ALLEN & OVERY

Defying the odds

M&A Insights | Q4 2017

Data provided by THOMSON REUTERS

Defying the odds

Global M&A markets continue to defy expectations, weathering a barrage of political and economic woes. Values have fallen, partly as a result of fewer high value megadeals, but volumes are powering ahead boosted by mid-market transactions.

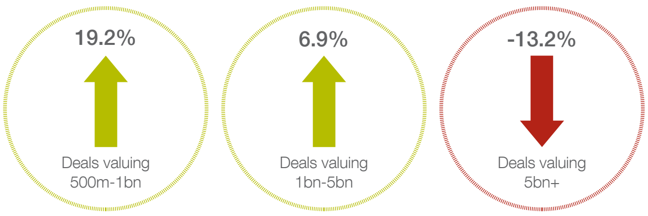
01 Resilience in extreme times

M&A markets across the world continue to prove highly resilient even as the range of potential geo-political risks continues to grow.

Deal values have slipped back in 2017, but volumes continue to climb steadily, with a decline in the massive megadeals that have featured regularly in recent years, offset by a proliferation of deals in the USD1 billion to USD5bn range. There's been significant mid-market activity where private equity funds, with record resources to invest, are particularly active.

In some sectors, notably consumer, activity may reflect a period of portfolio tightening, with non-core assets being sold off in the wake of big consolidation deals.

Global deal volumes – 2017 vs. 2016 % change



Equally it reflects the sheer time it takes to get complex strategic megadeals, such as the proposed AT&T/Time Warner deal, over the line.

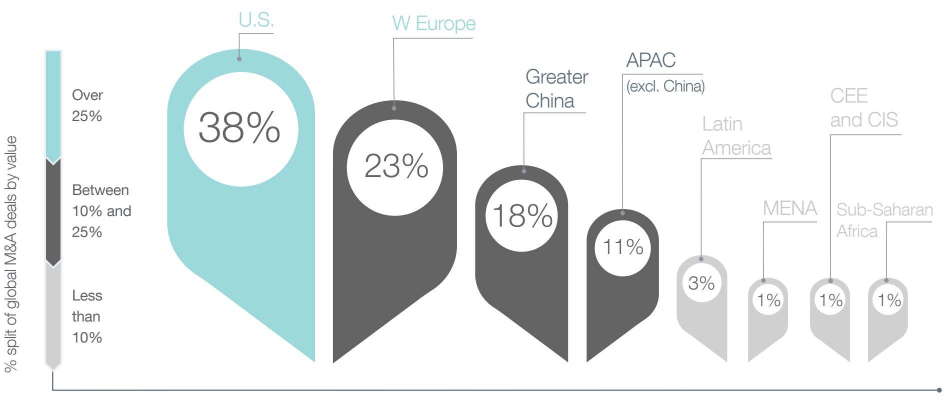
Most markets remain remarkably robust in the face of a range of political uncertainties, not least Brexit, rising tensions in the Middle East, the North Korea stand-off, and the unpredictability of domestic politics in key markets, such as the U.S., Spain and now Germany.

And yet we are experiencing the second longest bull market on record as investors take heart from a number of powerful fundamentals – strong corporate cash balances, buoyant equity markets and continued ready availability of debt financing, despite gradually increasing interest rate rises in key markets. Many companies have emerged from post-crisis doldrums in better health, often more efficient and with a new strategic purpose.

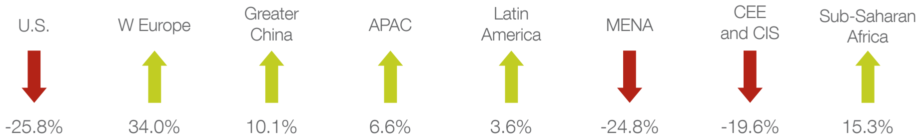
M&A cycles do not follow predictable patterns, apart from the fact that they do always eventually peak and go into retreat. But, barring significant political shocks (of which there could be many), there seems little else at the moment to prevent the market from remaining strong in 2018.

02 U.S. heads for record deal volume despite dip in values

% split of global M&A deals by value



% change from Q4 2016



Note: These figures represent deals announced between 1 January 2017 and 29 November 2017.

In common with several key markets, the U.S. has seen a sharp decline in deal values in 2017 (down 26% on 2016), but volumes are heading for their highest level ever, up 13%. The reverse is true in Western Europe (values up 34%, volumes 10% lower) reflecting continued strong outbound and domestic activity. As expected, Chinese outbound activity has slowed dramatically, but the Asia Pacific region is generally holding steady with the Singapore, Hong Kong and South Korean markets notably more lively. Continued political unrest has dampened activity in the Middle East, while Central and Eastern Europe remains at a low ebb, with deal values down 20% and volumes 24% lower.

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03 Funds make their presence felt in energy and infrastructure

A significant driver of activity in the oil and gas sector continues to be the major players rebalancing their portfolios, often with an accent on buying gas assets while selling off more mature offshore operations.

This is providing opportunities for specialist funds and private operators (particularly in the North Sea) who see a chance to acquire assets at attractive prices, which together with a lower cost environment and relatively stable and improved hydrocarbon prices, hold the promise of healthy returns.

With oil prices having recovered significantly from the lows experienced in 2016 and stabilising around USD60 a barrel, the conditions for more M&A activity in the sector have improved.

Shell, now around 70% focused on gas since acquiring BG in 2015, has this year sold its stake in the Corrib Irish Sea gas field to a group of Canadian pension funds. Total's acquisition of Engie's LNG assets this autumn has seen it become one of the world's biggest LNG producers. Elsewhere, Denmark's Dong Energy, now concentrating on offshore wind and other renewables having renamed itself Ørsted, has sold its oil and gas interests to Ineos.

Elsewhere, Chinese and Middle Eastern investors are increasingly active, not least in Russia, where some Western companies are also doing sizeable deals when sanctions allow.

While funds continue to dominate the infrastructure space, corporate deals have driven recent activity, not least the battle for Spain's global toll road business, Abertis, between Atlantia of Italy, and Hochtief, the German group majority owned by Spanish builder, ACS.

However, with a relative shortage of traditional infrastructure assets, funds continue to push into new areas. The ferry sector is busy – Red Funnel was bought by UK and Canadian pension funds this year and Scandlines could be sold in 2018. Fibre optic networks and data centres are also increasingly popular targets with new fundraising targeting differential returns by focusing on core and core plus infrastructure assets.

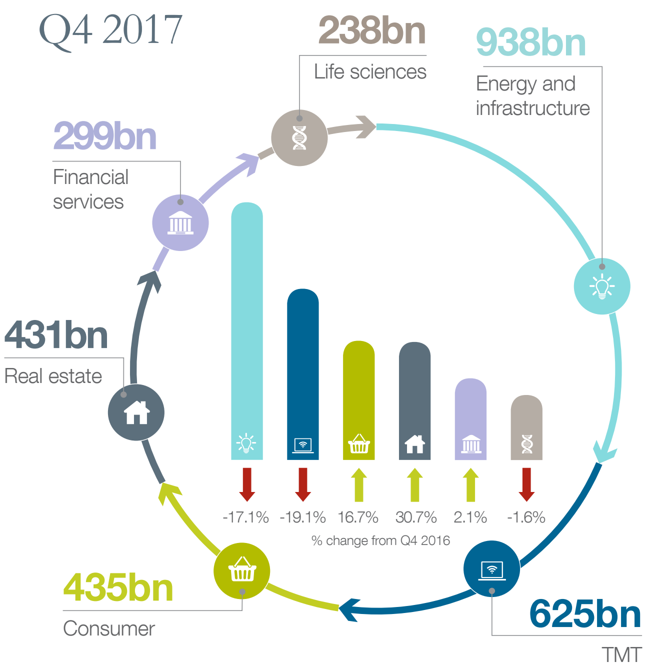
05 Data – regulation bites

At a time when data is becoming an increasingly important commodity and a key determinant of value in any transaction, dealmakers face a perfect storm of a heightened incidence of data breaches, much greater public awareness and a sharp tightening of regulation as to how data is stored and protected.

Many companies are working hard to get ready for the introduction of the EU's new General Data Protection Regulation (GDPR) next May. But some are still lagging behind, despite the threat of much-increased fines (of up to the higher of 4% of global annual turnover or EUR20 million at the uppermost level for certain breaches), the reputational damage caused and the huge costs they will face in remedying any breach.

That makes detailed legal analysis increasingly important in M&A due diligence. It's vital to establish whether the target has suffered past breaches, if its security systems are fit for the future and can be integrated in the combined business. Acquirers and funders should also establish if the way the target is using data and automation is compliant with the more stringent environment. These issues will have an increasing bearing on deal value and success.

04 Top six sectors by value (USD)



06 Distractions abound in financial services

M&A activity in the financial services sector has remained steady throughout the year, albeit at a low level. We expect that to remain the case in 2018 as institutions remain firmly focused on significant internal housekeeping issues rather than buying growth through acquisitions.

In Europe, Brexit predominates. The New Year will see institutions begin implementing their plans, with the majority having to work on the assumption the UK's departure from the EU on 29 March 2019 will be abrupt rather than softened by a transitional deal on passporting rights.

Other regulatory issues are also distracting teams that might normally be scanning for M&A opportunities. Big UK banks, for instance, continue to be pre-occupied by ring fencing their retail and investment operations to meet a 2019 deadline.

The MiFID II regulations, which take effect on 3 January, could spark further consolidation amongst asset managers, as firms seek to defray new compliance and other costs, notably on paying for external research. After a period of rapid growth, the challenger bank sector also looks increasingly ripe for consolidation.

Beyond the pill – are digital health deals set to spike?

Transactions between big pharmaceutical companies and start-ups working on potentially highly disruptive but beneficial technologies in the healthcare space have not taken off as fast as some expected. That could be about to change.

It probably wasn't meant to take centre stage, but the small white circle on the arm of UK Prime Minister Theresa May certainly grabbed some headlines.

She was wearing a glucose-monitoring patch – an essential part of her daily routine to deal with the Type 1 diabetes that, to her credit, she has been happy to be open about – and press photographers were quick to spot it.

It's a high-profile reminder of the increasing role that technology is playing in modern patient care, with digital systems being used to help millions of people manage a growing range of conditions from diabetes, through to asthma, chronic obstructive pulmonary disease, heart conditions, hyper-tension and depression.

This ought to be fertile ground for the big pharma companies as they battle a range of growing cost and intellectual property challenges that are forcing them to rethink their business models.

Chief amongst those is the time and cost of developing blockbuster drugs – for decades their highly valuable stock-in-trade – and finding cost-effective ways to continue innovating as those drugs near the patent cliff.

But other pressures are mounting too, not least the increasing demand by hard-pressed health authorities, struggling to contain escalating budgets, that drug developers should be paid relative to measurable patient outcomes.

These pressures have forced big pharma companies to explore ways to get closer to the patient, to collect and analyse data to help them develop more efficacious drugs, and to find ways to make sure patients follow their prescribed treatment regimes – one step in making treatments more effective and to justify drug costs to payers.

Big data is clearly key to these efforts, as well as to a range of novel technologies to diagnose conditions and to monitor patients, some of which, like the first ingestible monitor (effectively a digital pill) cleared last month by U.S. regulators, are quite mindboggling.

It is part of what the outgoing Novartis CEO Joe Jimenez has called the search for "life beyond the pill" to describe the sector's need to embrace the disruptive technologies that could threaten its long-term survival. With patient data set to be so important a part of future medicine, better that the pharma companies have access to it, than cede that advantage to tech industry disruptors.

Early focus on VC investment

So far, the evidence of industry excitement about digital health has largely been seen through a surge in VC funding. Investment in digital health start-ups is expected to reach USD7bn this year, up from USD6.4bn in 2016, according to recent analysis by Accenture. Investors are largely traditional VCs, but with funds focusing on the sector (such as Rock Health, Khosla Ventures) being well represented. In the past couple of years however, big pharma like Merck, GSK and J&J have also become increasingly active.

Yet it's perhaps a little surprising that, in an industry so familiar with using partnering and M&A as a tool to stock the R&D pipeline, we've not seen more follow on transactional activity coming out of these investments. We think that's likely to change and that we will see an increasing wave of collaboration and M&A.

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>
> Jim Ford
> Partner, London

Eyes on the prize

Much of the focus of investment thus far has been on wearables, monitoring and virtual care – perhaps reflecting where digital companies see some of the "easier" opportunities to enter the more consumer-focused end of the market or to partner with the healthcare service providers and insurers. In one recent example, Sanofi and Alibaba have teamed up to provide a disease management platform to 100,000 patients in China. Big pharma can certainly benefit from these technologies, but there are other very interesting areas that might be ripe for cooperation, collaboration and investment also.

For example, Khosla Ventures recently made its first investment in France by leading an USD18m round in Eligo Bioscience, a preclinical-stage company developing biotherapeutics to bring precision medicine to the microbiome, using proprietary methods in synthetic biology, CRISPR-Cas, and protein engineering. The field of genomics, in particular, seems one where big pharma might take more active positions through collaborations or acquisitions, in a bid to increase the efficacy and personalisation of their medicines.

In the "back office", technologies like big data and blockchain offer the potential to re-imagine manufacturing processes, the supply chain, and approaches to marketing and pricing, to drive down costs and become more transparent.

A clash of cultures?

One of the factors that might be holding back the pace of digital health transactions in the pharma space might lie in the clear clash of cultures between large pharma companies and technology start-ups.

It frequently takes more than ten years to take a major new drug from conception to the market place and the culture, practices and procedures of pharma companies are built around those extended life-cycles – an alien concept in the start-up world.

Big pharma needs to speed up its processes and can clearly benefit from exposure to the agile and fast-moving world of tech. But equally, tech companies have little experience of the highly complex regulated world in which big pharma has to operate and will need to master it to prosper in this promising arena. Both sides have a lot to learn but, for now, there is a sense that they are feeling their way.

Structuring deals

So when momentum starts to build, what are the factors that will help make the deals go smoothly?

Much will be down to structuring deals in a way that can command the confidence of both sides.

We expect to see a growing shift to new, more open-source forms of collaboration where the costs and benefits of breakthrough are shared more widely than in a traditional outsourcing approach. More open source arrangements come with particular challenges around the ownership of IP that need to be carefully navigated. Parties should not, for example, assume that joint ownership of IP gives automatic rights to use, licence or carry out transactions, and that the legal treatment of joint ownership differs from jurisdiction to jurisdiction. Parties should use assignments and cross-licences to ensure parties own the rights in the manner intended and have appropriate use rights.

Structuring the financing of deals more flexibly will be increasingly vital, particularly to make sure there is a long enough investment runway to allow a product to be successfully developed before it reaches the point of making a return.

It's also crucial that both sides operate to an agreed and workable project timetable, supported by appropriate sharing of risk and reward. Collaboration in partnering deals and in M&A needs to be built around clear goals and incentives, with each side understanding the other's interests.

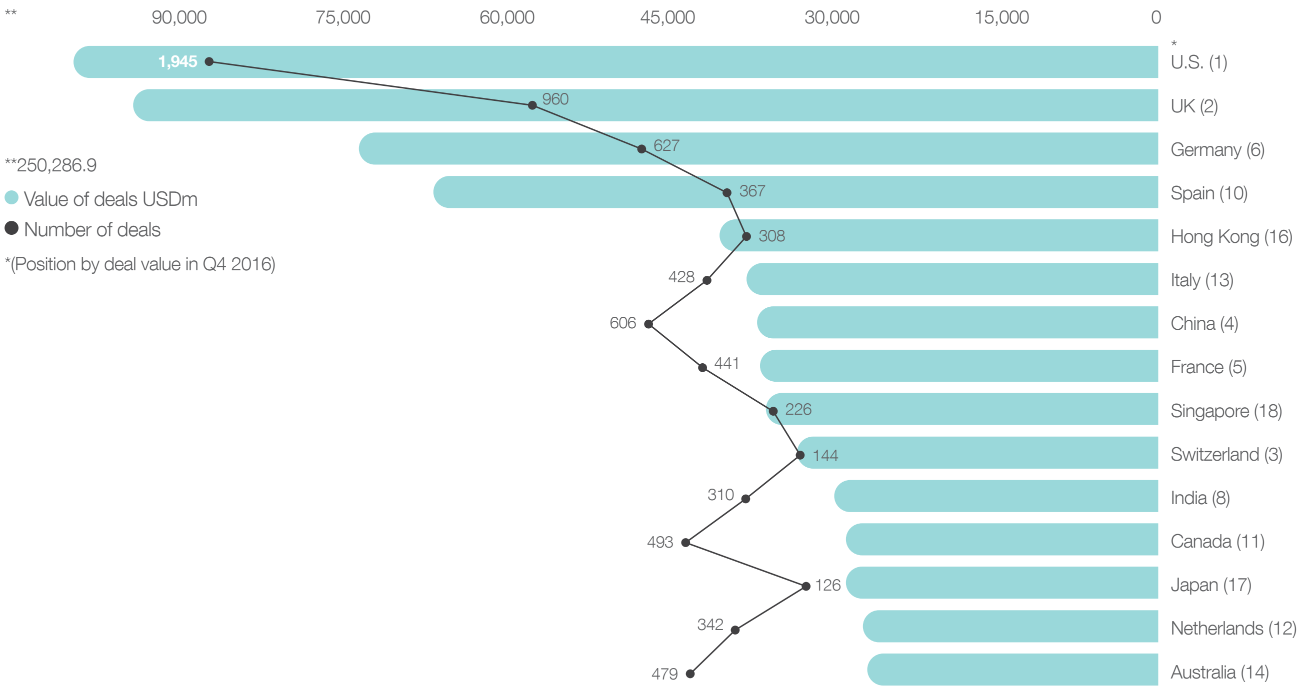
Exclusivity can be a deal breaker for collaborations. Parties should balance their possible interests for exclusivity and ask for it only where it will genuinely be important.

Establishing a strong sense of trust between the parties will provide an important foundation for future partnership. In deals between start-ups and larger players, there is inevitably an inequality of bargaining power. But industry participants who take full advantage of the power imbalance can store up future problems. Imagine, for example, the impact of bullying behaviour on a founder team in a situation where, for the buyer, much of the value of the deal comes from retaining key people.

Above all, collaborations of all shapes and sizes need to keep the patient very firmly in sight. This is all about creating better products and services and improving people's health. In the world beyond the pill, outcomes are everything.

Global deal flows

Inbound target markets



01 Italy makes its mark

A boom in M&A transactions has underlined the growing sophistication of Italy's transactions market, propelling it into sixth place in the roster of leading cross-border targets and eighth place in the top 20 league of acquirer nations.

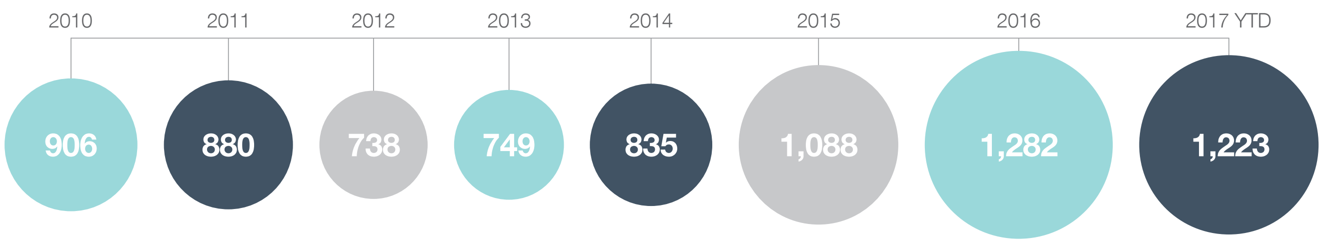
The early part of the year saw Italy centre stage of some the biggest transactions of 2017, not least the EUR24bn merger of France's Essilor and Luxottica and the increasingly fierce three way battle for control of Abertis, one of Spain's crown jewel companies, with Atlantia now competing with Hochtief, the German arm of Spanish construction group ACS.

Recent months have seen smaller transactions predominate, with Italy's vibrant mid-market industrial sector provoking strong inbound interest. Chinese and Japanese investors looking for access to markets, technology, supply chains and the cachet of the "made in Italy" label are particularly active in sectors as diverse as fashion, luxury goods, automotive and industrial design. The real estate and NPL markets also appear to be vibrant with many chances for robust M&A opportunities.

By contrast, concerns are growing about foreign control of assets in strategic sectors such as defence, communications, energy and transport. In December, we saw Parliament decide to strengthen so-called "Golden Powers" to protect such assets on both national interest and public safety grounds – an approach Italy, Germany and France are urging the EU to adopt more widely.

2018 looks set to be another strong year for the market, but elections in the first half could test investor confidence, especially if former Prime Minister Matteo Renzi fails to assemble a winning coalition of centre left parties and if more populist parties with a less investor-friendly approach, notably the 5-Star movement, gain further ground.

Italian deal volume



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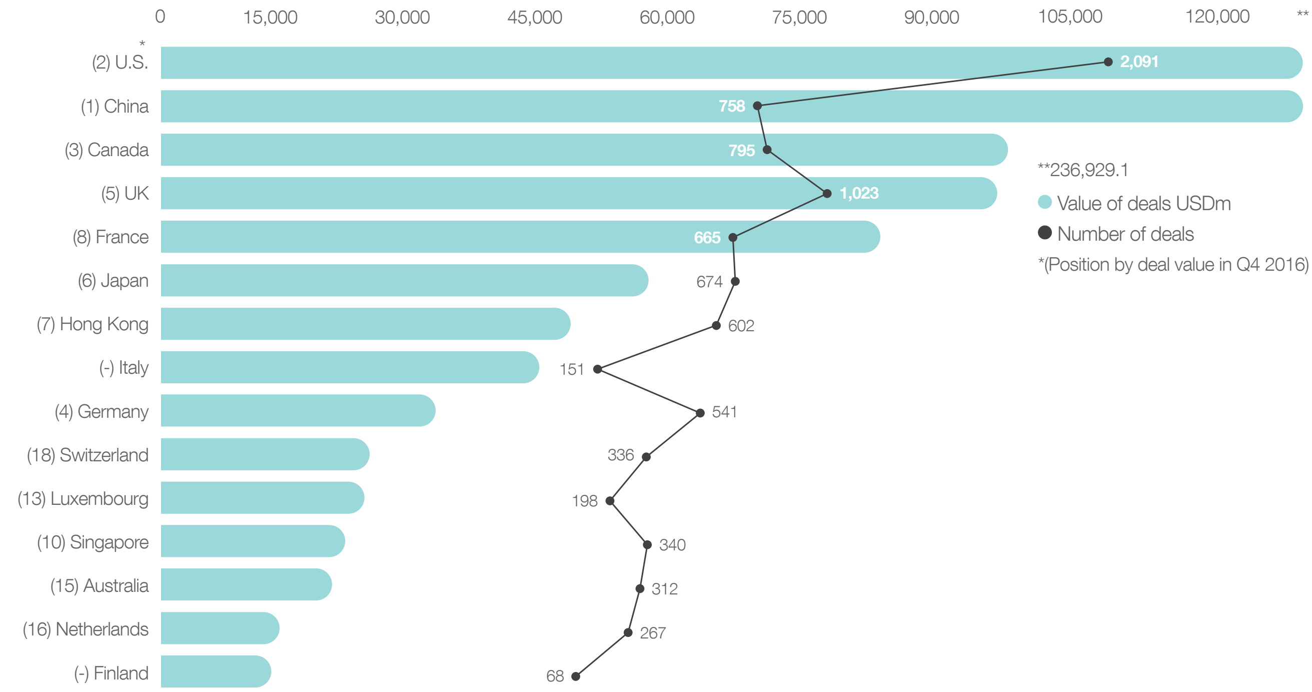
Outbound acquirers



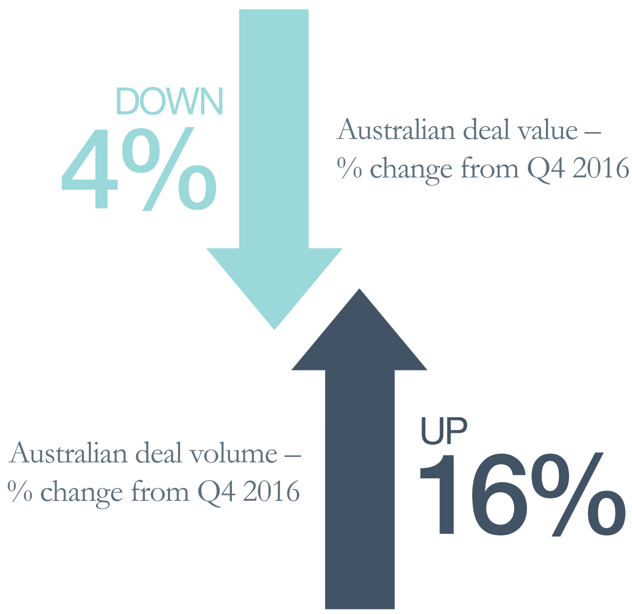
02 New Australian funds tap into the mid-market

With deal values sharply down, but volumes rising strongly, the Australian market is experiencing a phenomena familiar in other markets with strong growth in mid-market deals and a fall in the very biggest transactions.

Mid-sized PE funds are staying busy in this environment, looking for opportunities to buy assets where they will avoid competition from large Chinese investors and the global PE players and from which they can potentially make higher returns. We've seen a number of new entrants, including Adamantem and Odyssey, launched with the specific aim of targeting mid-market opportunities.

Resources deals are back on the agenda, although on a smaller scale than in the past. Higher and more stable commodity prices are giving investors the confidence to push ahead with sizeable deals as we saw when Yancoal first competed and then co-operated with Glencore to take control of Rio Tinto's Hunter Valley coal operations. More widely, Japanese inbound investors, in search of higher yields, are increasingly to the fore.

Privatisations by individual states continue although transactions tend to be smaller than earlier energy and power sell-offs. The sale of land registry operations has been a growing trend, with South Australia and now Victoria following New South Wales in selling or commencing processes to sell these assets, often giving bidders who miss out in one auction a chance to win elsewhere.



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