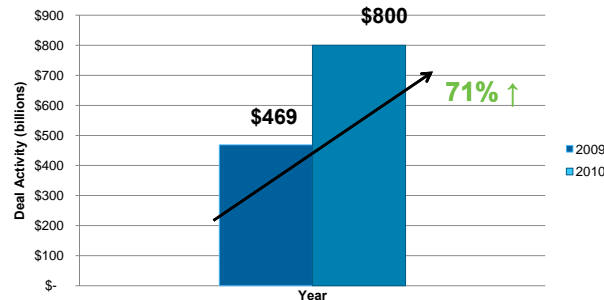
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## McGladrey M&A Perspective

According to the latest McGladrey Economic Update, “Even with effective debt management policies, the developed economies are likely condemned to modest GDP growth for years to come. By contrast, many emerging markets are poised for robust economic growth that will strengthen their standing as rising global powers.”

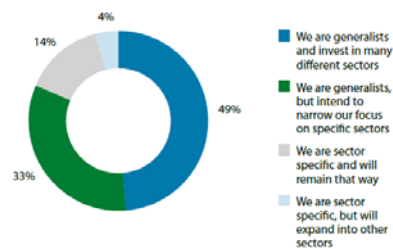
According to a recent Deloitte survey, “Cross-border M&A increased 71% to USD \$800 billion in 2010 from USD \$469 billion in 2009, representing 28% of total global



## McGladrey M&A Perspective

- McGladrey has completed nearly 300 deals in the past 12 months, which highlights how the M&A space is really heating up.
- In today's competitive deal environment, buyers are finding industry specialization can be a true differentiator. And post-deal, that specialization can be used to create efficiencies and improve growth.
- This trend is highlighted in a recent private equity survey published by McGladrey in which 33% of respondents said they intend to narrow their industry focus.

Which of the following best reflects your investment strategy?





## What is Due Diligence?

- Due Diligence in emerging markets is a validation of historical streams of earnings
- Whether performing due diligence domestically or in emerging markets, the process remains fairly consistent.
- Focus Areas:
  - Financial
  - Tax
  - Information Technology
- Based on experience, we have found the key to successful emerging market due diligence is a structured approach where the due diligence team includes a select number of individuals on the ground with intimate key local knowledge, culture and experience.
- Local country awareness is critical. If the due diligence team sent in is foreign, often they can run into issues related to a lack of cooperation and/or incomplete information provided by the target.

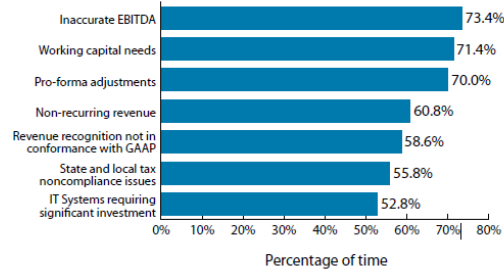
## Financial Due Diligence

- As mentioned earlier, buyers still need to perform due diligence with a similar focus as if the target was domestic.
- Additionally, we recommend a deeper validation of financial assumptions and analysis of external market forces for targets in markets with more risk and uncertainty.
- Example of increased risk in emerging markets includes how some Chinese companies were found to have manipulated financial statements.
- It's important to work with the target and obtain all sets of books if multiple do exist.

## Financial Due Diligence

- Quality of Earnings and Working Capital are the most important areas of consideration.
- In emerging markets, it is important to fully understand the quality of working capital, as it can be affected by local country factors such as severance, local laws and corporate policies, as well as other unique local practices.

How often do each of the following issues play a role in purchase price adjustment?



## Financial Due Diligence Additional key financial areas

- Revenue recognition, billing and collection, work-in-process accounts and estimates to complete
  - Local advisors on the ground during the due diligence process helps ensure all unique accounting treatments are considered.
- Accruals at interim periods (bonuses, payroll, vendors and subcontractors)
  - This is especially important in emerging markets where Foreign Corrupt Practices Act (FCPA) regulations may not exist and bonuses and pay-outs are common.
- A/R and A/P aging(s)
- Customer, vendor and product concentration
- Drivers of changes in revenue, margin and profitability

## Financial Due Diligence Additional key financial areas

- Management adjustments
- Customer contracts, subcontracts or vendor agreements and leases
  - Include local legal advisors during review of contracts
- Regulatory or compliance issues
- Contract backlog or waterfall
- Weaknesses in management, accounting infrastructure or system limitations
- Accounting policies and procedures
- Pro forma type adjustments

## Tax Due Diligence

- Tax compliance issues are often very significant during the due diligence process in all markets, even more so in emerging markets
- It's not uncommon to find a lack of, or inadequate attention to, tax compliance matters when performing due diligence
- It's important for the buyer to work in collaboration with the due diligence team to evaluate the size and nature of the issue(s)
- Given the recent trends in the global economy, United States and foreign tax authorities are continually seeking revenue sources.
  - In particular, the imposition of significant penalties for compliance-related failures has become prevalent, especially by the IRS. Many of the IRS penalties for failure to file particular international forms are USD \$10,000 or more per instance
- Largest issue in Tax Due Diligence is Transfer Pricing

## Transfer Pricing

```

graph TD
    A[Manufacturer Country A] -- Owns 100% --> B[Distributor Country B]
    B --> C[Customer Country B]
    
```

Sale Price	\$1,000
Actual Costs	<u>700</u>
Taxable Profit	<u><b>\$ 300</b></u>

<b>Country A</b> Tax Rate	40%
<b>Country B</b> Tax Rate	25%

To the extent possible where would business want income to be earned?

Sources: McGladrey

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## To which transactions does transfer pricing apply?

- Transfer of products
- Royalty payments from use of intangibles
- Management fees
- Other services – R&D, Warranty related expenses, etc.
- Interest payment on debt financing
- Transfer of “know-how”
- Any other related party transaction

Sources: McGladrey

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## Transfer Pricing – Resulting risks

- The single biggest taxpayer risk is a one sided redetermination of taxable income via a transfer pricing adjustment.
- A one sided entry can occur when one country disagrees with a transfer pricing adjustment made by another country resulting in a portion of income being taxed twice.
- The one sided entry risk is increased when considering the various countries differing methodology for determining the proper transfer price.

## Transfer Pricing in Brazil

- Current enforcement
  - Full enforcement of transfer pricing started in 2001 and it is now in place in all major customs facilities.
- Cargo can be released without any analysis, but tax authority reserves the right to present a post challenge in up to 90 days after customs clearance.
- Documentation requirements:
  - Full documentation supporting the taxpayer position is required, including the cost disclosure at the foreign company level (if it is an import) and sale price at the foreign market (if it is an export)
- Penalties
  - Import cost in excess of the transfer pricing ceiling is not deductible for corporate income tax purposes, and sale price below the minimum is added to the corporate income tax taxable base

## Other Brazilian Tax Due Diligence Issues

- Labor Taxes
  - Employment taxes can add up to more than 70% of base pay
- Income Taxes
  - Can be computed on actual profits or “deemed profits”
- Import Taxes
  - Can be as high as 35%
- Lack of Treaty Network
  - Limited network may not provide protection
  - No treaty with the US

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- Financial and tax due diligence
- **The M&A process in Brazil**
- **Final thoughts**

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## The M&A Process in Brazil

### Screening the Market



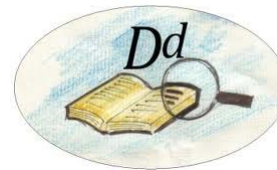
### Approaching Targets



### Offering / Negotiating



### Due Diligence



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## Screening the market

- Amount of Public Data on Companies is quite small
- Amount of Public Companies even smaller
- Quality of Data is always to be extremely well scrutinized
- Selecting more than 1 target is almost always the best – to **be on the safe side**
- Exact correspondence with USA operations is normally difficult – either Brazilian operations do only part of what is done by the US counterparts or on the other extreme, a larger company does more than what'd be expected (no specialization) – that leads to the need of: a) buying portion of companies; b) buying 2-3 different companies and merging them.



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## Approaching targets

- Direct Approach can have significant impact in Prices in Brazil
- Targets are normally unprepared for it (financial information, above all)
- Targets are normally afraid of being “used” just to obtaining market information – this fact is directly linked to the ability of enforcing an NDA in Brazil
- Brazilian Entrepreneurs (family owned business) normally don’t have companies – they have “sons and daughters”



## Negotiating

- Never be blunt!
- Never to tell the Brazilian executive or (worst of all) owner(s) why his or her company is not that “great” in terms of value – notion of value in Brazil is normally dictated by other factors that not technical calculations (sometimes it’s “their baby”, not their company)
- Situations such as Escrow and Due Diligence Adjustments must be carefully explained – the smaller the activity the longer and more detailed the explanation
- Earnouts are getting more and more common and Brazilian business owners are getting used to it
- Obtaining an accountable and simple earnout calculation method can be a challenge.





## Due diligence

- Takes more time as in the US – as an average – therefore can be more expensive
- Important aspects that CANNOT be neglected and analyzed in depth:
  - Labor Aspects
  - Tax Aspects
  - Form of hiring manpower – some “tricks” to lower social charges can mean an adjustment in the EBITDA
  - Environmental Aspects
- Succession Law – new owner is responsible for every act performed on behalf of the Company, from its inception – Therefore the need of larger Escrows



## Today's agenda

- The Brazilian economic landscape
- Due diligence and the M&A process in Brazil
- Transfer pricing considerations
- **Final thoughts**

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## Why US companies normally fail in Brazil

- Poor initial analysis of the market
- Poor (or no) Due Diligence
- Small Escrows – “Size Matters” most of the time
- Failure to maintain present executives motivated and “on the saddle”
- Underestimating the competition / Delay in Reacting – Brazil has fierce competitors in almost all fields
- Difficulty in adjusting to a tax-nightmarish and overregulated environment
- Difficulty in understanding how big and diverse Brazil is – in case of doubt, start from the south!
- Difficulty in capturing critical information of the company not recorded in ERPs and other information systems – killing the “living files”

## Please submit any additional questions you may have at this time.



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