Trade tensions, tax changes slow Canadian deal making in U.S.

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Corporate Canada has cut back substantially on its cross-border shopping habit as the country's political and economic relationship with the United States has sunk to its lowest point in recent memory.

After a few lively years of hunting for deals, Canadian public companies have slowed the pace of acquisitions of U.S. assets so far in 2018 – a sharp contrast to the surge in outbound mergers and acquisitions of the previous three years. The slowdown coincides with a deterioration in U.S.-Canada trade relations, as the protectionist leanings of U.S. President Donald Trump have resulted in competing tariffs and brinkmanship over trade negotiations.

With the fate of the North American free-trade agreement up in the air, some Canadian executives have become reluctant to commit new money to U.S. assets.

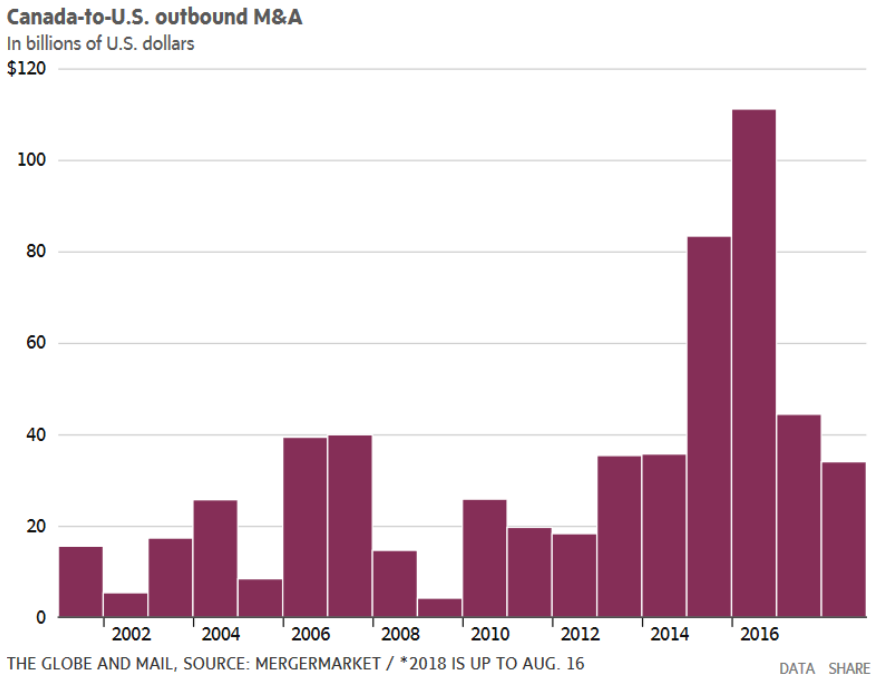
The attraction of the U.S. market has also been affected by sharp reductions in U.S. corporate tax rates, which seem to have changed the calculus that informs strategic acquisitions.

“There are likely several factors driving this slowdown, including NAFTA uncertainty, U.S. tax reform and higher valuations in many sectors,” said David Rawlings, chief executive officer in Canada for JPMorgan Chase & Co.

Mr. Rawlings pointed out that Canadian caution has emerged as global mergers and acquisitions (M&A) continue at a frenzied pace. Canada-U.S. cross-border M&A are on track to decline moderately, even as global deal value soared by more than 60 per cent in the first half of the year to US$2.5-trillion.

This new-found austerity casts doubt on an important source of growth for Canadian corporations that build value by buying U.S. assets, which rank among the best-performing Canadian stocks of the past 10 years.

Of course, deals are still getting done, such as Enbridge Inc.’s $4.3-billion acquisition of Texas-based subsidiary Spectra Energy Partners LP, announced last month. And Canadian pension funds show no signs of reducing their appetite for U.S. assets.



In the public market, however, outbound deal activity is decelerating. Canadian corporations have completed a total of 10 U.S. acquisitions of at least US$5-million so far this year (excluding property transactions and restructurings), representing US$10.2-billion in total deal value up to late August, according to Mergermarket. That is well off the pace set over the three previous years, which ranged from a low of US$21.5-billion for all of 2015 to a high of US$93.8-billion in 2016. "Given the geopolitical environment and tariffs and trade tensions, in general, dealmakers appear to be treading more cautiously these days," Elizabeth Lim, Mergermarket's research editor for the Americas, said by e-mail.

"However, Canada is still a country in need of investments outside of its own borders, and they will be looking for markets externally," she added.

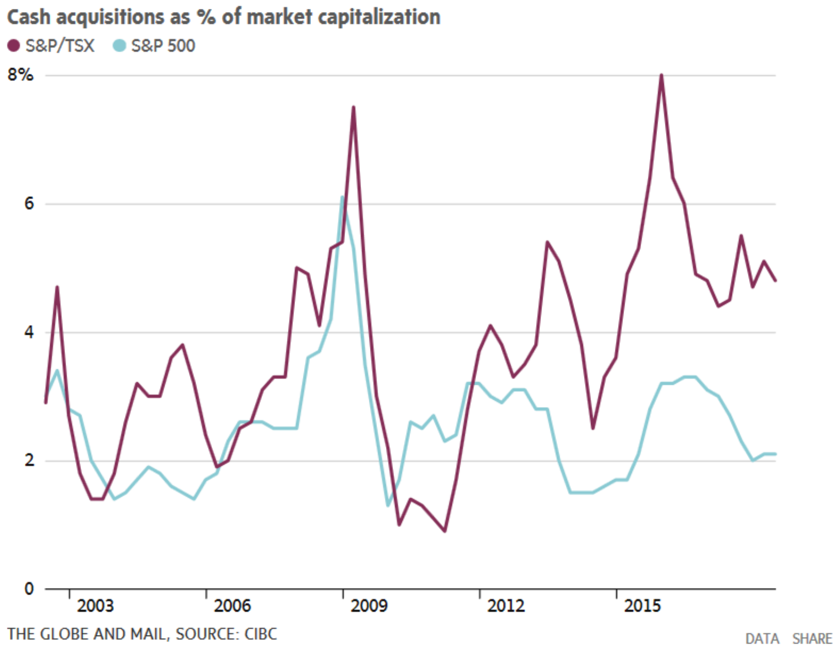
But if the exuberance of the past few years wanes, investors could be forced to reconsider premium valuations on some high-profile growth-by-acquisition stocks.

The past decade had ideal conditions for cross-border deals. In an era of languid economies and paper-thin yields, corporate acquisitions helped satisfy the appetite for growth. There is no quicker way to expand than to scoop up a competitor, making it a tempting option for companies flush with cash on solid profit trends and with easy access to cheap financing.

"There are huge drivers to consolidate," said George Schindler, chief executive of Montreal-based IT-services provider CGI Group Inc. CGI has completed a dozen major acquisitions over the past decade, half in the United States. Over that time, the company's value has increased more than eight-fold, its market capitalization now just less than $25-billion, making it the country's largest tech stock.

The software space has its own strategic considerations, Mr. Schindler said – the need for global scale to match clients' multinational operations, and a highly fragmented market offering up to 3,000 potential target companies in the United States. This has not deterred CGI, which counts on acquisitions for half of its growth, the other half generated organically.

In pipelines and utilities, $80-billion worth of Canadian corporate M&A went after U.S. targets in 2016 and 2017 – the largest being Enbridge's $37-billion takeover of Spectra Energy Corp. and TransCanada Corp.'s $13-billion acquisition of Columbia Pipeline Group Inc. The deals were driven partly by the high valuations of the buyers and a favourable tax regime.



Across all sectors, M&A activity as a proportion of the Canadian stock market has roughly quintupled since 2011, according to recent report by Ian de Verteuil, head of portfolio strategy for CIBC World Markets. Cash acquisitions make up about 5 per cent of the total market capitalization of the S&P/TSX Composite Index, which is more than double the number in the United States.

Companies considered to be serial acquirers, also known as "roll-ups," which elevate strategic acquisitions to a key growth proposition, have assumed a heightened profile within the Canadian stock market. Of the 10 best-performing stocks in the S&P/TSX 60 over the past decade, five qualify as roll-ups – Alimentation Couche-Tard Inc., CGI, Constellation Software Inc., Open Text Corp. and CCL Industries Inc. all posted average growth rates of between 20 per cent and 40 per cent a year for the past 10 years.

"Canadian companies have been extremely aggressive acquirers over the past decade," Mr. de Verteuil said. "In our opinion, taxation, or rather, relative taxation, has been a major contributor to the exuberance."

Until recently, many Canadian growth-by-acquisition companies have exploited a corporate tax advantage when buying U.S. assets. Significantly lower corporate tax rates in Canada allowed for profit shifting to reduce the tax burden, for example – one of the techniques that may have helped tilt the deal math in favour of Canadian suitors.

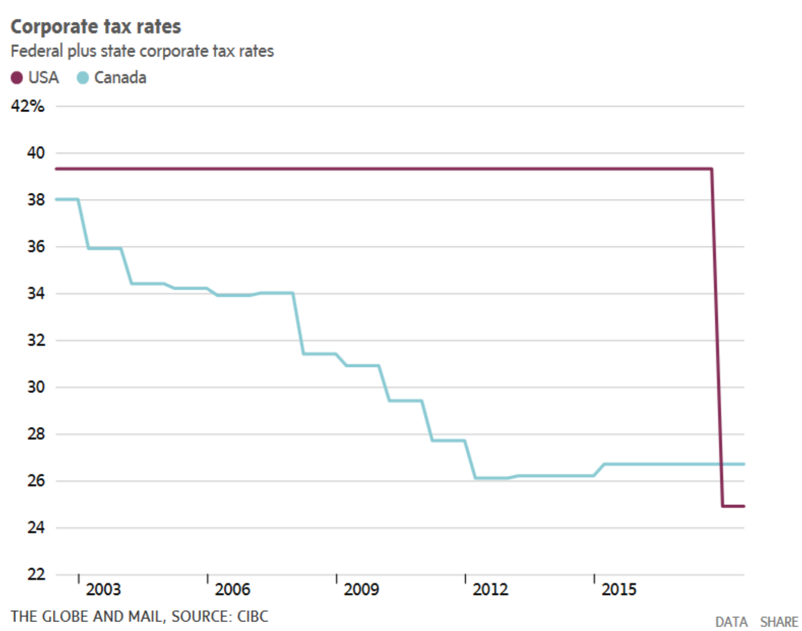
About 10 years ago, tax reforms began in Canada that widened the gap against U.S. corporate rates considerably. A U.S. Congressional Budget Office report from March, 2017, pegged Canada's effective corporate tax rates, which account for various tax exemptions, allowances and deductions, at 16.2 per cent – third-lowest among the countries in the Group of 20. That compared to 29 per cent in the United States, according to the CBO.

While the complexities of the tax systems make comparisons difficult, it is reasonable to assume a Canadian acquirer could extract 5 to 10 per cent higher earnings from an acquisition than a U.S. acquirer could, Mr. de Verteuil estimated. One way to do so was to redirect profit into Canada, where an acquirer could retain about 20 per cent more of its pretax income. "The simplest way to achieve this was to saddle the U.S. entity with as many costs as possible, billed as intercompany costs," he said, suggesting the allocation of head-office costs and the transfer pricing of goods or services as examples.

Another way of reducing the profit subjected to higher U.S. tax rates is to shift debt onto the U.S. subsidiary, thereby increasing interest expenses and reducing taxable income. Yet another manoeuvre is "double dipping," in which a company claims multiple tax deductions for interest payments through hybrid securities. Canadian corporate tax regulations also exempt most or all income earned outside of Canada, which was not the case in the United States.

"You take advantage of the tax rules," said Dan Lefaivre, CFO of Stantec Inc., the Edmonton-based engineering firm, which has completed about 150 U.S. acquisitions since 1991. "Through the years, we've used cross-border financing scenarios, which reduce our overall effective tax rate. With tax reform, those deductions go away."

The Tax Cuts and Jobs Act, spearheaded by Mr. Trump, slashed U.S. corporate tax rates in January. U.S. effective tax rates are now comparable to Canada's, if not slightly lower, according to calculations by University of Calgary economist Jack Mintz.



Additionally, U.S. tax reforms targeted profit shifting, interest deductions and hybrid securities, while also allowing profits earned overseas to be largely repatriated tax-free. For Canadian roll-ups accustomed to a long-standing competitive edge based on relative tax rates, the rules have changed. And Canadian investors have yet to appreciate that, Mr. de Verteuil said. The group of 20 or so names in the S&P/TSX Composite Index that qualify as true roll-ups – companies that made at least five acquisitions over the past five years, and one exceeding 5 per cent of total asset base over the past two years – are still trading at a premium valuation, on average.

"Portfolio managers need to be aware if they are overexposed to these types of companies and whether valuations are at risk," he said. "It is reasonable to assume that M&A activity, with Canadian companies as predators, will taper off, while we expect U.S. companies to become more aggressive."

For Canadian pension funds and private equity, however, longer-term considerations govern the approach to acquisitions. That group is still chasing U.S. assets, the latest example being Ontario Municipal Employees Retirement System's purchase of a 50-per-cent stake in a Texas oil pipeline known as BridgeTex for US$1.4-billion. And in July, the Canada Pension Plan Investment Board teamed up with a U.S. developer to buy a business park in Santa Monica, Calif., in a US$628-million deal.

"Canadian pension funds are massive investors in the U.S.," said David Mattingly, a New York-based lawyer who specializes in the tax aspects of cross-border mergers and acquisitions for Torys LLP. "[They] have deep pockets and will continue to have an appetite for U.S. assets."

Canadian public companies will also continue to be drawn to the United States. Of all the considerations that factor into the decision to undertake a big acquisition, taxes are material, but not crucial, said Barry Perry, CEO of Fortis Inc. "Even if you put U.S. tax reform in the negative category, the U.S. economy is growing quickly and we're seeing the benefits of that in our businesses in the U.S."

In 2016, Fortis paid US$6.9-billion in cash and stock for ITC Holdings Inc., which gave the St. John's-based utility power-transmission operations in seven Midwestern states. Mr. Perry said he would have done the deal even if the U.S. tax rules had changed before. "It was a pretty major step for Fortis to diversify, at that point, from the distribution business into transmission," he said. "It might have been a little more difficult to do under U.S. tax reform, but it wouldn't have stopped us from doing the transaction."

One indirect effect of reduced U.S. corporate tax rates has been to push valuations up across the market as a result of increased corporate profitability. Any given company might fetch a higher price than under the old tax regime. "Sellers are now looking at their bottom lines and saying, 'Hey, we're worth more,' " Stantec's Mr. Lefaivre said, adding that the company remains committed to U.S. acquisitions.

Tax reforms will also tend to add strength to the U.S. economy, as well as to spending, capital flows, stock prices and currency, all of which increase the power of U.S. roll-ups, said Brad Cherniak, founder of Sapient Capital Partners in Toronto, and an investment-banking veteran. That will, on average, make U.S. acquirers more competitive, he said. "U.S. buyers are very aggressive, they're loaded to the gills with capital, and they'll use any advantage they can."