

# ALLEN & OVERY

## Staying power

M&A Insights | Q1 2017

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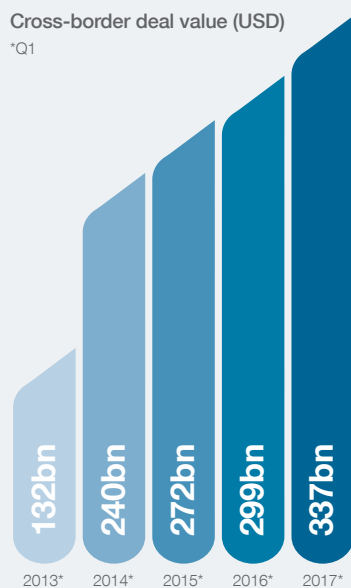
THOMSON REUTERS

# Staying power

Global M&A markets continue to show remarkable resilience, with investors determined to navigate economic uncertainty, regulatory complexity and the threat of increasing political intervention to achieve growth through strategic transactions.

## 01 Ten-year high for cross-border M&A

The value of global cross-border M&A transactions in the first quarter has reached a ten-year high, with a 13% increase from Q1 2016, despite a relatively significant 10% reduction in cross-border deal volume. Worldwide M&A is at a two-year high, up 12% by value on Q1 of last year, but with a 9% reduction in deal volume. By contrast, mega deals worth over USD5bn have fallen, with a 9% drop in value.



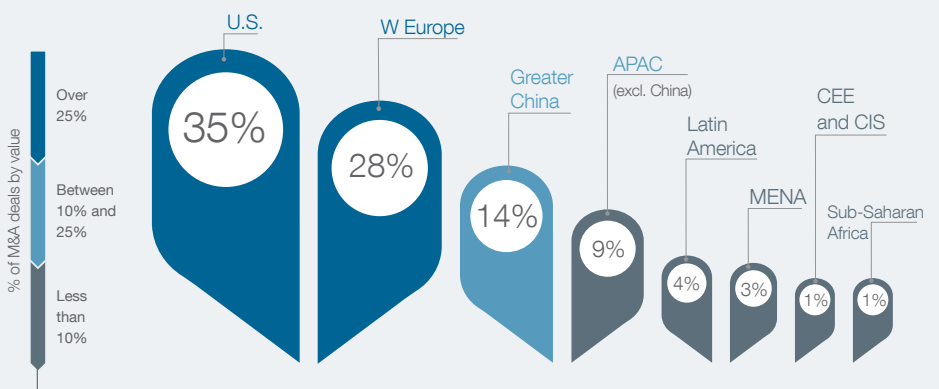
## 02 Intervention – how real a threat?

The threat of increased government intervention and more aggressive activity by antitrust regulators is a growing concern for international investors. But it remains unclear how rhetoric will translate into policy and action.

China, for instance, appears to be signalling a less interventionist stance on inbound investment, although it is tightening controls on outbound deals. And while there has historically been growing pressure on U.S. authorities to be more interventionist, the Trump administration's policies are still unclear and we do not anticipate a significant shift to a more restrictive regulatory environment in the immediate future.

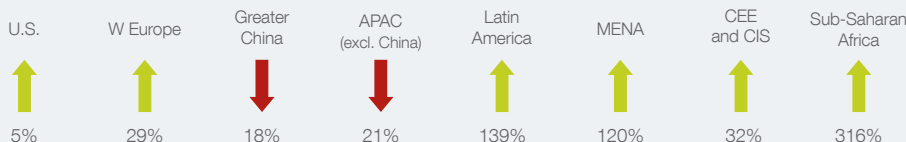
The UK Government has at times indicated a potential interventionist stance in certain sectors (e.g. pharmaceuticals and critical infrastructure), but currently has limited tools to intervene and will also want to show that the UK is open for business.

## 03 U.S. still dominates – Q1 deal value by region



The U.S. market remains the main powerhouse of global transactions with deal volumes up by 20% from Q1 2016, the highest level for a first quarter on record. Western Europe has had a mixed first quarter with deal value up 29% but volume down 25%. Deal value is also on the rise in emerging markets such as Latin America, Sub-Saharan Africa and MENA, driven in part by a small number of large deals. Asia Pacific has hit a much quieter patch, with Greater China slowing markedly, especially in terms of outbound deals.

### Q1 2017 vs. Q1 2016 by value



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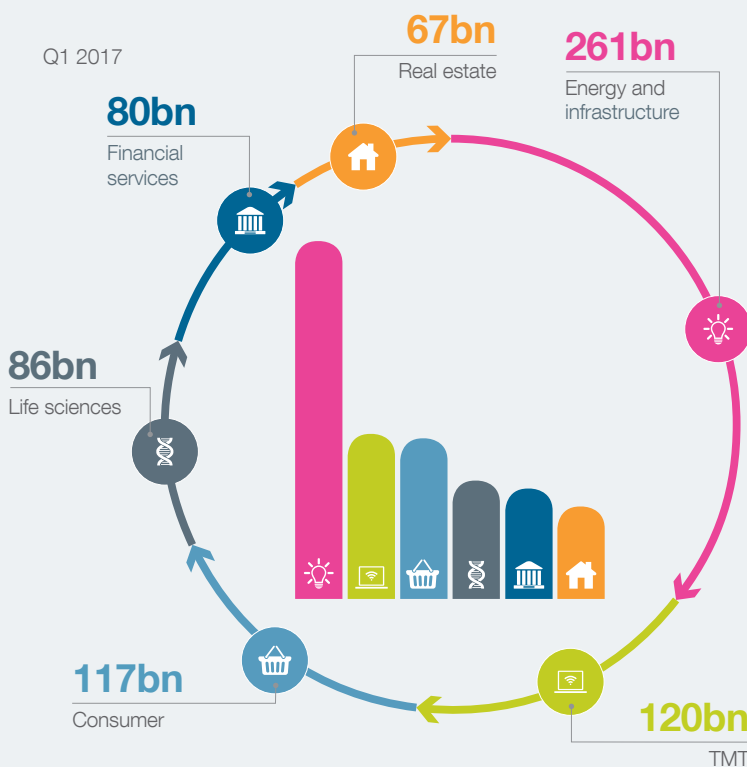
Note: These figures represent deals announced between 1 January 2017 and 31 March 2017.

## 04 Demand and higher commodity prices driving mining revival

Commodity prices have continued to strengthen, bringing confidence back to dealmakers in the mining sector. Those who invested at the bottom of the price trough are now making money again. Continuing strong demand, particularly from China, is bolstering this confidence, helped also by measures in recent years to cut overcapacity.

While the huge 142% increase in deal values from Q1 2016 may somewhat overstate the level of recovery in the sector, many expect commodity prices to continue to stabilise this year and next and that will surely encourage banks and investors to get behind new projects and deals.

## 05 Top six sectors by value (USD)



## 06 Strategic life sciences deals surge

The life sciences sector sprang back into life in Q1 with deal values increasing by a massive 61% from Q1 2016. Volumes fell by 2%, but this is a relatively modest decline compared with the market at large. Although a number of big deals underpinned that growth – not least J&J's USD29bn acquisition of Swiss blood pressure specialist, Actelion – generally investors are clearly determined to stick with their strategic investment plans despite the ongoing political uncertainties.

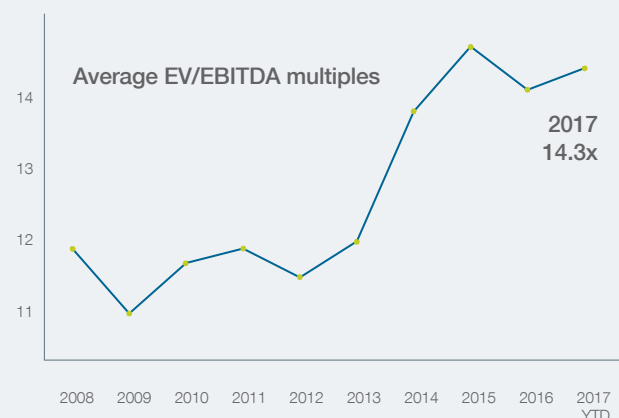
## 07 Strong consumer sector growth

The value of consumer transactions grew 29%, although deal volumes have fallen slightly from Q1 2016 in line with the wider market. A number of big cross-border deals were behind this growth, including the EUR49bn eyewear merger between Luxottica and Essilor, Mars' move into pet health care through the acquisition of VCA, and RB's USD16.6bn acquisition of Mead Johnson, the baby formula maker, which secures their access to key markets including the U.S. and China.

## 08 Deal multiples at near record high

Escalating multiples reflect the extraordinary accumulation of corporate, private equity and other capital competing for a relative dearth of high quality assets. Unsurprisingly, the highly active life sciences (17.0x) and TMT (14.8x) sectors are currently the most expensive for buyers.

Investors are clearly prepared to pay big premia for specific benefits – the chance to squeeze higher margins out of a consumer goods maker through efficiency measures, for instance, or the chance to exploit a drug still in patent.



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# China outbound: A tide stemmed?

After record levels of outbound investment in 2016, China has moved to slow the rapid outflow of capital and deal volumes have shrunk dramatically. Some Chinese buyers are in “watch” mode assessing the new regulations. The question is: for how long?

## A policy shift?

An explosion of overseas dealmaking by Chinese state and privately owned companies drove outbound investment to record levels in 2016.

Given the government’s explicit support for this expansion abroad, not least through its so-called “One Belt, One Road” policy, many expected to see the tide of foreign investment to continue to rise in 2017.

But with the renminbi depreciating significantly as last year drew to a close, it became clear that the Chinese authorities were becoming increasingly alarmed by the speed at which capital was pouring offshore and were determined to act.

There was no formal announcement or decree.

Instead, through a series of press briefings and commentaries in November and December, the government let it be known it planned to tighten its regime of regulatory controls to curb what it regarded as more speculative, rather than strategic, investment.

The new policy stance has, without doubt, sown confusion in the minds of Chinese investors, both state – and privately – owned. They haven’t lost their appetite for overseas deals, but some of them have entered a “watch” period and are deferring deals while they work out the best way forward.

The effect has been dramatic. In the first quarter of 2017, outbound dealmaking fell sharply, with China dropping from the very top of the outbound investment league table to a more modest fourth place.

Inevitably, that has led some to speculate that we may have seen an end to China’s great outbound adventure.

In truth, the story is a great deal more nuanced than that.

## What deals are impacted?

Closer scrutiny of the regulatory changes makes it immediately clear that this is a shift in policy rather than a reversal. China remains committed to the outbound strategic goals of “One Belt, One Road” and is still keen to encourage deals offering access to valuable resources and technologies.

It’s also important to realise that the new controls have been superimposed on an already onerous regime that obliges Chinese investors to clear outbound deals with a range of regulatory bodies, such as the National Development and Reform Commission, MOFCOM and SAFE.

The new controls are overlaid on this regime.

They include a new stipulation that any outflow worth more than USD5m must be verified by SAFE. Where overseas investments are concerned, the threshold is USD50m, with investors forbidden from breaking transactions into smaller tranches to avoid scrutiny.

Purely financial (rather than strategically important) investments will also no longer be encouraged, while six types of investment are being targeted for greater scrutiny, including:

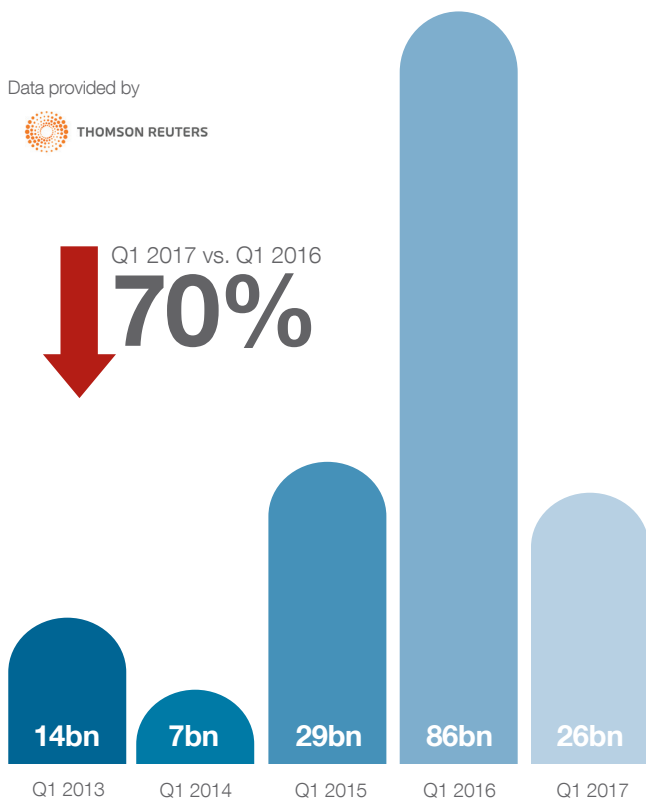
1. Small parent, big subsidiary transactions – where the target is bigger than the buyer – and so-called “swift in, swift out” deals made soon after the buyer has been set up
2. Consortium deals where investors band together in a limited partnership
3. High risk, low return transactions
4. Take private deals where the ultimate owner is a Chinese company
5. Extra-large core business deals worth in excess of USD10bn or non-core business transactions worth more than USD1bn. Property deals by SOEs worth more than USD1bn are also caught in this net
6. Investment in minority shareholdings of less than 10% in listed companies

In addition, curbs are being imposed on deals in five specific sectors – real estate, hotels, cinema, entertainment and sports clubs – all areas of growing non-core investment in recent times.

Significantly there has been no tightening of the rules on securing transaction finance offshore, a vital source of funding for outbound investors. No prior approval is required here.

## China outbound deal value (USD)

Data provided by



*“The current downturn in transactions will, we think, eventually prove to be more of a hiccup than a permanent correction. China remains open for business.”*

Victor Ho  
Partner, Beijing

Note: These figures represent deals announced between 1 January 2017 and 31 March 2017.

## Impact on M&A

The modified regulatory landscape will no doubt be more complex to navigate. Investors of all types need to be prepared for more intense and lengthier scrutiny. The scope for unpredictable regulatory discretion, even in non-restricted areas, will also be increased.

SOEs are prohibited from investing in non-core business. But if they can prove that their investments are in line with their own, or national, strategic goals, there is a good chance they will get the green light.

Private companies and SOEs with access to offshore cash will, we think, find it easier to get deals over the line.

Some investors may be tempted to use creative deal structures to bypass the new controls, but in many circumstances this looks ill advised. For buyers and sellers alike, there is no substitute for starting the process of due diligence early so that they fully understand and begin preparing for the potential regulatory roadblocks in their path.

The good news is that Chinese and international banks and financial institutions remain very supportive of outbound investors and are prepared to provide part of the deal finance from offshore branches. For investors worried that regulatory delays may prevent them raising finance in time to avoid deal break fees, the option to use bridge financing to cover the equity element of the deal remains an entirely realistic, if more expensive, option.

## Outbound outlook – our view

It is too early to predict how these changes will affect the volume of Chinese outbound deals in 2017.

If investors remain in the current “watch” mode for a protracted period, we could see a significant retrenchment.

But there’s good reason to believe the period of adjustment will be shorter-lived, and this is borne out by work we are currently doing with clients on both the buy and sell side.

Tighter controls will squeeze some transactions out of the market, for sure.

But the current downturn in transactions will, we think, eventually prove to be more of a hiccup than a permanent correction. China remains open for business and, while it does, outbound investment will continue.



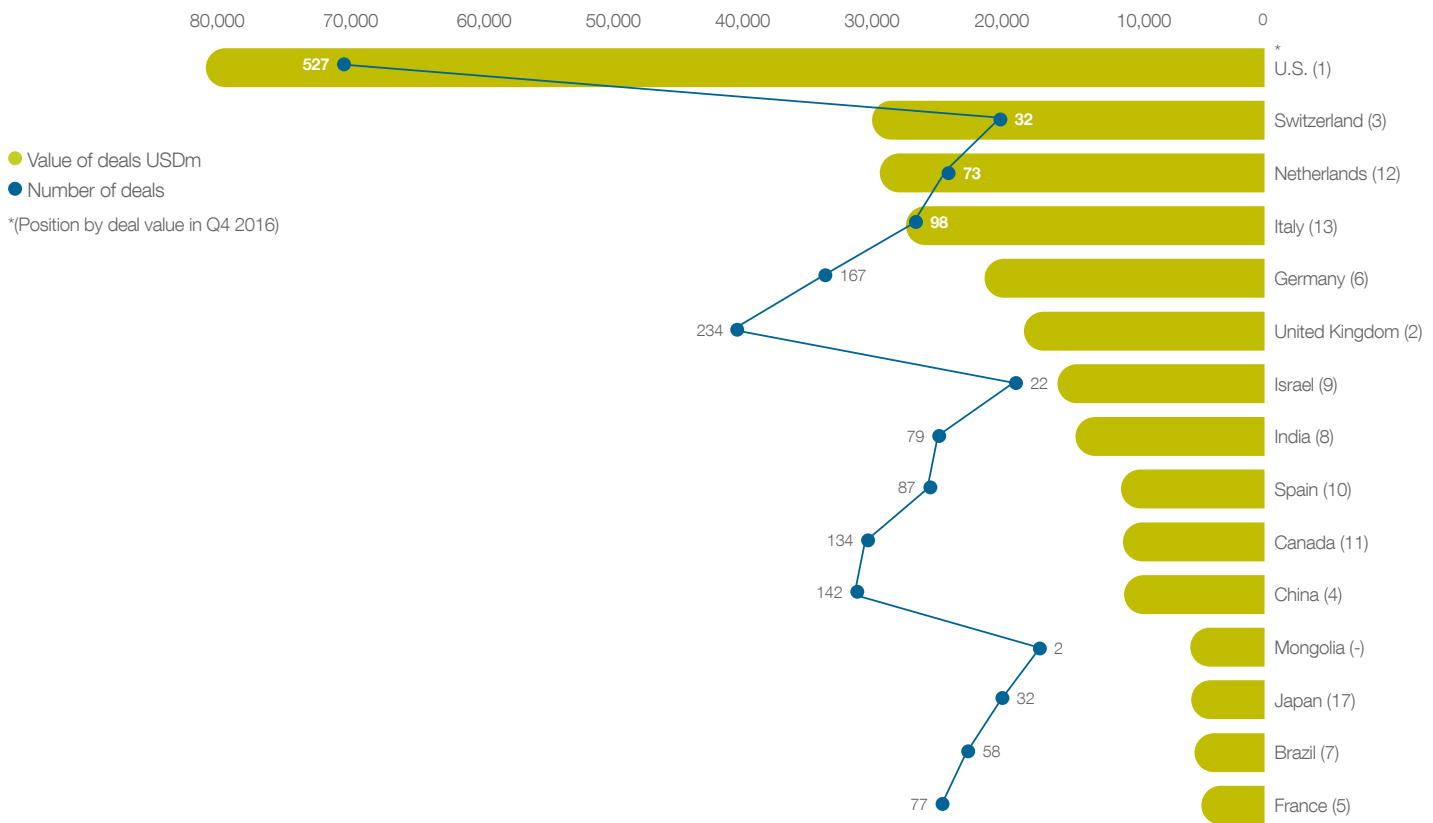
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# Global deal flows

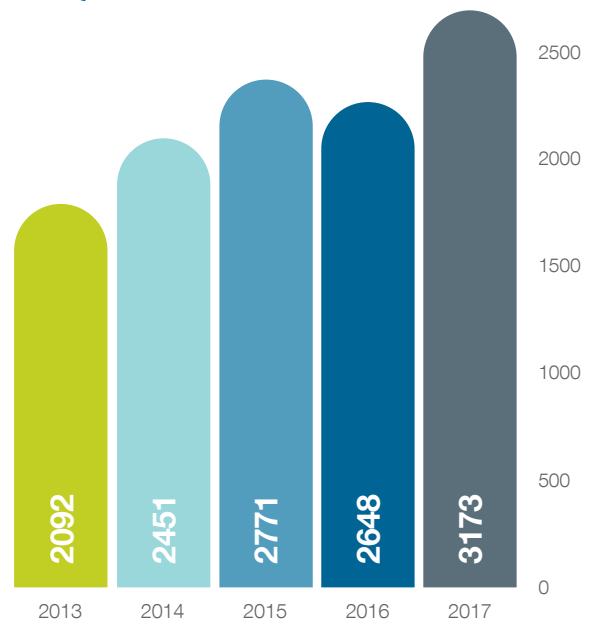
## Inbound target markets



## 01 U.S. market shows continued resilience

- Neither post-election political upheaval nor the roll out of the Federal Reserve's long awaited programme of interest rate rises appear to be dampening the powerful U.S. transactions market, with deal volumes and values rising by 20% and 5% respectively in Q1.
- We are seeing strong activity domestically and across borders, with the U.S. climbing to the top of the outbound investment league. While U.S. companies dominate big deals, it is notable that half of the ten highest value deals, globally, involved a U.S. target and that four of these were domestic.
- It's clear that companies, buoyed by strong equity markets, good reserves of cash and access to relatively cheap debt, continue to see strategic M&A as the best way to add value in a low growth environment. The fundamentals of a healthy M&A market remain intact, and we feel we will continue to see a pipeline dominated by synergistic and transformative deals in the year ahead.
- In addition, the regulatory environment for transactions may be somewhat more favourable now than it has been in the recent past. While the Trump administration's policies towards antitrust enforcement are not completely clear yet and may not track historical Republican positions, we do not expect to see a more restrictive environment in the near future.

### U.S. Q1 deal volume

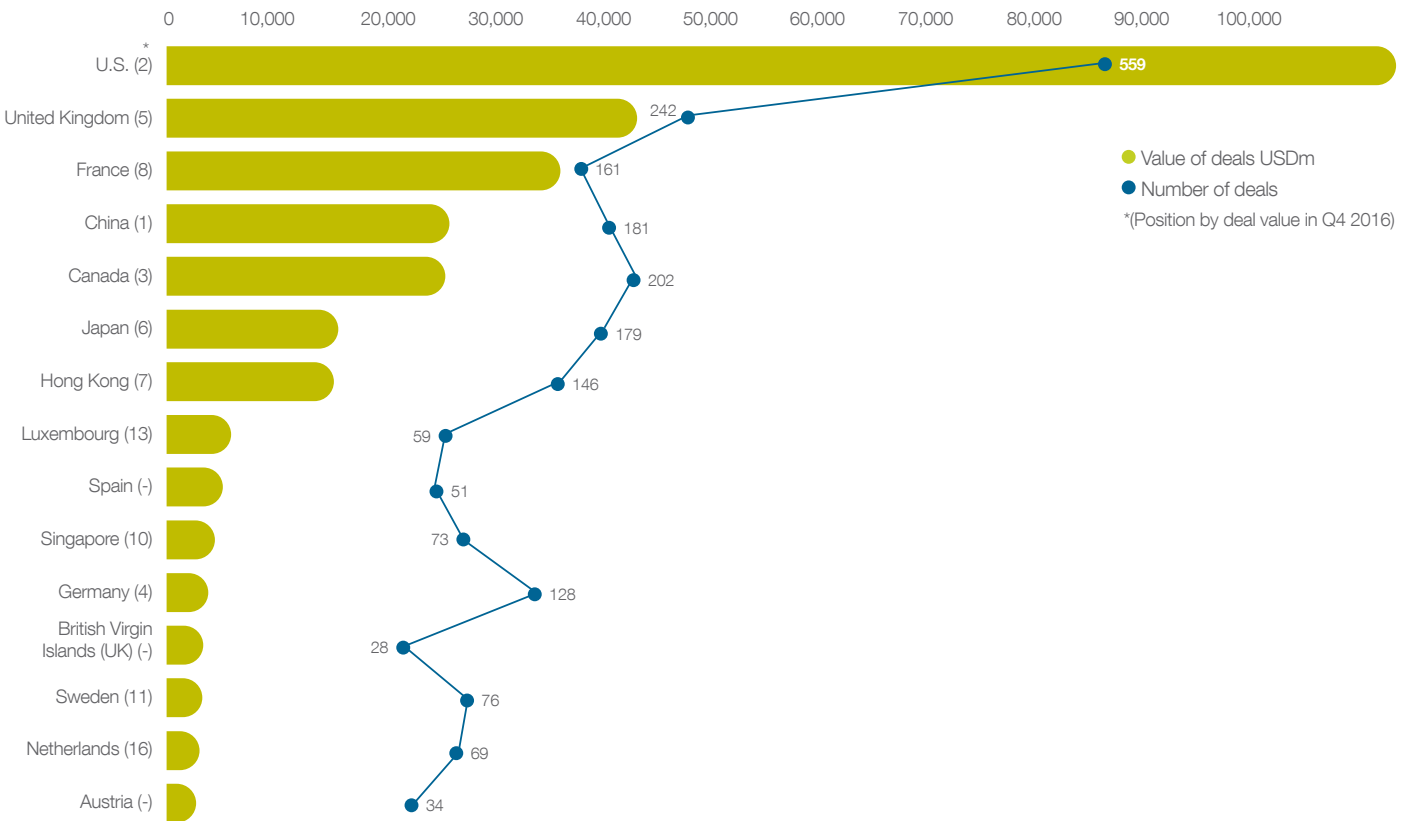


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## Outbound acquirers



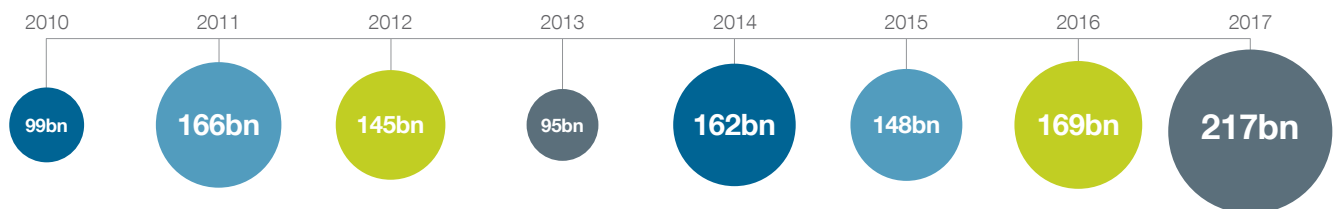
### 02 Is Germany looking to new markets?

- Germany saw Q1 inbound deal values grow by 125%. PSA's proposed takeover of Opel/Vauxhall was unveiled and the battle between rival PE consortia to buy drug maker STADA intensified. Smaller Chinese investors continue to scout Germany's powerful middle market, although national security remains a hurdle in some sectors.
- Outbound activity included Henkel's acquisition of U.S. detergent maker Sun Products and a Russian gas disposal by Uniper.
- Looking forward, with greater U.S. protectionism a looming possibility, Germany looks increasingly keen to build reciprocal investment relationships elsewhere, including China.

### 03 France picks up the pace

- France stood out as one of the strongest outbound performers in a resilient Western European transactions market.
- Powered by some big-ticket deals, notably the EUR49bn Franco-Italian eyewear merger between Essilor and Luxottica, France climbed to third place in the outbound acquirers' league table.
- Domestic deals, such as the proposed EUR10bn Zodiac/Safran aerospace merger and EDF's acquisition of Areva NP, also suggest the political uncertainties of Brexit and the French presidential elections are not deterring investors.
- Forecasts remain uncertain and will largely depend on the outcome of the forthcoming election. Certain candidates are supporting pro-business tax and employment reforms which, if adopted, could have a positive effect on the French M&A environment and, in the context of Brexit, favour foreign investments and repatriation of employees.

### Western Europe Q1 deal value (USD)



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