ALLEN & OVERY

Adjusting to new realities

M&A Insights | Q3 2017

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Adjusting to new realities

Global M&A transactions remain surprisingly resilient as investors adjust to growing geo-political and economic uncertainties, including the imposition of tougher sanctions in key jurisdictions and moves towards tighter merger control.

01 Strategic deal multiples reach record highs

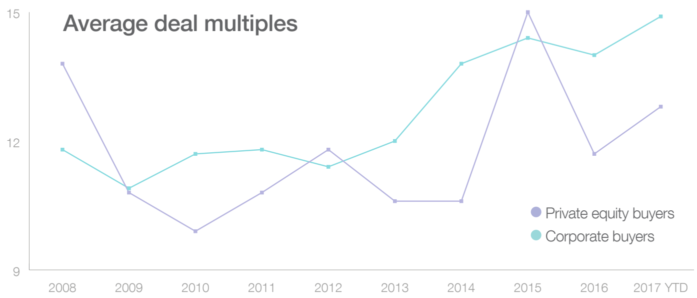
Corporate buyers, intent on making consolidation deals that help them to further globalise their operations and achieve important synergies, continue to push up the price of assets, with average deal multiples at a record high of 14.9x EBITDA in the year to date.

At this level – the highest on record – there is a growing divergence with the prices being paid by private equity funds. Typically unable to extract the synergies that come with a consolidation deal, private equity buyers have paid an average of 12.8x EBITDA this year.

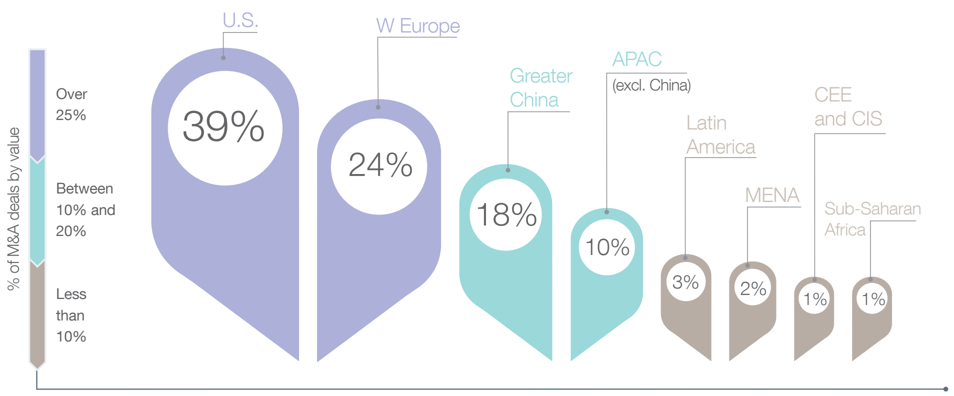
Access to diverse and affordable sources of bank, debt and capital market financing is helping both strategic and private equity buyers do deals. But corporate buyers are clearly willing to reach further for the chance to boost their revenues and cash flow through carefully targeted deals, particularly in high growth sectors like technology, consumer and life sciences.

Moody's USD3.3 billion acquisition of corporate information group Bureau Van Dijk (BvD) is a case in point. It completed the acquisition of the group from Swedish PE fund EQT in August at a multiple of 21x, clearly confident it can boost its earnings significantly by integrating BvD's data into its products.

There is little sign this price escalation will go into reverse while consolidation and globalisation remain key themes for strategic buyers – even at a time of growing nationalist and protectionist rhetoric in the political arena.



02 Western Europe deal values continue to grow as the U.S. drops back



% change from Q3 2016

U.S.	W Europe	Greater China	APAC	Latin America	MENA	CEE and CIS	Sub-Saharan Africa
↓ -11%	↑ 21%	↑ 5%	↑ 2%	↑ 40%	↓ -20%	↓ -10%	↑ 33%

Note: These figures represent deals announced between 1 January 2017 and 19 September 2017.

Western European deals continued to grow strongly in Q3 with transaction values up by over 21% in the year to date, even though volumes have fallen back by 13%. The reverse is true in the U.S. where values are running 11% below their level at this time last year, despite a near 16% increase in the number of deals. Deal values in Asia climbed by a modest 2%, but, with China outbound activity in the U.S and Europe still held back by capital controls, much of the activity was within the Asia region.

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03 Foreign investment control – building walls?

At first glance the decision to block the proposed USD1.3bn takeover of U.S. chipmaker Lattice, by Canyon Capital, a PE House part funded by the Chinese government and with links to China's space programme, looks like a hardening of U.S. foreign investment controls in line with President Trump's "America first" rhetoric.

Certainly that's how it was seen in China where officials said that, while nations had a right to vet deals on national security grounds, this should not be used as a way of "advancing protectionism".

In truth, it is still too early to say where Trump's policy really stands on the issue and, in some ways, the move is just a continuation (albeit more loudly) of a trend started under his predecessor, Barack Obama, with the number of reviews mounted by the Committee on Foreign Investment in the U.S. (CFIUS) steadily increasing over the last three years.

Today there appears to be a pretty wide political consensus in Washington around the issue of protecting technologies seen as key to national security. The idea of tightening the CFIUS regime, for instance, appears to command bipartisan support in Congress.

Close vetting of deals with a national security element is also a growing trend in other jurisdictions including Germany, Australia, Canada and China itself, for instance. The UK has also signalled that it may be more inclined to intervene in sensitive deals, particularly those relating to "critical infrastructure".

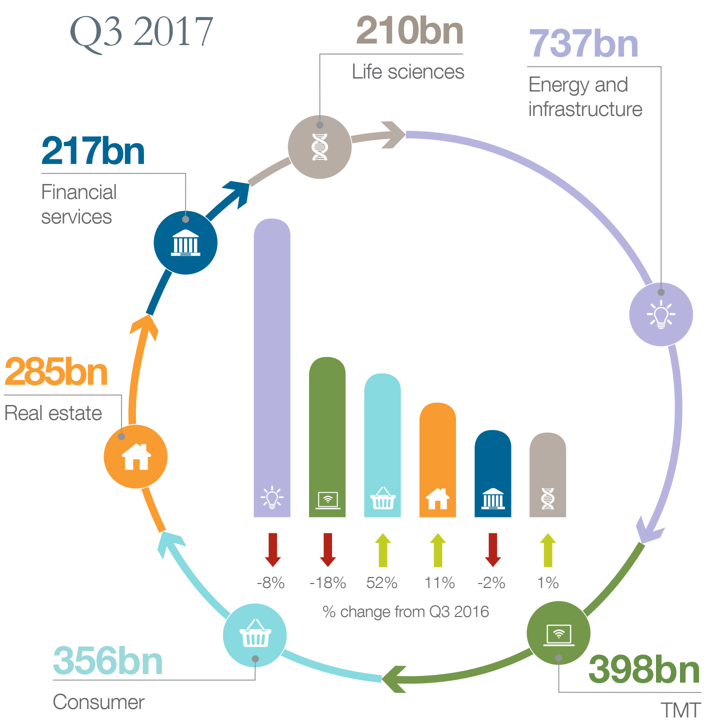
Meanwhile the European Commission (EC) has just outlined plans to create a common EU foreign investment framework for screening deals on the grounds of "security or public order" – a responsibility that, to date, has always fallen to individual Member States.

The EC proposal is meant to improve cooperation and coordination between Member States, setting common ground rules on substance and procedural safeguards. It also enables the EC to issue opinions and screen investments targeting businesses supported by EU funding. Member States are entitled to maintain and amend existing foreign investment vetting measures, or adopt new ones. Importantly, however, Member States are not required to do so.

Whilst welcomed by the Member States that had repeatedly called for it in recent months (France, Germany and Italy), the EC proposal may face a bumpy ride before adoption by the Council and the European Parliament.

Increased scrutiny from regulators will present a hurdle for investors in the years ahead, but often these hurdles are surmountable with the right preparation, due diligence, notifications and filings. That said, getting it right is time-consuming and dealmakers need to factor that into transaction timetables.

04 Top six sectors by value (USD)



05 Life sciences M&A in a holding pattern

Continued uncertainty surrounding President Trump's proposed tax reforms has slowed activity in the life sciences sector, with deal values holding well below the record levels seen in previous years. If Trump's promised corporate tax cut materialises, big U.S. players may be encouraged to repatriate (and spend) the huge amounts of cash currently held offshore. But as the timeline for reform has continued to drift, a number of players in the sector seem to have hit the pause button. Reports suggest that, following the announcement of the Republican framework for tax reform in late September, the draft legislation will be put before Congress by the end of this year. If so, the industry may have a clearer picture by early 2018.

This ambiguity has not completely deterred buyers from opportunistic acquisitions, particularly where there is a strategic need to fill gaps in their portfolios. Gilead Sciences' USD11.9bn acquisition of Kite Pharma is an example of this, with the former gaining access to the fast-moving field of cell therapy for the treatment of cancer.

Elsewhere in the sector, pricing continues to be a major concern for generic drug companies, driving ever growing pressure on margins and shrinking growth. Many have been forced to divest of non-core assets in order to pay down debt, for example Teva Pharmaceutical Industries' recent sale of both its contraceptive brand PARAGARD and the remaining assets in its global women's health business for a combined value of USD2.48bn.

Standing up to activists

Having honed their disruptive skills in the U.S. market, activist shareholders are now increasingly targeting companies in other open markets around the world, including the UK, Europe, Japan and Australia. Boards need to be ready.

They have their origins in the controversial 1980s era of the corporate raider, but have now reinvented themselves – sometimes plausibly, sometimes less so – as champions of shareholder value, but their strategy remains basically the same.

Activist shareholders, who first cut their teeth in the U.S. market, take relatively small stakes in big listed companies, attack the incumbent management and then agitate for change that will increase the market value of the target company, pushing up the value of their holding.

Their influence grew in the immediate aftermath of the financial crisis, when many boards were thought by some to have become excessively cautious.

With the boom in equity and M&A markets in recent years, activism has continued to grow, dominated by key figures like Carl Icahn, one of the first corporate raiders, Bill Ackman of Pershing Square, Jeff Ubben of ValueAct Capital and Daniel Loeb of Third Point. In the process, a specialist movement has evolved into a veritable industry, with many new players entering the scene.

Indeed their influence has grown so prevalent that the U.S. market is now deemed to be overcrowded with activist campaigns, forcing some funds to turn their attention to other open investment environments.

The UK in particular is in their sights, as are other "Anglo Saxon" markets such as Australia. Japan has seen a surge in activity following government reforms to corporate governance rules. And other northern European markets are important hunting grounds too, even though tighter governance rules and disparate local measures to protect boards make the activist's job harder in places like the Netherlands, Germany and France.

European companies that have been targeted for attack in recent years include Rolls-Royce, Kabel Deutschland, Invensys, Danone, Nokia, Vivendi and Rentokil.

"As activism spreads, boards need to be increasingly on their mettle."

Richard Cranfield
Partner, London

On your mettle

As activism spreads, boards need to be increasingly on their mettle.

Typically an attack will start with blunt criticism of management for overseeing alleged underperformance and an assertion that the market has lost confidence in the CEO's strategy.

There could be a demand for a place on the board, a detailed, and invariably well-argued, case for management change, calls for subsidiary business divisions to be sold off, for mergers to be pursued, or for debt to be increased to fund share buy-backs that return cash to shareholders.

We're quite some way from the days of the corporate raider. Indeed some funds promote themselves these days as "constructive activists" or "constructivists" determined to help businesses increase shareholder value.

But the effects of such an attack remain highly destabilising, even if the approach does no more than bump the share price so that the activist can walk away with a profit.

Powerful minorities

In truth, activism has become an increasingly common alternative to a hostile bid. Acquiring a big global company is out of reach for most bidders, apart perhaps from a strategic buyer of similar scale. While traditionally companies have focused on bid defence, the increasing likelihood is that they will get an activist approach rather than a takeover offer and the activist only needs a stake of 1% to get going.

Recent high profile cases have included the attempted USD26.3bn takeover of paints giant Akzo Nobel by its U.S. rival PPG Industries, a traditional M&A proposal where Elliott Management, an increasingly aggressive activist force in Europe, made its presence felt by clubbing with other institutional investors in Akzo to swing behind the bid.

As part of the rancorous and litigious battle, Elliott tried but failed to get the Amsterdam Enterprise Chamber to force the Dutch company to negotiate with PPG. PPG eventually called off the chase after several rejected offers and some open criticism of the bid from Dutch politicians.

Daniel Loeb, head of the Third Point activist fund, followed a more usual path in targeting the food giant Nestlé. Having built a USD3.5bn, 1.6% stake in the company, he fired off a letter demanding, among other things, a hike in profit margin targets, increased debt to buy back shares and the disposal of the group's stake in L'Oreal.

The letter also accused the company's management of "being stuck in its old ways" – sharp language, although actually quite mild by the standards of other campaigns.

"Don't assume, complacently, that you know your shareholders – constant engagement is vital."

Richard Cranfield
Partner, London

A grain of truth

Some of the charges laid by activists may be no more than "allegations", but they only have to contain a grain of truth to gain potentially devastating traction with other shareholders.

Some of those shareholders will be on the look out for a campaign, ready to pile in behind the activist in the hope of also making a turn. That presents real difficulties for the management in trying to mobilise more passive investors.

A tight group of investors standing behind an activist is relatively easy to organise. But in response a company and its advisers will have to co-ordinate perhaps 80% of the share register to mount a defence and inertia can build up quite quickly.

Differing corporate governance and takeover rules in some European markets can make the job of the activist trickier and, as the Akzo battle shows, local regulations can work in favour of the defending company.

Provisions under the Dutch Civil Code, for instance, allow boards to use a variety of poison pill defences like the issue of shares with special voting rights to a "Stichting" or foundation to prevent unwanted outsiders wielding undue influence.

But the security provided by such measures can be short-lived and what they don't do is win the argument, leaving the activist free to continue a patient campaign of building wider shareholder support.

Lines of defence

In helping clients prepare for a potential attack, the advice is pretty straightforward. The best defence is repeated out-performance of the share price. That's not a luxury many businesses enjoy, so it's vital they:

- maintain strong relations with major shareholders;
- stay on top of changes in the shareholder register;
- anticipate potential areas for attack; and
- have good counter-arguments in place.

And there are as many "don'ts" as "do's" for mounting a defence. Don't, for instance, ignore or stonewall an activist; don't attack the activist in the media; don't ignore the possibility of compromise; and don't assume, complacently, that you know your shareholders – constant engagement is vital.

It's about having a plan in place so that you are always ready to react. Failure to do that planning can quickly divide boards when an attack hits.

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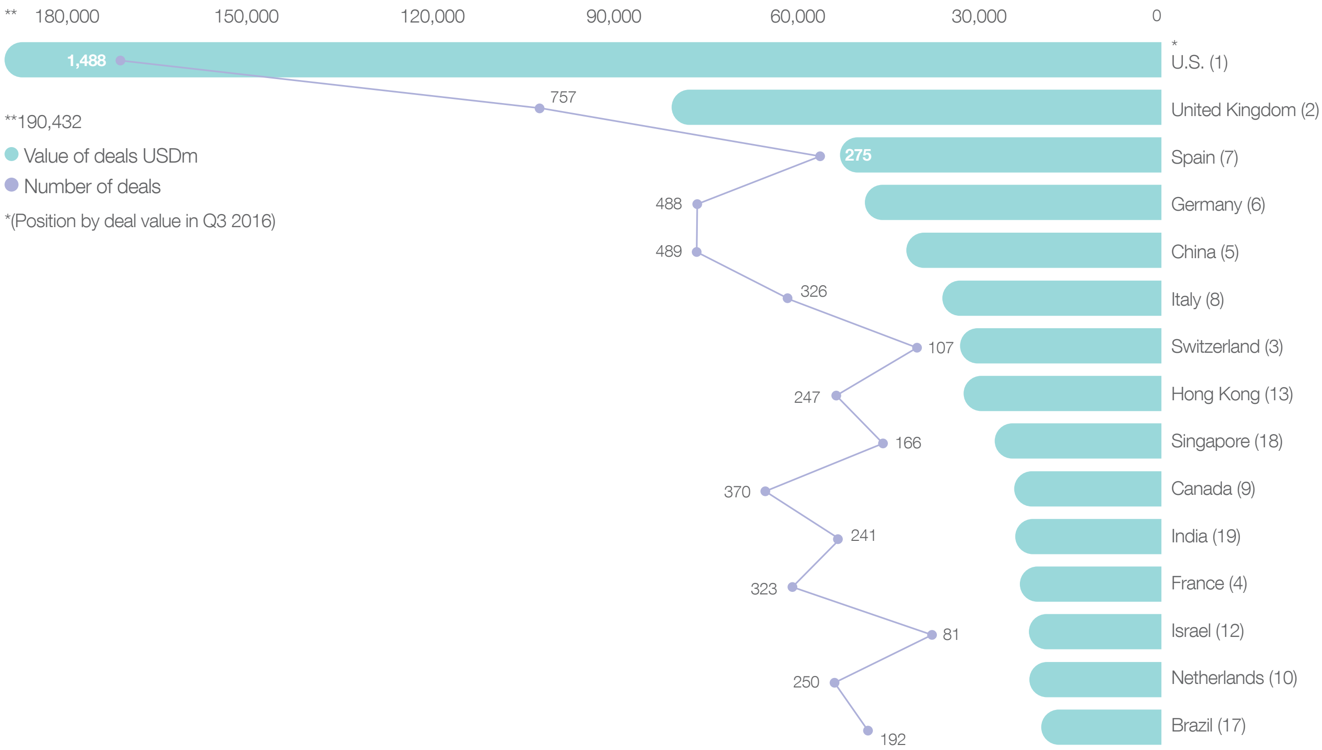
Global deal flows

Inbound target markets



01 Intra-Asian deals dominate the regional picture

While deal values (up 2%) and deal volumes (down 2%) have remained relatively flat in the Asia Pacific region in recent months, there has been a noticeable spike in intra-Asian transactions, which were worth nearly USD121bn in the first nine months – their highest Q1 to Q3 level on record.

That picture reflects, in part, the impact China's ongoing capital controls regime is having on outbound activity into Europe and North America and the fact that the restrictions are having relatively less impact on deals within the region – particularly those considered to be genuinely strategic and more in line with wider political objectives (such as "one belt, one road").

Where possible, Chinese investors have been looking to deploy cash that has been held offshore in either of the region's two main financial hubs, Hong Kong and Singapore, enabling them to operate outside the scope of the capital controls.

The growing challenges facing Chinese buyers in completing transactions which are subject to U.S. regulatory scrutiny is also depressing outbound activity – a trend that is likely to increase following the European Commission's recent proposals on screening investments into Europe.

Much of the intra-Asian activity has been focused on Southeast Asia and especially on the region's burgeoning tech sector. Companies like e-commerce provider, Tokopedia, online market place, Lazada, the ride-sharing and life-style group, GO-JEK and its rival Grab have all recently attracted considerable new investment. Leading that drive have been China's Alibaba and Tencent, with JD.com and Japan's Softbank also in the mix.

Big opportunistic Chinese outbound deals are still subject to intense scrutiny, but the consensus is that the controls will be relaxed once currency reserves stabilise and irrational transactions weeded out. We expect activity to pick up considerably thereafter, although probably not to 2016's record levels.

Japanese trading houses have started to ramp up their investments across Southeast Asia again and we are seeing Korean investors beginning to contemplate more outbound deals, with Vietnam, the Philippines, Indonesia and Myanmar in their sights. Financial services, consumer and food and beverage brands are a particular focus.

Conglomerates from Thailand and the Philippines also continue to scout for deals across the region, while Hong Kong's big conglomerates are taking a hard look at the performance of their portfolios and are expected to be increasingly active in the months ahead.

PE funds are also rethinking. Having raised huge amounts of dry powder and seen asset prices hold their ground, they are now more prepared to execute on the basis of higher valuations than before. Where emerging markets are concerned, PE funds still tend to opt for a buy and build strategy, acquiring a variety of smaller assets and putting them together to create a platform of their own rather than buying an existing platform off-the-shelf.

Growing regional tensions, notably around North Korea, are having a negligible effect on investor sentiment in the region even though tensions this time have been increased by more aggressive U.S. rhetoric. These tensions are still viewed by many on the ground as part of the usual cycle.
For European and North American investors less familiar with regional nuances it is a different story and they are noticeably more cautious.

Note: These figures represent deals announced between 1 January 2017 and 19 September 2017.

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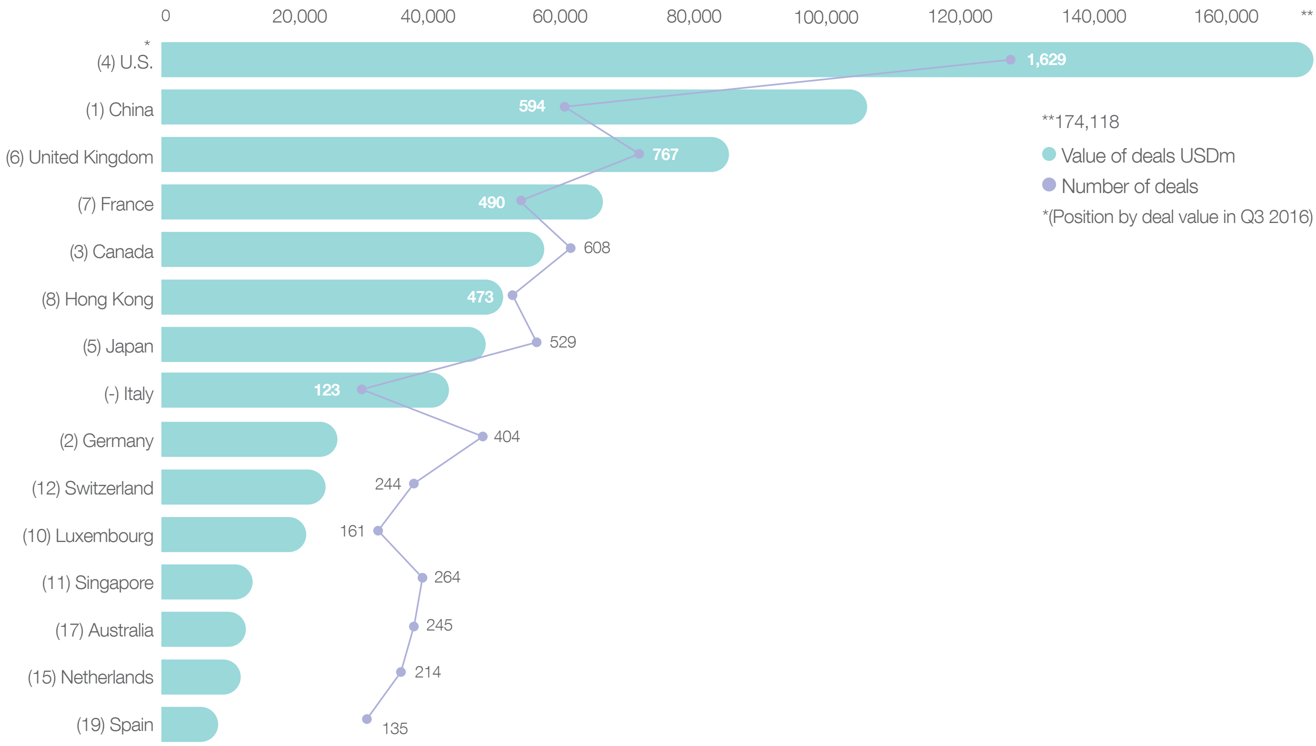
Outbound acquirers



02 "Car Wash" disposals drive increased activity in Latin America

The continued fallout from the corruption scandals that have gripped Brazil over the past two or three years continues to push the value of M&A activity to higher levels – with deal value up by nearly 40% in Q3 – but the fruits of economic recovery depend very much on political stability and the results of next year's presidential election.

Companies caught up in the so-called "Car Wash" scandal and other corruption probes have lost access to credit lines, lost business and lost customers and are now selling assets to pay fines, repay debt and to raise cash to fund remaining operations.

The scope of these disposals is sweeping, much wider than the construction sector, and involves asset sales both in Brazil and abroad. The giant multi-sector conglomerate J&F Group, for instance, has made nearly USD7bn of disposals, including selling a paper business to the Indonesian group APP and a dairy business to Grupo Lala of Mexico.

Mexican outbound acquirers have been particularly active in recent months pushing Mexico into the top 20 league of cross-border dealmakers in Q3, with Mexichem, Grupo Bimbo and OHL Mexico all completing significant deals. Brazil and Argentina also both feature in the top 20 target markets for cross-border deals.

Strengthening of the Brazilian currency versus a weaker dollar has helped to bring buyer and seller price expectations more closely into line, indicating that further activity is likely in the months ahead. But Brazil has a long way to go to secure economic recovery and presidential elections next year could prove vital in bringing greater calm to the market after several torrid years of political and economic upheaval.

03 Investors adjust cautiously to tougher sanctions regimes

A summer that has seen a tightening of U.S. and international sanctions on countries including Russia, Iran, North Korea and Venezuela, has, not surprisingly, left investors feeling cautious. But there are signs that they are adjusting to the new, more complex reality.

Where Russia is concerned there is no doubt that sanctions imposed by the U.S and EU in 2014/5 had an impact on deal activity. Western finance going into certain Russian banks – a main target for the first round of sanctions – was particularly sharply curtailed.

Tougher sanctions announced by the U.S. this summer, triggered in part by alleged Russian interference in last year's U.S. elections, have proved controversial in Europe, not least because, amongst other things, they target key energy pipeline projects connected to Russia. The regime also has a long reach, structured in a way that could catch European investors as well as U.S. companies and individuals.

With most, but not all, EU sanctions on Iran lifted following the nuclear deal there are many industrial investors – notably in the energy, manufacturing and chemicals sectors – keen to do M&A deals. But significant U.S. sanctions remain in place and the country remains a "no-go-area" for financial institutions both in terms of financing deals and transferring money into or out of Iran. Despite investor appetite, dealmaking will remain on a slow burn setting for some time, particularly given President Trump's recent comments on walking away from the nuclear deal with Iran.

Investors are, though, becoming more sophisticated in handling complex sanctions regimes, recognising that careful deal structuring and deep due diligence are required to make sure deals remain compliant.

GLOBAL PRESENCE

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