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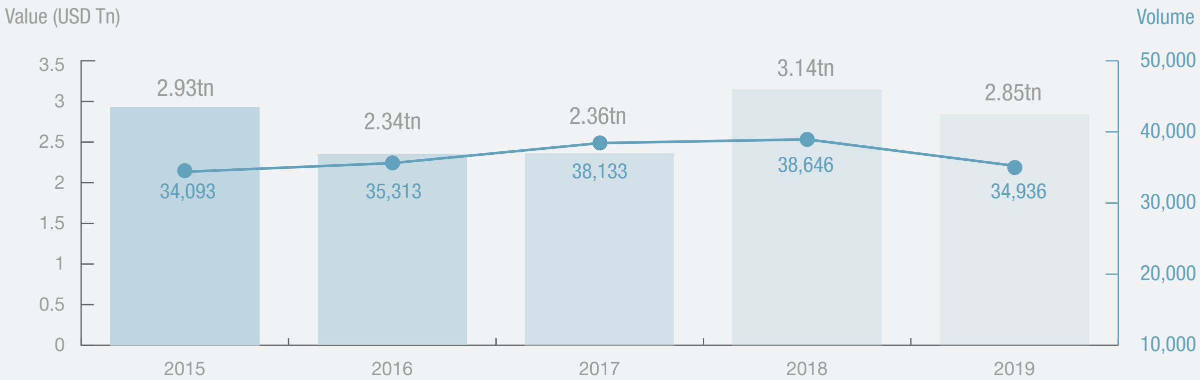
M&A Insights

Q3 2019

Fortune favours the brave

Global M&A Q3 2019 snapshot



10%

Decrease in global deal value
Q3 2019 vs. Q3 2018

10%

Decrease in global deal volume
Q3 2019 vs. Q3 2018

Note: Figures represent deals announced between 1 January 2019 and 30 September 2019

Data provided by REFINITIV

"The global M&A market has undoubtedly become a more nervous place in 2019 and dealmakers are having to confront a range of increasingly complex governance challenges to complete transactions."

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ESG – from the wings to centre-stage?

Environmental, social and governance issues are now firmly in the spotlight in transactions and increasingly sparking litigation. Yet many companies underestimate the detailed analysis they need to do on the climate, cultural and human rights impacts of deals.

In the last two decades environmental, social and governance (ESG) issues have been steadily climbing up the boardroom agenda for large companies and financial institutions.

Yet awareness has grown in fits and starts.

The corporate social responsibility (CSR) movement – which saw many organisations start to report on their environmental and social impacts in the late 1990s – was, in truth, half-hearted for many and often little more than a 'nice-to-have'. Activists regularly dismissed CSR reporting as 'greenwashing'.

In a second wave, and perhaps partly in response to those accusations, we saw an increasing number of organisations embrace a more thorough form of sustainability reporting. The most serious, eager to prove that they had embedded sustainability into their day-to-day operations, began measuring progress using key performance indicators (KPIs) and other verifiable metrics as rigorous as those used to assess financial performance.

While these efforts were genuine, they remained vulnerable to changing investor priorities and market conditions. In the wake of the global financial crisis, for instance, ESG issues once again took a back seat as companies and investors focused on the business of surviving the ensuing downturn.

It was only after the financial crisis subsided that ESG issues once again edged back into the limelight, with climate and aspects of governance, notably anti-bribery and corruption, becoming a particular focus in the due diligence carried out around M&A transactions and project financing.

But now we are seeing a more significant sea change.

ESG issues are increasingly a hot topic for corporate players, lenders and financial investors, and a key topic at the deal table as acquirers seek to finance and execute transactions. Yet many companies continue to underestimate the level of scrutiny they will be put under and the growing level of legal risk attached to ESG issues.

What's changed?

Although the term ESG covers a wide range of issues, many of which are already part of the standard due diligence package, a number of developments are driving change in this area, none more so than expanding regulation and the increased risk of litigation.

In addition, we are seeing a far greater focus on ESG issues in the financial services sector, which, given the pivotal role it plays in the financing of transactions, is inevitably spilling into other sectors of the economy. This trend has been further accelerated by a number of central banks, including the Bank of England, now identifying climate as posing a systemic risk to the banking system, an edict likely to drive further regulatory and behavioural change.

Where climate is concerned, investors, lenders, insurance underwriters and acquirers are now routinely looking at assets from a climate resilience point of view, identifying climate-related risks (and/or opportunities) and assessing their likely impact on a company's future financial position. This reflects the evolving debate over climate. Few now question the science of climate change or the fact that humans are responsible for at least a portion of it. Indeed many are now focused on specific real economic and business threats that could ensue, such as food and water shortages, droughts, coastal flooding and social instability.

Shareholder activism is also playing a significant role. NGOs are either buying shares

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in companies or getting other investors to buy them on their behalf so that they can bring pressure to bear on boards on ESG governance and disclosure issues or even challenge acquisitions or investment decisions in CO_2 heavy projects. We are also seeing climate and ESG-themed shareholder resolutions being submitted by investor-led groups such as Climate Action 100+.

Pressure is coming from another direction as well. The signing of international agreements, such as the Paris Agreement, has emboldened countries, states and municipalities to take action on carbon reduction and renewable energy.

In addition we are seeing an increase in litigation, particularly around deals that have a negative environmental impact. Although we have yet to see many claims resulting in damages, companies are increasingly realising they may be forced to defend themselves, with claimants demanding additional discovery around climate impacts and courts in many jurisdictions willing to see such impacts as causation.

It all adds up to something of a perfect storm and we are seeing similar developments beginning to play out where human rights and social engagement issues are concerned. Here, international commitments, such as the UN's Guiding Principles on Human Rights, are cascading into regulation at the EU level and within individual states and provoking an increase in litigation.

This is most obvious in the growing pressure on states to place a duty of care obligation on companies not just domestically, but wherever in the world they have subsidiary operations or interests.

France has taken a lead here, bringing forward a very strenuous due diligence law that has a "plan de vigilance" obligation at its heart. A similar proposal is now being debated in the UK, with the Labour Party under pressure to commit to such an approach and with a House of Commons committee also pushing the case. This would go further than the existing requirements under the UK Modern Slavery Act, which was recently the subject of an independent review.

Litigation risk is rising here too, and increasingly the risk has an extra-territorial reach affecting both corporate players and multilateral lenders.

The UK Supreme Court, for example, recently ruled that nearly 2,000 Zambian villagers, affected by the discharge of toxic waste from a copper mine, could bring action in the UK courts against the mine's ultimate owner, Vedanta Resources, underlining its duty of care for its overseas impacts. Vedanta had argued the case should be heard in Zambia alone.

The U.S. Supreme Court recently issued a similar ruling affirming the viability of a claim by a non-U.S. community group against a U.S.-based multilateral institution – that had consented to a loan to a local coal-fired plant – seeking recovery for environmental damages linked to the plant's poor environmental performance, and analogous cases are pending in the U.S., Canada and elsewhere.

Diligence and disclosure dilemmas

In this increasingly complex environment, companies, lenders and financial investors find themselves facing a range of dilemmas around disclosure and due diligence and, in the absence of globally accepted standards and further regulation, many are finding themselves on treacherous terrain. Investors in particular are concerned that the data being made available by companies on various ESG issues are not good enough to enable them to make a proper risk assessment.

Although some new standards and forms of guidance are emerging, for instance from the Organisation for Economic Co-operation and Development (OECD) and the Task Force on Climate-related Financial Disclosures (TCFD), dealmakers are still feeling their way with little to guide them.

How do you make a financial disclosure about the risks of climate change or human rights issues? How do you identify the real risks and quantify them? When doing due diligence within your own company, what metrics do you use? How can you be sure, in making an acquisition, that all legacy issues acquired with the asset that might lead to future claims have been identified?

The pressure to be more transparent and to disclose areas of risk is undoubtedly intensifying. But as laws and regulations crystallise around these issues it leaves organisations in a considerable bind. They are effectively being encouraged to disclose more issues that, increasingly, have a legal risk attached to them. That leaves companies having to think very carefully about what facts are material and what to disclose without exposing themselves to greater, or even unforeseen, risk.

Meanwhile, the demands being placed on borrowers, especially by multilateral lenders, are now routinely quite onerous, with loan covenants demanding that borrowers both comply with all applicable local and international laws but also take responsibility for protecting and preserving human rights and cultural heritage.

Such demands can be difficult for borrowers to satisfy, but we believe they will only become more common in the years ahead.

Reality check

In the deal environment, there are natural limits to the depth of diligence that can be done. Inevitably, the level of scrutiny undertaken is dictated by a number of factors, including, among other things, deal timing and pace, the parties' relative leverage and sophistication, the parties' willingness to devote financial and personnel resources to conduct due diligence, and the availability of digestible, meaningful information. In a competitive auction, those constraints can be even tighter.

Even where circumstances would permit adequate due diligence to be conducted, dealmakers often forego this opportunity because they underestimate the potential risks at stake or the degree of detail or rigour required to adequately assess such risks.

As acquirers think about the issues that need to be addressed in the standard due diligence process, their horizons need to be set much wider than in the past with a longer list of topics that need to be covered.

Increasingly they also have to take a much more sophisticated approach to ESG issues than has previously been the case. Where necessary that might mean involving technical consultants in their team of advisers, such as experts able to model the physical and financial impact of climate on assets.

They will also increasingly need to report on ESG and financial issues in an integrated way, paying careful attention to whether disclosures made in their CSR and sustainability reports match what they are saying publicly elsewhere (for instance, in filings to stock exchanges or to the Securities Exchange Commission). This includes the need to accurately incorporate ESG data about a newly acquired business into the acquiring entity's overall disclosures.

The tide has once again risen on ESG issues, but this time it has risen higher than ever before and shows no signs of receding.

Companies and financial institutions are beginning to realise that they need to take ESG reporting much more seriously and do it in a truly integrated way. Effective assessment, management, and disclosure of ESG issues will be an increasingly critical component of many organisations' success in the years to come.

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"Take-private" deals take off

Despite choppier conditions in the global M&A market, public to private deals are proving remarkably buoyant and, this year, look set to exceed levels seen before the financial crisis.

"2019 will see take-private deals match or even exceed the levels seen in 2007 when PE activity in public markets reached its pre-financial crisis peak."

With all the economic and political uncertainty hanging over the global M&A market, it is perhaps surprising to see one particular type of deal-making showing not just resilience but robust growth.

Public to private (P2P) transactions, or so-called take-private deals, are on the increase in many markets, but most noticeably in continental Europe and particularly in the UK.

It has been a consistent theme since the end of last year and one that shows no sign of abating, with PE houses, often with other longer-term funds and pools of private capital investing alongside them, showing an increasing willingness to bid for public companies, no matter the prevailing macro-economic turbulence or the size and complexity of the deal.

Indeed, in the UK, funds are proving to be a dominant force in deals valued in excess of GBP500 million with a number of important, big-ticket transactions of a greater size standing out in the year so far.

These include the USD3.4bn consortium acquisition of satellite operator, Inmarsat, by APAX, Warburg Pincus and two Canadian pension funds in March and the GBP6bn acquisition of theme park operator, Merlin Entertainments, in June by Kirkbi, the investment vehicle of the Kristiansen family, owners of Lego, supported by Blackstone and another Canadian pension fund, CPPIB.

We've also seen the GBP4bn bid for Cobham, the defence group, by Advent, which awaits government clearance, while the brewer and owner of UK pubs, Greene King, is recommending a GBP2.7bn offer from CKA, the Hong Kong investment vehicle of Li Ka-Shing. Both of these deals have involved complex regulatory approval processes.

Commentators are now forecasting that 2019 will see P2P deals match or even exceed the levels seen in 2007 when PE activity in public markets reached its pre-financial crisis peak. One report forecasted that an all-time high of 212 P2P transactions would take place globally this year.

We've seen a similar – if not quite so dynamic – picture in key European markets this year. Germany, for example, has been one of the biggest markets for take-private deals, rivalling the UK with deals such as KKR's acquisition of an interest in Axel Springer and the on-going Osram takeover causing a stir in the media.

By contrast, big corporate buyers, often executing highly strategic deals, continue to be the dominant force in the U.S. market, though there is P2P activity here too.

Familiarity breeds comfort

The return of PE funds to the UK's public market follows a period when they fought shy of take-private deals. That was particularly the case in the aftermath of the Kraft/Cadbury takeover in 2010, when new rules on public deals were introduced requiring bidders to be identified at an early stage and bids to be announced within 28 days of any leak. An inability to secure break fees in target companies under these rules, or to win exclusive negotiating rights, also deterred PE bidders, as did the intense competition from corporate buyers willing to pay much higher premiums for sought-after synergies.

While those rules persist, it's clear that sponsors have grown more comfortable with them and their confidence appears to be growing as more and more funds enter the fray.

Other more fundamental factors are driving activity. PE sponsors have accumulated record levels of cash in recent years – cash that needs to be deployed during the relatively constrained lifetime of newly created funds. Debt financing markets remain relatively benign and look likely to remain so in the immediate future. Low equity values, compared to other developed markets, and the steady devaluation of sterling also mean that UK asset prices are currently attractive.

In addition, we've seen the confidence of strategic buyers dip in recent months. In some cases they may be struggling to make investment decisions at a time of political and economic uncertainty, not least the turbulence caused by Brexit and the trade standoff between the U.S. and China. Some are holding back, except where there is a clear defensive opportunity to cut costs through a merger.

Hurdles

Despite all that, it would be wrong to conclude that sponsors are finding it plain sailing in the public takeover market. Transactions – especially the larger ones where PE bidders are particularly dominant – are invariably complex and can be highly competitive, as the auction battle for telecoms company KCOM demonstrates, with USS finally pipped to the post by Macquarie.

This also remains relatively unfamiliar territory in a number of important ways. For example, sponsors are typically used to higher levels of due diligence access than is typical in public deals. Instead, they have to make use of already public information issued by the target and deal with rules that insist that all bidders have equal access to information.

Yet careful diligence remains key, particularly around financial forecasts, as PE deals tend to be tightly financed and, in some cases, funds may have less flexibility than strategic buyers to get into a bidding war.

These strategies do still have the benefit of cost (and potentially revenue) synergies, which in some transactions might represent a significant advantage in the race to win an asset. On the flip side, depending on which way the antitrust/competition winds are blowing, the PE houses may have a distinct advantage on certainty of execution and speed to closing.

Another factor that sponsors must weigh up is management. Many will want to keep the current management in place. Incentives and rollover arrangements, therefore, tend to be a big focus of negotiation – but usually only when a price has been agreed.

Even if a share price has been in decline, target boards are tending to insist that valuations are based on an average view of the share price over a period and will be looking for a sizeable premium over that price. Having said that, boards know this is an expectation from shareholders to engage if such terms are offered.

In the case of the UK, a weak pound can obviously work in favour of overseas bidders, but they may need to carefully hedge themselves against any rebound in sterling that might come in the months ahead. Assessing political and economic risk is also a significant factor, but this has clearly become more nuanced in recent months. How a potential hard Brexit might impact a company will depend on its sector, markets and supply chain. There remains a high degree of caution, but some investors are betting that the current political difficulties will ease in the months ahead, and that the prospects for companies with a dependable home market will look much brighter.

Can the boom last?

All the signs point to this trend continuing, not least due to the amount of capital funds have accumulated and the need for them to deploy their dry powder. That is likely to remain the case for some time, provided that debt markets remain strong.

The growing willingness of funds to club together in consortia to execute deals also provides them with added firepower to take on bigger and more complex transactions. Increasingly that will be with the support of pension and sovereign wealth funds and family offices, although some longer-term funds prefer to support transactions later in the process, sensitive about being seen to be overexposed to any one market or sector.

For now, sponsors are active in looking at public company opportunities. Should targets or the relevant currency become more expensive, once there is greater certainty, deals will undoubtedly become harder to finance.

As and when confidence returns to corporate buyers, we may well see the balance swing back. However, that is unlikely to happen quickly and we see sponsors playing a dominant role in public takeovers for the short to medium term.

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Real estate – sustaining growth through challenging times

Despite the inherent volatility of the sector, real estate transactions have experienced dramatic growth over recent years fuelled by an increasingly diverse range of international investors with huge amounts of capital to deploy.

"We are continuing to see activity in the most developed markets such as the UK, the U.S. and parts of Europe, but global investors are also looking to new markets for opportunities, for instance Eastern Europe and Asia."

On the face of it, few sectors would seem more vulnerable to the perils of boom and bust than real estate and, traditionally, it has been safe to assume that property transactions would rise and fall radically with the economic cycle.

The prevailing political and economic uncertainty and fears of slowing global growth are beginning to impact levels of real estate M&A activity, and certain sectors, such as retail, are suffering and showing signs of distress. However, the fundamentals remain strong; debt remains cheap; loan-to-value (LTV) coverage is within sensible limits; and the levels of "dry powder" available to international investors, in particular to U.S. real estate private equity funds and Asian investors, remain at all-time highs. While we anticipate that there may be a moderation of activity in some markets, activity in favoured asset classes, particularly those with an income operational focus, is likely to continue into 2020.

Property transactions have followed a path of relatively stable and sustained growth in the years since the financial crisis. Growth in investment has accelerated in the last two years as an increasingly diverse range of well-resourced international investors have allocated more of their capital to real estate transactions across the world. In 2018, USD1.8tn was invested in global real estate – the most active year ever.

What was once a predominantly domestic market has become increasingly international in recent years. We are continuing to see activity in the most developed markets such as the UK, the U.S. and parts of Europe (albeit cross-border capital flows slowed in the first half of 2019), but global investors are also looking to newer markets for opportunities, for instance Eastern Europe and Asia. In Europe, Poland is seeing continued growth following its reclassification to "developed market" status. This, combined with higher yields and therefore a better return on investment than mature real estate markets such as France and Germany, has resulted in new investors entering the market. China is also attracting growing amounts of inbound investment and has overtaken Australia as the prime target for international funds in the Asia Pacific region.

At the same time, Asian investors are looking for opportunities in Europe and beyond. Although Chinese investors, the vanguard of this activity throughout 2015, 2016 and the first half of 2017, have been deterred by strict capital controls imposed on speculative investments in property and entertainment assets, they have often been quickly replaced by other Asian investors, notably from Korea and Singapore.

Likewise, Middle Eastern sovereign wealth funds also continue to pursue outbound opportunities, often taking advantage of currency fluctuations to find assets at good prices.

The main factor driving activity on an international scale remains the sheer volume of capital raised by investors in recent funding rounds and the continuing availability of affordable debt financing for transactions in buoyant parts of the real estate market from both the banks and alternative lenders. In particular, PE funds have built up huge amounts of dry powder for both their equity and debt real estate strategies and are increasingly widening their search for targets that can deliver attractive returns in the relative short term.

However, new entrants, including sovereign wealth funds, pension funds and insurers, are also favouring real estate over other asset classes and, with lower costs of capital, are finding plenty of opportunities that meet their demand for stable returns over a longer investment timescale.

"We expect to see the market moderate rather than to decline sharply. The real estate boom of recent years appears to have some way to run."

Multi-jurisdictional deals

Another feature of the growing internationalisation of transactions in the sector is the proliferation of multi-jurisdictional deals, with investors looking to deploy huge amounts of capital in one go, aiming to achieve scale at speed and obtain a diversified portfolio to hedge themselves against variations in local market conditions.

For example, we've seen a sharp rise in pan-European transactions in recent years, particularly in the logistics space. The EUR12bn sale of Blackstone's logistics platform, Logicor, to the China Investment Corporation, and Brookfield's USD2.8bn sale of its Gazeley warehousing operation to the Singapore-based GLP fund, both involved assets spread widely across Europe. Another recent pan-European acquisition by Blackstone saw the fund buy Canadian REIT Dream Global whose assets include over 200 office and warehouse properties in over 100 cities across Western Europe.

Regional variations

Regional markets are inevitably subject to different short-term dynamics, each at varying stages of maturity and development. We are seeing significant disparities within Europe for instance.

Deal activity in Germany has become increasingly hectic after a relatively slow start to the year with a number of sellers looking to offload large portfolios before the year-end in expectation of the market moderating in 2020. However, demand from buyers remains strong, exacerbated by a relative dearth of attractive assets, which is forcing even cautious investors to consider more risky, greenfield development opportunities.

The French market, by contrast, has experienced a slow year with yields at an historic low, while in Spain activity by funds specialising in distressed assets remains a dominant theme with the big U.S. funds, such as Blackstone and Cerberus, still active alongside new investors in the region, such as Korean pension funds. Spanish banks continue to seek buyers for non-performing loan portfolios five years after this activity started and the secondary market remains busy as funds look to make exits.

In Poland, despite projects of significant scale across a range of asset types, particularly offices and logistics, deal values tend to be considerably lower than in other European jurisdictions.

Despite worries about currency and the slowing of growth, activity in the mainland China market has remained strong over the last 18 months, again partly driven by a shortage of good assets, which is driving up valuations. Platform-type deals predominate and we are seeing international funds taking increasingly innovative steps to reposition and restructure existing portfolios, recycling existing assets and enticing new investments from long-term investors as limited partners.

In the Middle East, efforts to diversify from a dependence on oil revenues continues to drive outbound investment into international real estate, although in many locations within the region real estate valuations have fallen in recent years. However, there are now signs that the market may have found a bottom and there have been some high profile investments by international funds, including the recently announced AED5bn (USD1.36bn) joint venture between the Dubai government owned developer Meraas and Brookfield.

A number of "mega-projects" in Saudi Arabia are at the planning stage, including a large number of hotels to be constructed along the Red Sea coast and some of these are now moving towards the implementation phase. The progress of this implementation (and the sources of capital used to fund it) will be closely watched by market participants.

The search for alternatives

Despite these regional differences, one theme remains fairly consistent in a wide number of markets – the search for alternative investment opportunities that offer the potential to earn higher yields than those available on traditional core real estate assets like offices and retail. Investors have shifted their focus towards operational assets with potential for stable long-term income growth. These tend to be less cyclical in nature.

Student housing is one example. Although a fairly well developed market in the UK, there are a growing number of developments planned in France, Germany and Spain. Investors clearly see this as a growth market, as public sector investment declines in this area and young people prolong their studies at a time when the job market remains uncertain.

Data centres and warehouses are also increasingly popular alternative investment options in many markets, driven by technological and social change. Where logistics is concerned, there is a concerted focus by major funds on "last mile logistics" – storage space sited close to the final product destination, often created by converting traditional retail property into local warehousing.

The demise of traditional retailing is a consistent theme across regions, as shoppers increasingly go online to make purchases rather than visit the high street or shopping centre. That trend has been acutely apparent in the UK (which leads the way in retail disruption) in recent months as a growing number of major retailers, including Arcadia, Debenhams, House of Fraser and Monsoon, seek to close outlets or renegotiate rents, often through contested Company Voluntary Arrangements (CVAs).

Landlords and developers are responding by working to change the use of retail schemes to include a mix of residential, office, retail and leisure amenities such as restaurants, bars and cinemas. The focus is on repurposing and right-sizing. Flexibility is key – property that cannot be flexible will struggle.

A number of large-scale retail centres continue to thrive in their own right, but to attract investment and debt financing most centres need new ways to attract footfall, even if that involves navigating government and local authority planning rules. Where such schemes are under development, they are, however, attracting opportunistic international investors.

Outlook

The impact of Brexit on the European market remains uncertain as is the wider global economic impact of the continuing U.S./China trade standoff. Taking into account these political and economic head-winds, coupled with the historic cyclical pattern of the real estate market, it would not be surprising to see a slowdown in deal activity in the course of the next year.

However, given the demand for assets, record levels of capital targeting the sector, and the willingness of investors to pursue alternative investment opportunities or create innovative platforms, we would expect to see the market moderate rather than to decline sharply depending on the sector and geography. The real estate boom of recent years appears to have some way to run. Furthermore, where distress does hit, there is an increasing number of investors waiting to seize these opportunities and it is likely that non-performing assets will be actively managed, rather than left for an extended period in a "zombie state" such as that following the financial crash in 2008.

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