THE CAPITOL FORUM

Vol. 9 No. 410 November 18, 2021

More Aggressive UK Security Reviews Might Delay—But Won't Derail—Sensitive U.S. Deals, Experts Say

The UK's scrutiny of Parker Hannifin's (PH) planned takeover of British rival Meggitt (Lon: MGGT) and other American-led buyouts on national security grounds has generated overblown fears that the country has become reluctant to approve investments from its U.S. ally, security experts said.

Most of the reviews are expected to delay deal closings and lead to mitigations, the experts said. But it's unlikely that any of the U.S. investments will be prohibited outright, they said. Instead of preparing for the worst, U.S. companies should seek to anticipate UK government apprehensions and ease them by pre-emptively proposing remedies, they said.

That optimistic viewpoint has been in short supply among some investors, who have watched in dismay as the government has ordered "public interest" reviews of four deals this year alone, citing national security concerns.

The interventions by Prime Minister Boris Johnson's Conservative government have included three proposed buyouts by U.S. companies—Nvidia's (NVDA) $40 billion deal for UK chip designer Arm Holdings; Parker Hannifin's plan to buy rival defense contractor Meggitt for 6.3 billion pounds ($8.5 billion today); and a private-equity firm's offer to buy Ultra Electronics Holdings (Lon: ULE) for $3.6 billion.

The heightened UK focus is also expected to fall on satellite broadband provider Viasat's (VSAT) $7.3 billion acquisition of London-based rival Inmarsat.

Buying spree. Not too long ago, investors rarely viewed UK security reviews as a serious regulatory hurdle to U.S.-led buyouts in the country. But that was before a weak pound and low interest rates spurred a foreign shopping spree for UK defense contractors and other companies deemed important to the country's national security.

Johnson's government has vowed to step up reviews of defense takeovers following the spurt of M&A in the industry. That scrutiny will, if anything, increase early next year, when a new UK law on foreign direct investment enters into force.

Yet the government probes shouldn't be interpreted as a sign of growing mistrust of the U.S., the UK's most important security partner, the experts said. Some recent deals have been so sensitive for UK security that any foreign acquirer might reasonably have expected the government to intervene, said Ingrid Rogers, a senior associate specializing in competition and investment security reviews at London law firm Travers Smith.

"The approach which the UK government has taken in identifying deals of potential interest from a national security perspective is largely, primarily driven by the nature of the target business, rather than the identity of the acquirer," said Rogers, who declined to discuss specific cases.

In some cases, of course, both the nature of the target and the identity of the buyer stoke concerns. In September, for example, the government ordered a public interest review after investors linked to China proposed to buy Perpetuus Group, a small Welsh company producing graphene, the world's thinnest, lightest and strongest material.

Graphene is used in the defense, electronics and energy industries, and Perpetuus accounts for "at least one-quarter of all graphene plasma goods and/or services supplied in the UK," according to a note from English law firm Stevens & Bolton. Although the government has provided scant information about its concerns, officials may worry that intellectual property from this emerging industry could leak abroad, "in particular to China," the note says.

That said, the UK regime focuses primarily on the target and whether its purchase might threaten national security, lawyers said.

'Taken aback.' Under the UK's current investment regime, the government can direct the Competition and Markets Authority to explore whether a deal might harm the "public interest" in one of four areas—national security, financial stability, media plurality and public health emergencies.

This year's uptick in "public interest intervention notices" involving American buyers surprised some dealmakers because the UK, as a close U.S. ally, last year gained a special "excepted" status allowing its investors to avoid scrutiny from the Committee on Foreign Investment in the United States (CFIUS). The expectation was that U.S. investors would receive similar treatment in the UK, given the intelligence sharing between the two countries and moves to integrate their defense industrial base.

Confusion among dealmakers deepened after it emerged in May that the UK government had come close to waving through the sale of the country's biggest semiconductor plant to Nexperia, a Dutch unit of Chinese chipmaker Wingtech Technology (SHA: 600745). The government "does not consider it appropriate to intervene at the current time," UK Business Secretary Kwasi Kwarteng said.

The failure amid a global chip shortage to review the purchase of Newport Wafer Fab for a reported 63 million pounds ($85 million) raised questions among politicians and security experts alike.

"Many in the [defense] industry were taken aback by the UK's decision to allow this deal to go forward," one U.S. national security expert told *The Capitol Forum*. Perhaps the government didn't consider the wafers made by Newport to be highly sensitive, he said.

With political pressure rising on his government, Prime Minister Johnson said in July that he had asked his national security adviser to review the deal.

Broader trend. The recent increase in deal interventions reflects a broader trend. Since 2019 alone, the UK government has intervened in deals eight times on the grounds of national security, according to data supplied by the Department of Business, Energy and Industrial Strategy (BEIS). That equals the total number of interventions on those grounds from 2002 to 2018. The pace of deals facing scrutiny is clearly picking up.

The UK government is primarily concerned with retaining oversight in industries deemed to be strategically important, such as defense and microelectronics, lawyers said. Its apprehensions are most apparent in the country's shrinking defense industry, where UK defense contractor Cobham—which was purchased by U.S. buyout firm Advent International last year—has agreed to acquire rival Ultra Electronics. Parker Hannifin's planned takeover of Meggitt has heightened the anxiety.

Of equal but less obvious concern is Nvidia's plan to buy Cambridge, England-based Arm, which licenses its microchip blueprints to a long list of tech companies. The government's digital secretary, Nadine Dorries, this week ordered the CMA to conduct an in-depth phase II investigation of the deal on competition and national security grounds.

"While not all individual devices relying on Arm-based chips are necessarily classed as 'critical' in themselves, the security and resilience of the broader supply chain is important for UK national security," the government said in announcing the order.

Although the U.S. investors still face a low probability that their deals will be blocked on national security grounds, reviews of transactions in these sectors are becoming the norm, attorneys said. Those planning acquisitions in sensitive UK industries need to mitigate the risks proactively, they said.

"Recent interventions show the sensitivity around certain sectors of the UK economy," said Damien Ryan, a competition lawyer at Scottish firm Brodies.

Screening overhaul. So far, all of the UK interventions in deals on security grounds have occurred under the Enterprise Act 2002, a law that aimed to crack down on anticompetitive behavior. But the increased scrutiny comes amid the biggest overhaul of the country's industrial intervention policy in some two decades.

A National Security and Investment Act approved this year will introduce reviews similar to those at CFIUS when it enters into force on January 4. The new regime creates an Investment Security Unit, or ISU, inside the BEIS.

The ISU is meant to identify and mitigate national security risks arising from both foreign and domestic investments in UK assets. Staffed by security experts rather than antitrust enforcers, the unit is expected to conduct up to 95 detailed assessments a year, according to a government impact assessment on the new act.

The act increases the scope for government intervention in deals by identifying 17 "core sectors" as critical to the UK's national interest. These industries supply goods and services ranging from advanced materials and defense equipment to energy and communications.

Reducing deal risk. The law makes it impossible to eliminate the risk that the UK government will intervene in certain deals because investments in the 17 core sectors will be subject to mandatory filings. But there are ways to make the intervention as painless as possible, attorneys said. That effort begins with how dealmakers draft their purchase agreements.

"It is certainly possible for investors to address possible risk areas in transaction documents, with the aim of reducing the likelihood of any remedies being required by the UK government," said Rogers at Travers Smith.

Merger parties will need to anticipate national security issues that might arise. Addressing those concerns might involve limiting the size of the stake acquired, blocking the sale or transfer of intellectual property, or restricting access to sensitive information and facilities at the target company.

Even investors from allied countries might be required to sign undertakings guaranteeing that the government will retain access to "key inputs and services," said Ryan at Brodies. Such agreements might also promise to retain UK nationals in key oversight roles and to keep information with UK security implications "secure and onshore," he said.

Inmarsat buyout. One risk at the moment is that the government might hold off on reviewing some deals until the National Security and Investment Act fully takes effect. That scenario is a distinct possibility with Viasat's proposed purchase of Inmarsat.

Inmarsat holds contracts with UK space, defense and civilian agencies, so there's little doubt that the government will intervene in the deal. It's just a question of whether it will do so under the current regime or the new one, attorneys said. Either way, the deal is likely to face mitigations.

Inmarsat is no stranger to this process. Once listed on the London Stock Exchange, the satellite communications company went private two years ago in a buyout by Apax Partners, Warburg Pincus and two Canadian pension funds. The deal secured UK government approval only after a public-interest review that ended with mitigations.

The UK required the buyers to maintain operations that would deliver on Inmarsat's contractual obligations to the Ministry of Defence and other government departments. Inmarsat also agreed to report any material changes in its operations to the government.

The parties promised to protect sensitive information, notably classified defense information that Inmarsat needed to fulfill its contracts. At least half of the company's board members were required to be British citizens with security clearances, including the chairperson. No foreign national could participate in substantive decision-making involving sensitive material information, the agreement said.

Those conditions offer just a foretaste of what investors can expect in the future when purchasing sensitive British assets, lawyers said.