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Long distance running

M&A Insights | H1 2018

Long distance running

Despite continuing geo-political uncertainty, the global M&A market is now enjoying the longest cycle of growth ever recorded. Key regions, notably Western Europe, are powering ahead and mega-deals are once again back on the agenda in many sectors, indicating an extraordinary level of confidence among investors.

01 The mega-deal returns

Growth in the global transactions market continues to be remarkably robust with signs that investors are once again willing to take on big, strategic mega-deals after a relatively quiet few quarters where mid-market deals were in the driving seat.

Overall, the market is now in its longest ever bull run, with dealmakers clearly undeterred by a range of geo-political issues that, in other circumstances, could well have dented confidence – threatened trade wars, Brexit, continued unrest in the Middle East and unpredictable domestic politics to name but a few.

The re-emergence of the mega-deal clearly shows through in the global numbers, where they helped to push up overall deal values by 64% in the first half of the year, despite an 11% decline in deal volumes.

The value of transactions worth over USD5 billion more than doubled in that time, with volumes up by an impressive 117%. As the half drew to a close, there had been 78 deals of this size in total. Activity is spread across a wide range of sectors, with the life sciences and TMT particularly to the fore.

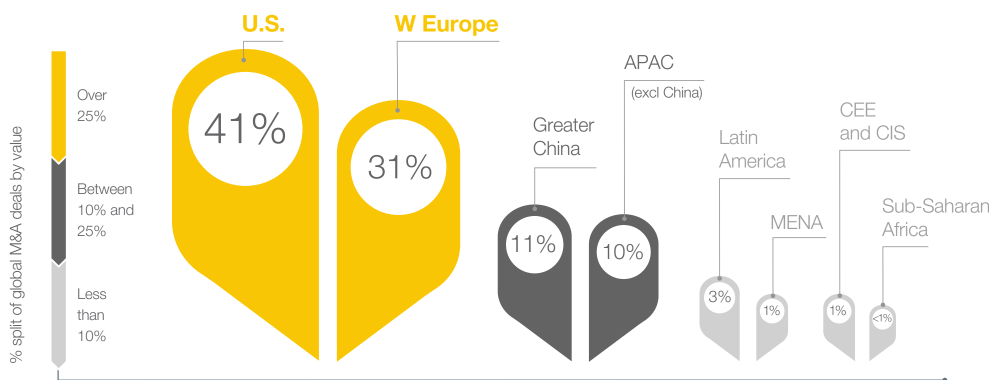
Deals worth more than USD10bn grew even more sharply. Here, the value of such deals increased threefold while volumes climbed by 150%, with a total of 35 transactions done.

Strong fundamentals, including high levels of corporate cash and a still benign market for affordable debt financing, are undoubtedly underpinning the market. However, there is also evidence that boardrooms remain in a confident mood, eager to grasp chances to complete strategic tie-ups to propel growth. In some instances, that has meant looking again at deals that previously foundered, while the effort to consolidate earlier transactions by selling off non-core assets is a continued theme.

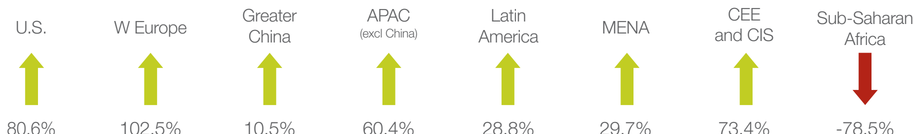
Global value of megadeals – H1 2018 vs. H1 2017 % change

02 Western Europe powers ahead in record market

% split of global M&A deals by value



% change from H1 2017



Note: These figures represent deals announced between 1 January 2018 to 19 June 2018.

The pattern of growth in transactions continues to vary quite widely from region to region. Western Europe is currently leading the charge, with deal values up by a remarkable 103% year on year, even though volumes declined by 15%. The U.S. – so often the global powerhouse for transactions in recent times – was slightly more muted though still impressive, with values up 81% but volumes falling by 15%. Asia continues to grow with values and volumes up but the sharp slowdown in China has continued from last year with just a 7% growth in the number of deals and values nudging ahead by 11%.

Data provided by THOMSON REUTERS

03 Could AT&T ruling spark a new wave of telecom and media deals?

A record-breaking first half for TMT deals ended with two significant U.S. antitrust developments that could unleash an even greater wave of transactions between telecom and media companies as they try to counter the growing power of Netflix and Amazon in the global entertainment market.

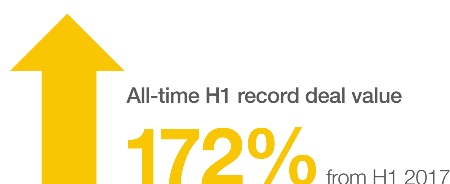
The Justice Department's decision to take AT&T's USD85bn merger with Time Warner to trial – the first challenge to a vertical integration transaction in any sector since 1977 – ended in failure when a U.S. District Judge allowed the deal to proceed and – to the surprise of many – without remedies.

The decision is controversial not least as Donald Trump had vowed to block the transaction during his presidential campaign. It remains to be seen if other big pay-TV operators and content providers will see it as a green light to follow suit, at least in the U.S. market.

That looks distinctly possible. The ruling has already spurred Comcast to announce a USD65bn cash offer for 21st Century Fox's entertainment business, pitting itself against Disney who recently announced a USD71bn counter offer.

Meanwhile, T-mobile and Sprint are proceeding with their planned USD57bn merger amid speculation that the DOJ and the Federal Communications Commission are now willing to see the U.S. wireless market shrink to three national providers rather than four. That would be a significant change, leaving the merged company to challenge the large players AT&T and Verizon.

TMT global deal value



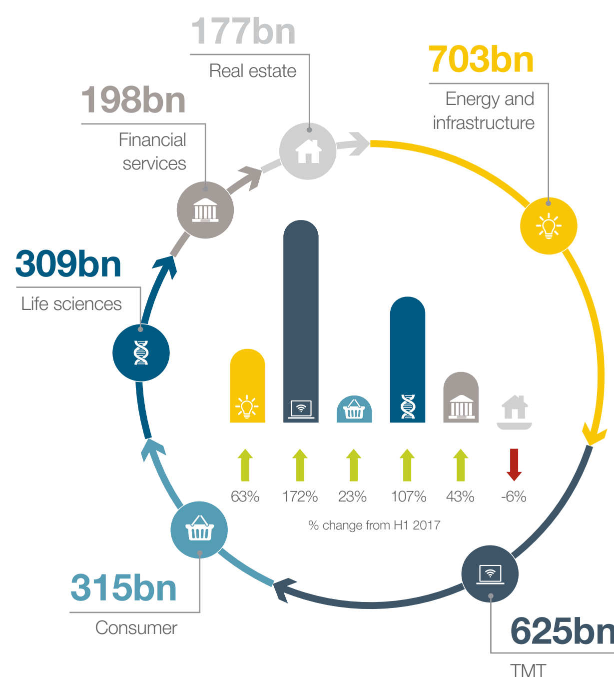
05 Asset managers consolidate for scale and expertise

M&A activity between asset management firms reached its highest level since the financial crisis in 2017 and that trend looks set to continue.

Extensive regulatory change is a main driver for transactions among traditional asset management firms. Their business models are being tested by new rules, such as MIFID II, and with the costs of compliance and technology rising, many firms, particularly in the mid-tier, have seen their margins eroded. They need greater scale to respond.

As the process of consolidation rolls out across the sector, it's likely we will see fewer but bigger transactions in the months ahead. We also expect to see more bolt-on deals, giving firms access to new markets or new areas of expertise.

04 Top six sectors by value (USD)



06 Life sciences deals return to the spotlight

The value of life sciences transactions shot to a record level in H1 – up by 107% to USD309bn.

While giant tax inversion deals predominated when the sector last peaked in 2015, the reasons for this spurt of growth are more varied.

Takeda's USD76bn acquisition of Shire, which dominates the numbers, is clearly an expansionary deal, allowing the Japanese group to diversify into rare disease treatments and build revenues in new markets, notably the U.S.

Elsewhere, specialisation in key product areas and disposal of non-core assets remains a powerful theme. Shire shed its oncology business to Servier ahead of the Takeda deal, for instance, while Sanofi sold its Zentiva generics business to Advent after buying Bioverativ in the U.S. and Ablynx in Belgium.

Vertical integration in the U.S. healthcare market is bringing pharmacy groups, pharmacy benefit managers and insurers together as both the USD54bn Express Scripts/Cigna deal and the earlier CVS/Aetna transactions attest.

Despite raising antitrust concerns, such moves are adding to the price pressures bearing down on the consumer market – which remains ripe for consolidation, albeit with mixed success this year. H1 saw GSK buy Novartis out of their consumer joint venture for USD13bn, while Procter & Gamble agreed to acquire Merck's consumer division. However, Pfizer is still looking for a buyer for its consumer operation – potentially a far larger transaction.

In Focus: China's outbound ambitions
Where now for the 'Belt and Road Initiative'?

China's efforts to build new trade routes and economic ties across Asia, Europe, the Middle East and Africa have powered many significant M&A deals. But how is the so-called 'Belt and Road Initiative' faring in the face of a strict regime of domestic capital controls and, now, a threatened trade war with the U.S.?

At a time when the brakes have been put on China's once seemingly unstoppable outbound investment machine it can be hard to remember that this is an economy pursuing one of the most concerted, ambitious and carefully thought-through plans to expand international trade.

The Belt and Road Initiative (BRI) – also known as "One Belt One Road" – is a major trade and development strategy unveiled by President Jinping Xi in September 2013.

It aims to create trading routes and business opportunities along up to six clearly defined trade corridors stretching by land and sea across Asia, Europe, the Middle East and Africa.

And the strategy is already well advanced. By the end of 2017, the Chinese government announced that it had signed 100 cooperation agreements with 86 countries and international organisations.

The initiative has seen Chinese State Owned Enterprises (SOEs) and Privately Owned Enterprises (POEs) invest billions in ports, roads and other infrastructure projects, in setting up manufacturing plants and in acquiring businesses across the globe through M&A. Billions more investment is planned.

Two views

Yet there are two fundamentally different ways of looking at BRI.

As the process of investment got underway some Western Governments portrayed it as a neo-colonial push by China to control and hedge its economic interests across Central Asia, Eastern Europe and Africa.

However, while trade policy is clearly a way to project soft power, from China's perspective it looks quite different.

At root, this was an effort to allow China's giant SOEs to deploy excess capital and capacity in new markets across the world.

That was an urgent need after the global financial crisis, during which the Chinese government used an expansionary monetary policy, flooding the economy with new money, to shelter itself – successfully – from the crisis.

That, however, led to a position that may have exacerbated over-capacity issues that many SOEs already faced. The BRI incentivised SOEs to look for returns in new markets with the hope that this would ultimately allow them to bring value back home.

Stemming the tide

The deluge of Chinese outbound deals, which reached their extraordinary peak in 2016, did not, of course, only include BRI-related deals. Indeed BRI investments never represented more than around 13% of total Chinese outbound investment in the three years to the end of 2017[1].

As the outbound adventure grew the Chinese government became increasingly concerned about the flood of capital leaving the country. In 2016 it imposed stringent capital controls to stem the tide and particularly sought to discourage (and in many cases halt) investments into sectors such as entertainment, sports and high-risk real estate projects.

The collapse in outbound investment was immediate and sharp. It continues to this day with China slipping to sixth place in the cross-border acquirers league table with USD73bn of outbound deals in the first half of 2018.

BRI is the new benchmark

Deals have not dried up completely of course and for SOEs and POEs alike the BRI has become a kind of KPI or benchmark for navigating those capital restrictions.

But we have seen some important changes in recent years and months.

Firstly, the definition of BRI-type deals has been broadened. Whereas investments in infrastructure and heavy manufacturing dominated in the very early days, now deals in other sectors, not least in financial services and IT, are likely to be included as POEs try to work through the controls to do transactions.

1_Source: MOFCOM official website

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"In its simplest terms, this was a hard-nosed policy to prevent SOEs falling off an economic cliff in an overheating domestic market."

That is, to some extent, in line with the government's separate but related "Made In China 2025" strategy where it wants to create a series of domestic champions in specific high tech areas of the economy. By doing so it hopes to reduce reliance on the U.S. for the supply of know-how and technology.

Clearer rules

The rules on foreign direct investment into China and outbound investment have both been clarified this year, however, and dealmakers are finding the process more straightforward.

Where outbound is concerned, far greater discretion has been given to the National Development and Reform Commission (NDRC) to vet the proposed deals. Chinese buyers can file their proposed deals with the NDRC and, in parallel, apply for a certificate from the Ministry of Commerce (MOFCOM). Once completed, the certificate is then presented to the banks designated by the foreign exchange administration (SAFE) for funds to be released.

For most SOEs, this is seen as a relatively easier exercise as they have better communication channels with the regulators. They also know the policy and what it takes to comply with it.

For private companies it can be a good deal more complex. Depending on the size of the proposed deal and the sector, it can be difficult to complete a deal if it does not clearly fall under the BRI umbrella or other sectors or types of investment supported by the government. The bigger the deal, the greater the scrutiny.

Other factors complicate matters further. Local banks have strict quotas on the amount of dollars they can move offshore each month. The A-share market has been locked down as a platform to raise finance and the use of offshore financial vehicles in territories like the Cayman and British Virgin Islands has been curtailed.

The Trump effect

Now, with President Donald Trump's aggressive stance on trade, the picture would appear to be even cloudier for Chinese investors.

Even before his decision to threaten tariffs on USD250bn of Chinese goods, it was clear that efforts to do U.S. deals were becoming increasingly hard. Acquirers and sellers have noted a tougher stance from the U.S. Committee on Foreign Investment (CIFIUS) now widely believed to be under instruction to block Chinese investment in businesses with even a remote national security connection.

The threatened trade war could make matters even more difficult. Amid the current uncertainty, several big questions remain. How will other major economies in the region, such as Japan and Australia, react? Some commentators speculate that the U.S. hard line approach could have the unintended consequence of drawing those economies closer to China as they recognise a common interest in the region, especially after President Trump withdrew from the Trans-Pacific Partnership. China's Development Bank may in future, they suggest, become an appealing lending platform for Japanese banks, for instance.

The bigger question for China, however, is clear. How will it fulfil its 2025 plan and continue to move its economy up the value chain in key high tech areas if a trade war does ensue? It could be greatly disadvantaged.

However, there is also reason to believe that it may benefit from a late mover advantage that allows it to, if not leapfrog, then catch up in key areas such a semi-conductors. It has done that already elsewhere, including data and renewable energy.

As China's economy has opened up, many might have expected it to move towards greater liberalisation, Western-style. In truth, the approach is a structured, top-down one, with the economy carefully directed from an increasingly powerful centre.

Its determination to carefully control the levers of economic power should not be underestimated, and nor should its resolve to make a success of BRI. The current severe downturn in outbound activity is therefore likely to be short-lived.

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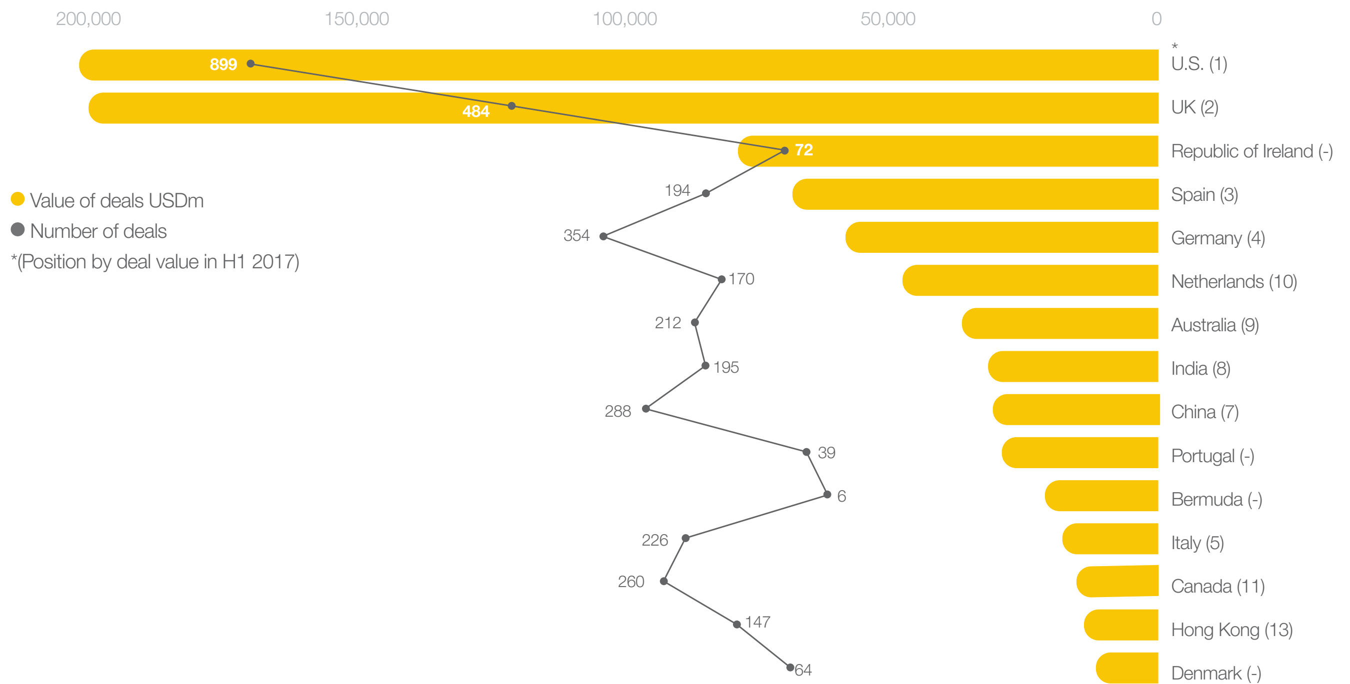
Global deal flows

Inbound target markets



01 Japanese outbound M&A breaking records

Japan has jumped from seventh to second place on the outbound acquirers' league table – a seven-year trend that we fully expect to continue.

There are four key factors behind this continuing spate of activity.

1. Japan's ageing population and a shrinking domestic market compels companies to look for growth opportunities internationally.
2. Japanese corporates have amassed large cash balances and with a favourable lending environment, Japanese banks are eager to provide deal financing at very affordable rates.
3. Political stability provided by the Abe administration and various government initiatives encourage Japanese companies to invest overseas.
4. Japanese companies tend to have fairly passive shareholder bases, leaving them free to concentrate on top line revenue growth rather than on making returns.

Taken together, these are inspiring businesses to do an increasing number of daring, transformational deals. As more get done, there is pressure on other companies to follow suit.

Japanese outbound deal value

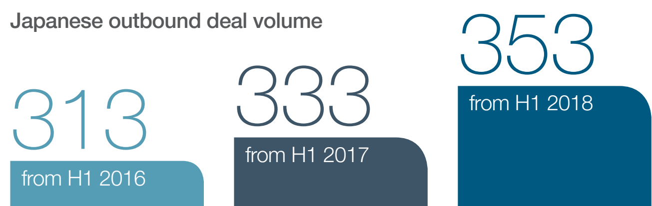
365% from H1 2017

Note: These figures represent deals announced between 1 January 2018 to 19 June 2018.

In the first half of 2018, we have already seen a number of significant transactions, including Takeda's proposed USD76bn acquisition of Shire, the SoftBank-led investment in Uber and the USD6.1bn Xerox/FujiFilm deal.

In many cases, Japanese acquirers are looking for deals that will propel them from being a largely domestic player to a global one. Takeda's proposed acquisition of Shire is a good example, Asahi's recent acquisition of Peroni, Grolsch and other European beer assets from SABMiller is another. The result of this is that we are seeing a growing interest amongst Japanese companies to invest in developed markets, particularly the U.S. and Europe, as opposed to developing markets. To the surprise of some, the UK remains an attractive market despite the uncertainties of Brexit as demonstrated by NEC's recent acquisition of UK-based IT services company Northgate Public Services Limited. A cheaper pound and the availability of good assets appear, for now, to be supporting this interest in the UK.

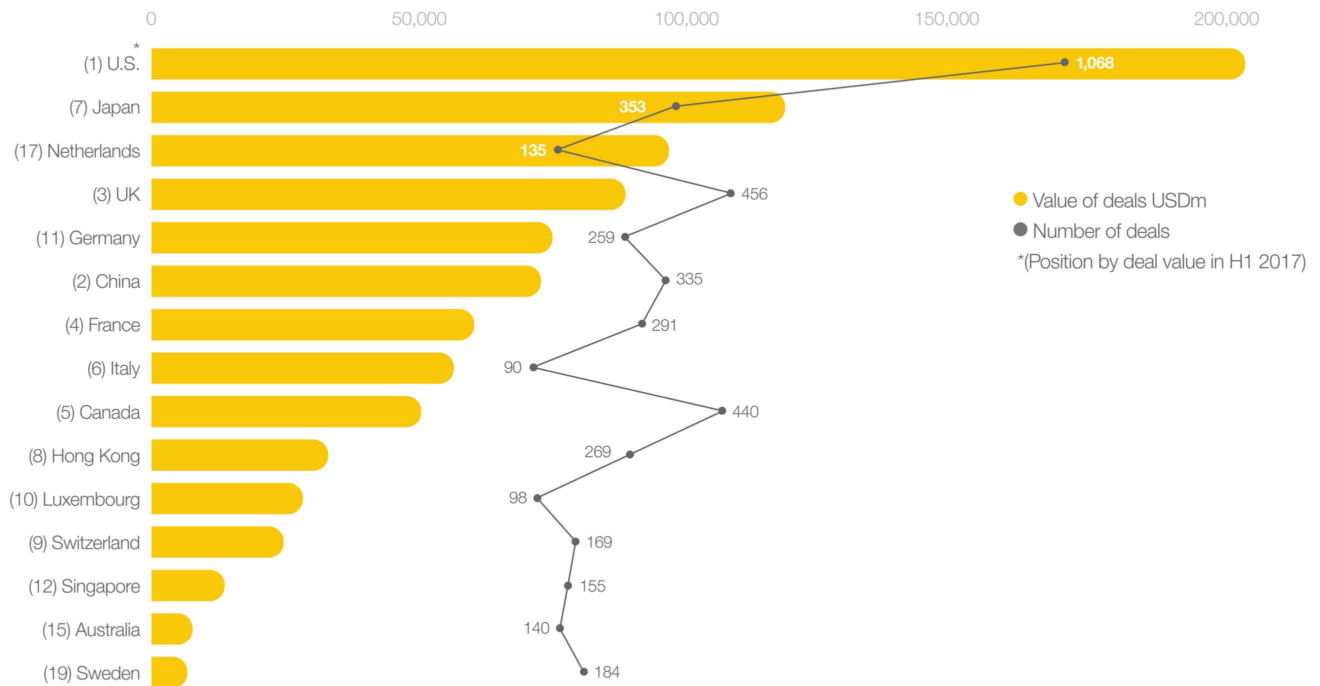
Japanese outbound deal volume



Data provided by

THOMSON REUTERS

Outbound acquirers



02 Private banking at heart of Luxembourg's buoyant M&A activity

Luxembourg, one of the world's leading financial centres, has seen a significant uptick in M&A transactions in 2017 and 2018, with the fast-changing private banking sector taking centre stage. Three main factors are behind this activity – changing regulatory environment, geopolitical shifts and the need to clean up legacy issues.

The softening of Luxembourg's once water-tight bank secrecy laws and the increased level of sophistication in the Luxembourg private banking sector have led some institutions to rethink their operations. Similarly, new regulations that are pushing up costs have had an impact, including Fatca, MIFID II and the EU's new GDPR data protection rules which came into force in May.

We are seeing a growing number of big Chinese banks choosing to base their European operations in Luxembourg, while Swiss banks are circling the market looking to reinforce their foothold in the Eurozone. Brexit is also forcing some UK-based institutions to seek an alternative EU location.

Large numbers of operators in particular from Germany, the Nordic region and France are cleaning up legacy issues, moving away from the old tax optimisation model which has now fallen foul of national regulators, creating significant tax compliance risks.

The number of big deals has grown steadily over the last two years and these have continued in 2018, not least with UBS acquiring Nordea and BNP Paribas buying ABN Amro's Luxembourg operations.

Changes in regulation, both on secrecy and tax, make these deals highly sensitive, placing the emphasis for acquirers on effective due diligence, indemnity structures and overall transition processes.

"The softening of Luxembourg's once water-tight bank secrecy laws and the increased level of sophistication in the Luxembourg private banking sector have led some institutions to rethink their operations."

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