M&A INSIGHTS | Q1 2019
Navigating complexity to sustain growth

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Global M&A Q1 2019 snapshot

Turning point or pause for breath?

23% decrease in global deal value
Q1 2019 vs Q1 2018

33% decrease in global deal volume
Q1 2019 vs Q1 2018

Commentators have wondered for some time when the deal market would end its record-breaking bull run. The question is whether the latest data marks that turning point or, as we’ve seen before, a temporary dip before activity picks up again.

Deal values and volumes declined across most regions and sectors, with megadeals – the mainstay of the market in recent quarters – also down. In volume terms, cross-border deals had their slowest start to the year since 2009.

At a time of geo-political turbulence, trade tensions and, more importantly, signs of slowing global growth, it’s fair to expect M&A markets to become unsettled.

Yet we are seeing a different picture – one of continuing resilience. Businesses remain eager to do deals, whether that’s transformational strategic deals, technology-driven transactions or IPOs. There’s a good supply of assets for sale, with auctions continuing to attract PE and strategic players. We are even seeing hostile takeovers, usually a reliable indicator of market strength and investor confidence. In this latest edition we examine some of these market trends.

The Q1 data could therefore reflect a moment of pause after the frenetic activity we saw in the first half of 2018, rather than a sign the market is going into retreat. All eyes will be on the data for Q2.
Global trends in private M&A

Allen & Overy’s annual study of the private M&A market – based on in-depth analysis of more than 1,000 deals we’ve advised on over the last seven years – showed growing levels of auction activity in 2018, with confident sellers gaining the upper hand on deal terms.

Increase in auction activity

Auction activity has increased steadily over recent years. But in 2018, for the first time, more than half the private M&A deals we advised on were conducted as auctions, with the figure rising sharply from 41% in 2017 to 53% last year. Sellers will only contemplate an auction if they believe they can attract significant competition for their assets, so this was a strong indicator of market confidence.

PE funds continued to win a high proportion of auctions – some 46% of those in our sample. Part of this success comes from a continuation of strategies that emerged a number of years ago. Buy and build, for example, means that many sponsors already have large portfolio companies they can merge targets into, achieving synergies that allow them to compete with strategic bidders on price. Last year, 60% of the auctions in our sample that were won by a PE bidder were bolt-on transactions of this type. Many more represented the first stage of a buy and build strategy – an initial investment to which further businesses would be added.

Despite their dominance, PE funds are now facing greater competition for assets as the universe of potential buyers expands. While sovereign wealth and pension funds were once happy to invest through, or alongside, PE, some have now established teams to source and execute deals in their own right.

Deals conducted by auction

Execution risk rises

Our analysis over recent years has shown the deal environment becoming riskier, with transactions more likely to require antitrust, foreign investment or regulatory clearance. This is mostly down to merger control regimes becoming stricter and more numerous, foreign investment regimes getting tougher, and regulators becoming more active. However, it may also indicate that buyers are receptive to doing riskier deals – something that typically happens in a maturing M&A cycle.

Execution risk continued to rise in 2018, with 85% of our deals worth more than USD250 million requiring some form of clearance – an increase of 8% on the previous year.

This means that, in reality, most sellers now have to accept some conditionality. Last year, they seemed willing to do so where the substantive risk of a failed deal was low, particularly if the buyer backed its ‘low risk’ assessment with an element of deal protection.

Protections are typically either financial or behavioural, with a reverse break fee payable by the buyer to the seller the primary example of the former. Last year, 13% of our conditional deals provided for one of these, with the average fee some 6% of deal value.

On the behavioural side, “hell or high water” commitments are increasingly common. These require a buyer to take all necessary action to get clearance, and last year 26% of the deals in our sample with an antitrust condition included one. PE sellers, in particular, insisted on them.

Antitrust, foreign investment or regulatory approval (Deal value USD250m+)

<table>
<thead>
<tr>
<th>Year</th>
<th>Clearance Required</th>
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<tbody>
<tr>
<td>2016</td>
<td>76%</td>
</tr>
<tr>
<td>2017</td>
<td>77%</td>
</tr>
<tr>
<td>2018</td>
<td>85%</td>
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Digital transformation leads to more earn-outs

Companies across sectors are increasingly using transactions to speed their digital transformation programmes or to ‘acquihire’ talented individuals with important digital skills. As a by-product of this we saw a rise in the use of earn-outs, designed to retain and incentivise founders and management shareholders or to share risk and reward in a new technology.

<table>
<thead>
<tr>
<th>Earn-out (% of deals)</th>
</tr>
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<tbody>
<tr>
<td>2016: 9%</td>
</tr>
<tr>
<td>2017: 16%</td>
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<tr>
<td>2018: 20%</td>
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</tbody>
</table>

Earn-out (% of deals)

Advantage seller

Sellers gained an increasing upper hand in the private M&A market in 2018, but that only becomes truly apparent when you look closely at changes in deal terms.

These include mechanisms designed to delay the passing of risk to the buyer ahead of closing such as material adverse change provisions, pre-closing termination rights for material breach of warranty, and warranty repetition (giving a buyer the right to claim damages if a warranty is incorrect at closing). Globally, we saw a sharp decline in the use of the first two mechanisms and a slight decrease in warranty repetition during the year.

We’ve also seen warranty cover diluted (including by more data room disclosure and consequential loss exclusions, and high levels of materiality and knowledge qualifiers), lower financial caps on the seller’s liability, and shorter terms for transitional services arrangements.

Taking a global view ignores the inevitable differences between market practice in different regions, but it does show the balance swinging in favour of sellers. As we move through a potentially far more uncertain M&A market in 2019, it remains to be seen whether that advantage will hold or if buyers will begin to push harder on deal terms in the months ahead.

W&I insurance continues to grow

Over the last few years, we have seen an explosion in the use of warranty and indemnity (W&I) insurance in PE exits. This trend continued in 2018, with the product used in some 70% of the PE exits we advised on globally.

W&I insurance started in Australia, but quickly caught on in the UK and Western Europe – the regions where it remains most popular. Although later to the party, the U.S. is now seeing greater use of W&I insurance though premiums tend to be considerably higher. Even in markets where it remains a newer phenomenon, like MENA and Asia, the product was used in around half of our PE exits last year.

All around the world, parties take a more selective approach to W&I insurance outside of PE exits. In 2018, it was used in just 16% of our deals with non-PE sellers.

We’re seeing interesting innovations in the W&I market. Some of these – like movement on previously standard exclusions, and synthetic elements of cover – are largely driven by increasing competition between insurers. But the biggest change has been the move towards so-called “stapled W&I”, with sellers going to market with a 100% insurable sale and purchase agreement, underwritten on the basis of vendor due diligence and on condition that specified checks are carried out on the buy-side.

W&I insurance in private equity exits

<table>
<thead>
<tr>
<th>W&amp;I insurance in private equity exits</th>
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</thead>
<tbody>
<tr>
<td>2013: 7%</td>
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<tr>
<td>2014: 17%</td>
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<tr>
<td>2015: 29%</td>
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<tr>
<td>2016: 33%</td>
</tr>
<tr>
<td>2017: 47%</td>
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<tr>
<td>2018: 71%</td>
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If you would like a detailed presentation on our analysis of global trends in private M&A, please get in touch with Elizabeth Wall or your usual Allen & Overy contact.

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Investors face rapid proliferation of national interest tests

While governments continue to welcome foreign investment as a way to secure economic growth and to create jobs, there is, nonetheless, growing sensitivity about the potential risks of such investment in certain sectors.

In the debate about foreign direct investment controls, much of the focus in recent times has been on outbound investment by Chinese companies, particularly state-owned enterprises, but by no means exclusively. While risks are often characterised as threats to ‘national security’, increasingly, governments are taking a broader view on what exactly that means: it’s no longer just about the defence sector; now sensitive technologies, utilities, media and ‘critical infrastructure’ are equally under the spotlight. At the same time, governments have been arming themselves with powers to intervene in a wider range of deal types.

With heightened tensions in global trade, this is a trend we fully expect to continue.

New EU foreign investment legislation adopted in March 2019 and applying from 11 October 2020, marks the first time that the supra-national body has taken a co-ordinated approach to the vetting of investment from outside the EU on security and public order grounds across EU Member States.

It represents a significant moment in the development of mergers and acquisitions vetting in the EU.

The EU’s move is part of a wider global picture, with investors facing a rapid proliferation of national interest screening across a growing number of jurisdictions around the world.

The EU’s new legislation can be seen as part of this trend. So too are moves in the UK to replace the existing public interest screening regime – to date used only in the context of acquisitions raising national security, media plurality and (exceptionally) financial stability concerns – with a significantly expanded national interest regime that would give the UK government powers to intervene in a far wider range of transactions and sectors. Other jurisdictions, such as the U.S., France and Germany, have been strengthening their existing review mechanisms. China itself maintains strict national security controls, while increasingly opening itself to inward investment.

It adds up to an increasingly complex environment for investors. Screening approaches, though often similarly motivated, certainly are not uniform. Some, such as the Committee on Foreign Investment in the U.S. (CFIUS), apply national security tests; other countries, such as Australia, apply a broader national interest test.

Some countries have mandatory vetting schemes, obliging investors to gain clearance before a transaction can proceed; others operate a voluntary scheme enabling governments to intervene after a deal has been finalised; while others still have no screening regime at all.

Some regimes operate entirely separately from competition regulation, while some are closely interlinked.

As new initiatives, like those from the EU and the UK, roll out, the risks and complexities for investors – as well as providers of acquisition finance – are only likely to increase.

“Increasingly, governments are taking a broader view on what exactly ‘national security’ means: it’s no longer just about the defence sector. At the same time, governments have been arming themselves with powers to intervene in a wider range of deal types.”
EU legislation

EU legislation was initially proposed by the European Commission at the behest of several Member States, including France, Germany and Italy, who were concerned about the absence of effective instruments to combat strategic acquisitions of European technologies by non-EU investors, as well as the lack of reciprocity with EU trade partners.

Screening at an EU level is not part of the new Regulation, which instead remains the exclusive preserve of individual EU Member States. However, Member States are effectively being encouraged (although not compelled) to adopt screening mechanisms and will be required to co-operate on vetting foreign investment.

The Regulation is built around a core set of principles that try to balance investor and national interests. They include a determination to create certainty, to encourage transparency and offer the possibility of recourse against screening decisions. The Regulation also requires all third-country investors to be treated equally although, in practice, national interest concerns and security tests differ depending on the nature of the investor.

Countries with screening regimes must also ensure they are robust and cannot be circumvented by investors.

The EU has drawn up a very long yet non-exhaustive list of areas where investment might pose a threat to security or public order. They include critical infrastructure, critical technologies and dual-use items, supply of critical commodities (including energy, raw materials and food), access to or control over sensitive information (including personal data) and the freedom and pluralism of the media. In practice this means that no transaction or sector is automatically excluded from the scope of the new Regulation.

In addition, Member States are explicitly allowed to take into account whether an investor is controlled, either directly or indirectly, by a foreign government.

Perhaps most significantly, a Member State probing a proposed transaction for security or public order concerns will be obliged to notify the EU Commission and other EU Member States of its review – even if a specific investment is not foreseen to have effects outside the territory of the relevant Member State. Other Member States and the EU Commission will be able to comment on the notified investment and indeed on investments not undergoing screening. The views expressed are to be taken into account by the Member State where the investment is taking place. Given the sensitivity of national security concerns (both from the perspective of the Member State and the companies involved), it remains to be seen how this cross-border information sharing and co-operation will work in practice.

It also remains to be seen whether the new regime is ultimately relatively innocuous – a further administrative hurdle for investors to leap, and no more – or a game changer for the European investment landscape. Either way, investors will clearly need to be on their guard as the Regulation comes into force.

UK – buyer beware?

The UK government insists that changes introduced in 2018, and the more profound changes now being debated, bring its national interest merger control regime into line with approaches already in place in the U.S. and in key EU states, like Germany and France. But the extraordinary breadth of the proposals should be of real concern to investors.

The proposed new regime marks a radical departure from the past. Prior to June 2018, the UK government was able to intervene (on national security, financial stability and media plurality grounds) only where the turnover and market share jurisdictional thresholds used for competition-focused merger control were met or the transaction fell into certain very narrowly-defined exceptional categories. In practice, these powers were used sparingly and intervention on national security grounds was limited to M&A deals with an obvious military or defence sector connection.

As an initial step last summer, the thresholds for jurisdiction were significantly lowered in three specific areas where the government believes even low value transactions could raise national security concerns: computer processing units, quantum technologies and military or dual-use technologies. These powers were used for the first time within a week of their introduction to UK law, with the government intervenin the proposed acquisition by Chinese-owned Gardner Aerospace of Northern Aerospace.

Changes now being consulted on by the UK government would create a new national interest merger control regime which would not only apply to all sectors of the economy, but would also permit intervention in any transaction regardless of the parties’ revenues or market shares, provided only that the government has a reasonable suspicion that it constitutes a “trigger event”. This is a broad concept designed to catch a wide range of transactions – from full acquisitions of companies, to minority stakes that bestow “significant influence or control”, to bare acquisitions of assets such as IP or land. Even the making of a loan could be caught.

It will be up to investors to decide whether to notify the government of a deal that might raise national security concerns (the UK government appears to have shelved earlier proposals to introduce a mandatory national security notification regime). But making that call can be trickier here than in other areas of merger control. Competition authorities tend to be transparent and apply economic principles that should generally produce predictable outcomes. Where national security is concerned, that is rarely the case. Decisions are inherently political, and governments are reluctant to publicise the substance of national security concerns for obvious reasons. That makes it hard to determine where issues might lie or to propose remedies.

The UK government has stated that it expects to conduct 100 in-depth national security reviews per year and impose remedies in 50 of these cases. To give a sense of the scale of the proposed reforms, this compares to only eight national security interventions in the nearly 18-year period since the existing regime came into force in June 2003.
Vigorous enforcement

Despite a growing focus on screening across jurisdictions, direct action to block transactions remains relatively rare – but it is certainly not a theoretical concern.

CFIUS has attracted particular attention in recent years with high-profile blocks of Chinese investments in the technology sector. Concerns to preserve the position of the U.S. relative to China in this area even led to the prohibition of the proposed Broadcom/Qualcomm merger, which involved a Singaporean acquirer. In addition to vigorous enforcement, new legislation in summer 2018 expanded CFIUS’ reach in a number of ways, with CFIUS piloting mandatory notification of transactions involving “critical technology”.

Germany, like France, has tightened controls in the last two years and, in 2018, for the first time issued a precautionary order prohibiting an acquisition – involving investment in a company supplying the aerospace and nuclear industries. Once again the investor was Chinese, although one that had previously been cleared to invest in another German engineering firm. In Belgium, despite no formal FDI regime being in place at the time, an investment in the energy sector was blocked following a leaked intelligence service report expressing concerns about sharing technology.

One direction

Some regimes allow for public interest considerations to work the other way, permitting deals that would otherwise have fallen foul of competition rules to proceed. This is exceptional – for example, during the financial crisis, the UK government permitted the acquisition by Lloyds of HBOS on the grounds that it would promote financial stability, notwithstanding concerns raised on competition grounds.

In a fascinating twist to the national interest debate, recent weeks have seen suggestions that could allow merger control rules to be overridden in pursuit of a new goal. Following the Commission’s decision to block the Siemens/Alstom rail merger, France and Germany are tabling proposals to change EU competition rules to allow the formation of EU-wide champions, including through a right of appeal to the Council that could lead to politicians overruling future Commission decisions. Europe, they argue, is at a competitive disadvantage to other countries, busily building their own champions. These suggestions are at a very early stage and it is too soon to tell where they will ultimately lead.

Investors should be in no doubt, the clear trend is towards an increased ability for governments to intervene, impose remedies and potentially prohibit deals on national interest grounds – across a wider range of sectors and transaction structures. Careful analysis of national interest-focused screening of mergers and acquisitions will therefore be increasingly important in planning regulatory clearance strategies and allocating execution risk.
Antitrust authorities maintain the pressure on dealmakers

The willingness of competition authorities to intervene in proposed mergers across the world remained undiminished in 2018, and there is every reason to expect that antitrust risks will stay high on the agenda of dealmakers this year.

Enforcement activity by antitrust regulators around the world remained intense in 2018, according to our latest survey of trends in merger control in 26 jurisdictions around the world.

Although the boom in M&A activity we saw last year, particularly in the first six months, has shown signs of peaking, there is no indication that merger control enforcement will slacken in 2019.

That’s all the more true given that the debate over the future of merger control shows signs of becoming increasingly political, at a time of considerable turbulence in world affairs.

It is significant that our latest survey coincides with the European Commission’s recent decision to block the Siemens/Alstom railway merger, a move that has provoked a furious reaction from politicians in both France and Germany. They have called for the EU’s merger control regime to be reformed to better take into account industrial policy considerations and allow for the creation of “EU champions”, European companies with the muscle to compete with industrial giants emerging in other markets, notably China.

It also comes at a time when a growing number of jurisdictions, particularly in Europe, are strengthening their scrutiny of inbound investment on national interest grounds, as we discuss in more detail on page 6.

The bigger uncertainty is Brexit and the impact it will have both on M&A activity and on antitrust and enforcement policy.

Against that background, it seems fair to conclude that antitrust and other regulatory risks are likely to remain very high on the agenda of dealmakers in the months ahead.

“Over 29 deals with a value of at least EUR46.3bn were prohibited or abandoned as a result of antitrust intervention.”

Record levels of activity

2018 saw a record number of merger notifications as global M&A activity continued its record-breaking run.

Our survey, focusing particularly on the U.S., EU and China, found that more than 29 deals worth at least EUR46.3bn were frustrated during the year by antitrust interventions. Seven deals were formally blocked, while a further 22 were abandoned after the merging parties learned that authorities had grounds for concern.

While the overall numbers are lower than in 2017 – when 38 deals worth EUR130bn were frustrated – they are on a par with the two preceding years, perhaps suggesting that the enforcement landscape is stabilising after an intense period of deal activity.

However, the figures hide some interesting nuances. For example, although the number of deals formally blocked fell from 22 to seven, abandoned transactions rose by 38% to 22 in 2018.

That might indicate that companies have become less willing to fight for clearance. But our analysis suggests another factor may also be at play – timing. Indeed, we saw parties walk away from transactions in Australia, China and the EU specifically because the merger review process was taking longer than expected. It’s an issue that regulators do seem increasingly aware of, with a number acknowledging that they need to streamline their processes.

The pattern of enforcement activity varied from region to region. Enforcement action declined in the U.S., despite transaction volumes remaining at a similar level. In the EU there were no prohibitions in 2018, but that has changed dramatically in the first three months of this year, with two deals being blocked – the Wieland/Aurubis copper merger and, far more controversially, the proposed Siemens/Alstom merger.

In a rare prohibition, the UK’s Competition and Markets Authority (CMA) called in the merger between Vanilla Group and Washstation five months after it had completed, underlining the risks, in a voluntary merger regime, of not notifying deals that may raise antitrust concerns. Post-Brexit, the CMA is likely to become more active as it gains the ability to review complex international deals in parallel with the European Commission.
Deals prohibited
by volume

Deals abandoned
by volume, allocated to jurisdiction where antitrust concerns led to parties’ decision to abandon the deal

Remedial action remains high

Concerns raised over tech deals

Deals where antitrust authorities accepted remedies to address antitrust concerns declined slightly in 2018, with some 139 deals given conditional clearance, compared with 155 the year before. The figure, however, remains high.

Remedies remain a key issue, with many regulators reviewing whether, once implemented, they have achieved the ‘right’ result. In addition, we are seeing increased collaboration between regulators to agree effective joint approaches on large cross-border transactions.

High overall levels of antitrust intervention, coupled with a willingness of companies to engage in more strategic deals, are likely to have contributed to rising execution risk for dealmakers. Separate analysis we have conducted of the private M&A market in 2018 shows an increase in the number of deals subject to antitrust or regulatory conditions. This is discussed in more detail on page 4.

2016: Total 159
2017: Total 155
2018: Total 139

Antitrust intervention focused on three main sectors in particular in 2018, according to our survey – industrial and manufacturing, energy and natural resources, and transport and infrastructure. In all three, the level of intervention was higher than would be suggested by their share of total global M&A.

In strict contrast, digital and other TMT deals saw a much lower rate of intervention compared with their share of global transactions. This fits with a number of concerns raised about the effectiveness of merger enforcement in this very active part of the market. Are deals going undetected? Also, do regulators have the right tools to take appropriate action, particularly in so-called “killer acquisitions”, where a large player quickly swallows up smaller companies that might have the potential, one day, to emerge as competitors?

Elsewhere, academic studies continued to raise other questions about antitrust enforcement in 2018, not least whether under-enforcement is contributing to growing levels of concentration in certain sectors and in certain markets, with such concentration increasingly being linked with inequality and market power.

Common ownership – where investors have holdings in a number of companies in the same sector – has also come under the spotlight, with commentators asking whether this is hampering competition and, if so, how antitrust authorities should respond.
Fines and information requests continue to rise

Authorities continue to strictly enforce procedural merger control rules on such issues as “gun-jumping” and filing incorrect information, often backed up by significant fines.

We saw a record number of fines in 2018, with authorities imposing some EUR148.4m of fines in 46 cases. Although that represents a slight decrease in the value of penalties compared with 2017, the volume of fines was a sharp 30% higher. We are already seeing this trend continue in 2019.

Authorities are increasingly using the review of internal documents to try to gauge the strategic intentions of merging parties and the likely impact of the transaction on competition.

In recent years requests for such information have rocketed, with parties being asked to submit tens, and even hundreds, of thousands of documents. For example, the European Commission reviewed some 2.7m documents relating to the Bayer/Monsanto merger. Clearly requests of this type have the potential to increase the length and complexity of merger reviews.

These documents can also have a real impact on the outcome of investigations. In the Dow/DuPont case, for example, document review led the Commission to conclude that innovation would be stifled by the tie-up and merging companies were forced to divest DuPont’s entire global R&D business.

New faces, new challenges

Who runs regulatory bodies, and how they are structured, remains a key factor behind merger control trends.

Appointments made by the Trump administration to the Federal Trade Commission, following earlier changes in personnel at the Department of Justice, may have contributed to a decrease in U.S. merger enforcement activity. Will we see more evidence of this going forward?

China, meanwhile, has combined three regulatory bodies into one to create the new State Administration for Market Regulation (SAMR). While there has been no tangible impact from this restructuring so far, it is definitely something to watch in 2019.

Changes are also afoot in the European Commission, with Margrethe Vestager soon to step down as Competition Commissioner. It remains to be seen if she will choose to cement her legacy by introducing key policy changes before her term ends.

Add the uncertainties likely to arise as the post-Brexit world takes shape, and it is clear the merger control landscape will continue to evolve in 2019, and that dealmakers could face a series of significant new challenges.

“The landscape will evolve in 2019 and dealmakers could face significant new challenges.”

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Digitalisation and innovation provide new fuel for M&A deals

Businesses across sectors are responding to the threat of digital disruption, looking to build, buy and/or collaborate to transform their organisations. The disruptors are increasingly busy too. Deal flow across the world, already moving quickly, looks set to get faster.

The disruptive power of technology is being felt right across the business landscape and across the world, but the last year has seen an acceleration of activity by traditional industry as companies set about transforming their operations for the digital age.

Pick almost any sector – from car making to financial services, from retail to mining and resources – and similar patterns of activity are playing out, as established players look for the best way to put digital technology to work to meet changing customer needs, cut costs and improve efficiency.

At the same time the giants of the tech industry are accelerating their efforts to project themselves into new markets and new sectors, making multiple investments and each aiming to put their technology platform at the heart of an expanding ecosystem. These technology enabled disruptors are able to quickly deploy technology platforms to address global problems and are structured to sit outside of the existing regulatory purview.

This strategy, particularly apparent in online payment systems and e-commerce, has been successfully used by the likes of Google and Facebook for some time. Now it is being put powerfully into action by some of China’s biggest tech companies.

Given that background, 2018 has seen a sharp increase in investment activity, and there is every prospect that this will translate into increased deal flow. As competition intensifies, we expect deal flow to accelerate.

Tech companies make multiple bets

As the biggest tech companies look to move into new markets and new product areas they are often making multiple bets, investing in a range of emerging companies to try to establish which ones will emerge as category leaders or local champions.

We’ve seen a series of big investment rounds in Asia’s booming tech sector, for example, with foreign capital, principally from China and the U.S., pouring into the region’s growing band of unicorn businesses – companies that have grown rapidly from start-up to achieve multi-billion dollar valuations.

Where payment systems are concerned, the investment strategy is to build partnerships with adjacent businesses, to drive captive customer volumes and create exclusive non-bank payment arrangements to lock out competitors.

E-commerce is also a fertile area for investment, particularly as bricks and mortar retailers are responding to the rise of e-commerce. Partnerships between bricks and mortar retailers and established e-commerce players are starting to emerge, as traditional retail moves to omni-channel, with clear industrial logic behind pairing world class technology platforms with brand presence and distribution.

The last year has also seen Asian unicorns continue to build on their capital-light, tech-enabled business models to continue growing, fuelled by outside investment and the rapid increase in consumer take up. Indonesia, for instance, now has one of the highest e-commerce penetration rates of any country, thanks to the development of super-apps offering customers access to an increasingly large range of products and services through their smart phones.

Go-Jek, for example, has transformed itself from a ridesharing service into a broad-based lifestyle app and is continuing to expand its offering, setting up a studio to produce local digital content, as well as its own venture fund. It is also moving into new markets, including Singapore, Vietnam and the Philippines, and investing newly raised capital at an accelerating pace as it expands its footprint and offerings.

Traditional players fight back

Despite this, established players in traditional sectors are also powering the recent sharp increase in investment activity, as they look for the best way to harness the transformational power of digital technology and data.

Here the challenges of disruption are significant. How do you transform the culture of your organisation to deliver real change when it means completely rethinking the way you have done things for, perhaps, 50 years or more?

The car industry is a classic example of this dilemma as it confronts a range of disruptive challenges not just from technology and the pervasive power of data, but also from a radical shift in consumer attitudes, not least towards car ownership.

We are now seeing a number of the industry’s major players confront the challenge of digitalisation and innovation head on. Toyota, for instance, is pushing ahead with a wide-ranging digital strategy that will transform it from being a car manufacturer to a global provider of tech-enabled mobility services.

As this strategy has unfolded over the last 18 months, we have seen Toyota pursue an ambitious investment strategy. It has set up the Monet Technologies joint venture with SoftBank, invested USD1 billion in Grab, another leading South East Asian ridesharing company, and ploughed USD500m into developing on-demand, driverless vehicles with Uber.
Meanwhile its venture capital arm, Toyota AI Ventures, armed with a USD100m war chest, is focusing on making minority investments in a wide range of carefully selected start-ups. The aim is to identify breakthrough technologies in such fields as robotics, AI, autonomous driving and data.

It’s a path being followed by other carmakers too. In February, for instance, BMW announced a EUR1bn joint venture to create a single mobility services portfolio, including self-driving cars, car-share schemes and electric vehicles, to head off disruptive challenges from ridesharing and other tech companies.

Build, buy or collaborate

Three main options are available to traditional players as they plan their digitalisation and innovation strategies, each presenting significant challenges as well as opportunities.

Build – Firstly, they can opt to build technology platforms by themselves relying on their own resources to change the way their products are made and services delivered. But this is a risky option, vulnerable to enormous cost escalation and to the danger of backing the wrong technology solution.

Buy – Another approach is to buy into an early-stage business or foster growth through corporate venturing or accelerator programmes, which allows incumbent players to get a clear view of what is happening in key areas of technology and, perhaps, the opportunity ultimately to make a full blown acquisition. To do so successfully means developing a new set of skills in corporate venturing, which are often very different from the capabilities required to execute big-ticket M&A transactions.

Collaborate – Finally, partnering with a player who can bring in the know-how and the technology to help speed the process of digitalisation. This collaborative approach has proved highly successful for some. But these collaboration and partnership agreements can be very complex, particularly when they are in relation to new products or developing areas, the future direction of which can be hard to predict. They contain many moving parts, including mechanisms for unwinding the venture if it does not live up to its promise.

But the truth is that no one route offers a guaranteed path to success at the kind of speed needed to meet the fast-changing challenges of disruption. Many players will look to use all three approaches – build, buy and collaborate – as part of a broad-based digitalisation strategy.


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Continued pressures driving change

Across sectors, digitalisation and innovation are being accelerated not just to meet changing consumer needs or to fend off incursions into the market by disruptive tech companies, but also for sound operational reasons. Established businesses recognise that by harnessing digital technology and data they can drive down costs, increase efficiency and sustain profitable growth.

That’s now a focus for companies in many markets, including high-growth economies in Asia where, in the past, there has been less attention paid to the bottom line. Now it is increasingly common to see businesses setting up dedicated business transformation offices, to manage the complexities of digitalisation and innovation and ensure they deliver the right outcomes.

The companies that do it well are those that really empower people within the business to bring about meaningful cultural change. They have an ability to look beyond the technology to ensure that the process of digitalisation and transformation is ultimately driven by customer and business needs.

Transactions supporting this activity are by their nature complex. But the need to stay in touch with customers and ahead of rivals in a fiercely competitive environment requires heavy investment – an investment many companies, new and established, are clearly willing to make.

That, we think, makes it highly likely that disruption will increasingly become a significant catalyst for ventures, partnerships and, increasingly, full M&A transactions in the months and years ahead.
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