ALLEN & OVERY

Transaction risk – the calculations change

M&A Insights | Q4 2018

Transaction risk – the calculations change

While deal values have continued to soar, driven by megadeals, the outlook is increasingly uncertain. To sustain that performance in 2019, dealmakers will need to think in new ways about the political, legal and trade risks they face.

01 Megadeals continue to power the global market

Despite increasing geo-political turbulence, the global transactions market continues to be remarkably strong, with a growing accent on very big, strategic deals.

So far this year, the value of transactions is up by 32% although deal volumes have fallen back by 10%. Cross-border activity continues to take a growing market share, with its value so far this year at a ten year high.

Megadeals are dominating again. Transactions worth more than USD10 billion have risen by 120% to reach their second highest figure in the last 15 years, while the number of deals in excess of USD5bn are also at their highest level for a decade.

Globalisation is now facing tough political challenges, with a lurch towards protectionism challenging the trading patterns that have dominated activity across the U.S., Europe and Asia, notably China. While companies remain resolutely global, we may see some choosing to focus on one or two regions.

The continued confidence of CEOs is down to a number of factors. Companies continue to perform strongly, and have strong cash reserves and ready access to finance. Capital markets have remained buoyant and relatively stable, although we've seen greater turbulence in recent months. In an era of disruption, gaining access to transformational technologies is a growing motivation to do deals across almost every sector.

Investor confidence may be dampened by Brexit and the trade war between the U.S. and China, so it's prudent to expect that 2019 may be quieter. But the drive to do strategic deals is likely to continue, providing finance remains readily available and markets don't fall off a cliff.

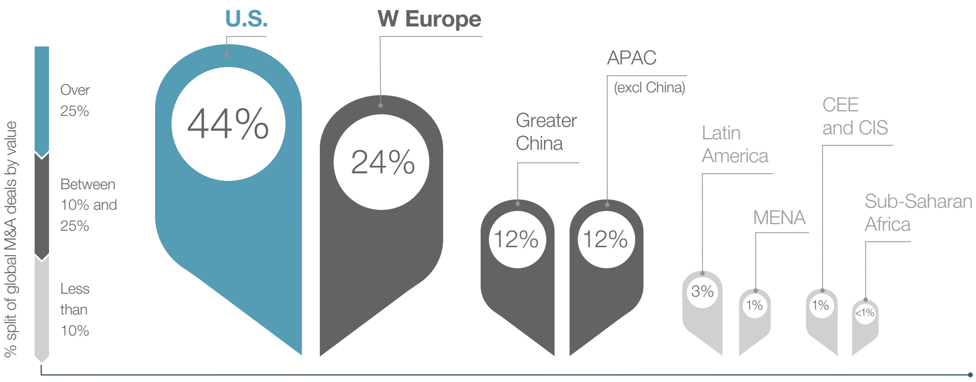
Global value of megadeals – Q4 2018 versus Q4 2017 % change

93% Deals over USD5bn

120% Deals over USD10bn

02 Old order restored – 2018 deal value by region

% split of global M&A deals by value



% change from Q4 2017

U.S.	W Europe	Greater China	APAC (excl China)	Latin America	MENA	CEE and CIS	Sub-Saharan Africa
57%	40%	-15%	35%	6%	22%	34%	-35%

Note: These figures represent deals announced between 1 January 2018 and 26 November 2018.

2018 has seen the U.S. accounting for 44% of global M&A activity so far this year, re-asserting itself as the fastest growing transactions market with the value of deals climbing by 57%. Western Europe continued to perform strongly, witnessing a 40% rise in transaction values. Greater China saw deal values decline by 15%, accounting for 12% of total activity, on a par with the APAC region. Sub-Saharan Africa continues to be a difficult market, with deal values 35% lower in 2018 so far.

Data provided by REFINITIV™

(formerly the Thomson Reuters Financial and Risk Business)

03 U.S. market prevails despite testing market conditions

The U.S. transactions market continues to tower over global M&A activity, but the latter part of the year has seen signs of increasing nervousness.

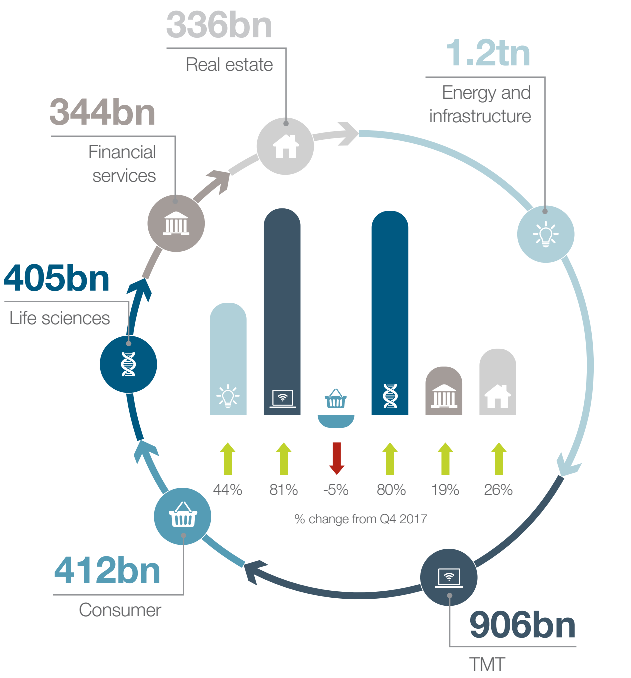
Deal values soared by 57% in the first ten months of the year with an accent on strategic, big-ticket deals across a wide range of sectors.

The domestic market has been particularly strong. But the U.S. also continues to be the world's busiest launch pad for outbound deals and is attracting more inbound investment than anywhere else, even though Chinese investment fell a staggering 92% in the first half thanks to stricter Chinese and U.S. controls.

We expect some of the biggest PE funds to be increasingly active in the near future, ready to contemplate larger more complex deals. For strategic buyers, strong fundamentals – notably high levels of corporate cash and affordable financing – have sustained activity in an economy that remains strong. They appear relaxed about further incremental rises in interest rates promised in 2019 and relaxed about, or possibly even relieved by, the potential for political gridlock following November's midterm elections.

While activity could remain strong early in the New Year, some commentators question whether recent equity market and oil price volatility and the impact of the U.S./China trade war could indicate an incipient slowdown. If so, that could persuade some dealmakers to conserve cash rather than invest it in transactions.

04 Top six sectors by value (USD)



05 Big life science deals dominate

Two giant deals dominate an 80% surge in the value of life science transactions this year with Takeda's USD77bn takeover of Shire and the USD69bn acquisition of Express Scripts by U.S. health insurer, Cigna, accounting for 36% of that increase in value.

Although Japan's largest outbound investment ever attracted criticism from some Takeda shareholders, it fits with a growing trend for Japanese companies, across sectors, to search for growth outside a shrinking domestic market. The Cigna deal continues the vertical integration between U.S. healthcare companies, medical insurers and pharmacy benefit managers as they try to contend with a squeeze on margins.

After Merck sold its consumer healthcare interests to P&G and GSK bought out Novartis from their joint venture, Pfizer is set to announce new plans having failed to auction off its own interests.

The development of immunotherapies and epigenetic treatments are helping big pharmaceutical companies address perennial "patent cliff" issues. These complex treatments are the focus of the big pharmaceutical companies' significant investments. But it's far from over for traditional small molecule medicines. Artificial intelligence (AI) has given birth to a host of healthtech start-ups, helping researchers find new uses for existing treatments. Early partnering deals with pharmaceutical companies could lead to full-blown M&A.

TMT global deal value

81% from Q4 2017

06 TMT heads for new peak and new targets

A spate of huge deals – notably in the U.S. and European telecoms and media sectors – has sent TMT transactions hurtling towards a ten year high in 2018, with deal values up by 81%.

Stand-out deals include Disney's USD71bn acquisition of 21st Century Fox and the follow-on battle for control of Sky, with Comcast's USD39bn blind auction bid trumping a rival offer from Fox.

Consolidation in the U.S. mobile market continues. However, we still wait to see if T-Mobile's USD26.5bn merger with Sprint, which would reduce the number of national operators from four to three, will win clearance from regulators.

By contrast, the tech sector continues to see a wide range of deals, both large and small, not only within TMT but across sectors – proof that digital disruption has become a significant engine of M&A transactions.

The open question is whether this frenetic activity can be sustained in 2019 or if we will see a natural lull.

New areas of investment are beginning to open up. One interesting development is the growing willingness of PE investors to target frontier areas of the tech market. We saw this with NXMH's acquisition of Bitstamp, a leading global cryptocurrency exchange. NXMH's parent, NXC, already owns the South Korean crypto exchange, Korbit.

In another example of this investment diversification, funds are also increasingly targeting telecom infrastructure such as submarine cables and data centres.

In Focus: M&A and the Brexit effect Deal or no deal, there's a lot more uncertainty to come

As the UK's withdrawal from the EU reaches its apparent "endgame", will Brexit finally test the extraordinary resilience of the M&A market in Western Europe?

The increasingly febrile atmosphere surrounding Brexit as it moves into its apparent "endgame" ought to be enough to unsettle even the steadiest of nerves.

The UK government is struggling to gain parliamentary support for a deal to proceed. This period of high uncertainty looks set to continue for weeks, if not months, with further turbulence promised if and when the next crucial stage of negotiations on trade begin.

M&A thrives in times of certainty – that, at least, is the accepted wisdom. So it would be fair to assume that the transactions market, at least in the UK and the rest of Europe, and perhaps more widely, ought also to be suffering a period of intense jitters.

Yet, for now, there is scarce evidence of that happening, and little sign that, in the 18 months since the surprise referendum result that set the UK on its journey out of the EU, M&A activity has been dampened.

Admittedly we did see investment activity quieten down in the first few months after the highly divisive vote. It soon resumed, however, not least as some investors took advantage of a plunge in the value of the pound to hunt for cheaper UK assets.

However, it has not all been about opportunistic buying. There have been plenty of deals done for good, old-fashioned strategic reasons and at high prices – look no further than the recent takeover of Sky by Comcast for proof.

The truth is dealmaking in Western Europe has been on the climb in 2018, and in the year to date actually stands 40% higher than at the same time last year, in value terms, although volumes of deals have declined by 14%.

Meanwhile the UK remains the second most-active market for inbound cross-border deals.

Also, in the first ten months of 2018 the UK was the third most-active outbound investor, after the U.S. and Japan. UK companies have particularly been targeting deals in Germany, although it is unclear to what extent such deals are being driven by Brexit. Our belief is that most are the result of more normal pressures on companies to reorganise their operations for greater efficiency and seek opportunities for growth in a low-growth environment.

Overall, however, the picture is clear. The resilience of the M&A market has been formidable to date.

The wider risk landscape

Part of the explanation for that could lie in the fact that investors are operating in the middle of a much wider, fast changing and increasingly complex risk landscape, where Brexit is just one of many risks. It is in this environment that investors are now having to assess and execute potential transactions.

In the last few years, three areas of risk have particularly come to the fore.

Political risk has been elevated at a time when disparate forces are at play – from the unpredictable politics of the Trump White House through to the rise of populist movements across Europe. For now at least it seems that the political and policy landscape in many countries is becoming less stable and much harder to predict.

Then there is **'change of law' risk**. Brexit is a prime example, representing the biggest change of law to hit the UK and the rest of Europe in many decades. Rarely have M&A investors had to grapple with this issue in the recent past, although the allocation of risk arising from a change in law has been a common feature in many long-term project financing deals for some time.

Finally, there is the march towards **greater protectionism**, seen most acutely in the increasingly hostile trade war between the U.S. and China as the recalibration of economic power from West to East is fought out through tariffs.

The UK is also contemplating tougher restrictions on foreign direct investment; Germany is already imposing stricter controls, France is thinking of following suit and Chinese investors are increasingly worried about the controls being exerted by the Committee on Foreign Investment in the U.S. Throw in sanctions as well, and it is clear that protectionist risks and the impact of assertive economic foreign policies are rising rapidly.

We are seeing a growing number of transactions where these dynamics are affecting the structuring and execution of deals and it is clear that plotting M&A strategies and deciding which markets to prioritise are becoming more complex tasks.

"For now, there is little sign that, in the 18 months since the surprise referendum result, M&A activity has been dampened."

Poorly prepared

One very worrying aspect remains in all this – many companies are being slow to tackle risks, and it's something we are seeing particularly in the context of Brexit. Issues such as regulatory equivalence, free trade arrangements and WTO rules have scarcely been on the radar of boardrooms before. Now they are right at the top of the risk agenda although many have yet to respond.

Some sectors are ahead of the game by force of circumstance: financial services, pharmaceuticals and aviation, for example. However, despite the obvious uncertainties around currency movements, stock market volatility, supply chains and regulation, many companies are leaving their planning to the last minute, waiting to see if the politicians can eventually provide some certainty around which to make important strategic decisions.

That's an issue that has been highlighted by some of the UK's leading industry organisations, one releasing a troubling survey in September suggesting that almost two-thirds of UK companies have yet to assess the risks of Brexit. More recently, the Bank of England Governor, Mark Carney, has warned that few UK companies are prepared for a no-deal scenario despite the growing likelihood this is where the UK may be on 29 March.

When they finally do they are quite likely to find the task all-consuming, as the big investment banks have done. If so, they are unlikely to have much spare management capacity to think about transactions and may even conclude that a period of increasing stress is hardly the time for heroic strategic moves on the M&A front.

"Many companies are being slow to tackle risks, and it's something we are seeing particularly in the context of Brexit."

More volatility likely

We are seeing these factors come to the fore as the UK government wrestles to get its withdrawal agreement through Parliament. We expect to see the currency and stock markets react quite violently as the time shrinks in which to get a deal in place for the 29 March 2019 exit deadline.

Will that provide openings for further opportunistic buying? Possibly, but it remains to be seen and could easily go the other way.

Recent market movements suggest that the prospect of a hard Brexit – where the UK crashes out of the EU with no deal – has not yet been fully priced in. The worry remains that a super-hard Brexit could quite quickly plunge the UK into a recession, one that might easily spill into other parts of Europe and, by extension, hit investor confidence more widely.

If the outcome is more positive and a deal is given the green light by the UK Parliament, that does not spell the end of the uncertainty.

Instead it marks the start of the next, vital stage of the Brexit process as the two sides move into a transition phase of at least 21 months, during which they try to agree the terms of a new trading arrangement between the UK and the EU27. That process is likely to be just as fraught.

Only at the end of that phase are we likely to see companies turn their attention to doing transactions that are directly and more strategically in response to the reality of Brexit. For most there will be no done deal until the shape of the new trading arrangement is finally known.

In the meantime, there are changes that buyers should consider now on transactions where the target has UK operations, including diligence on the target's Brexit contingency planning and Brexit-related warranty cover. Sellers, on the other hand, will be looking to avoid liability for the, as yet largely unknown, impact of Brexit.

It all adds up to a very volatile outlook.

While Brexit may not be the dynamic that brings this record-breaking period of M&A growth to an end, it looks certain to pose a big test for investors' nerves in the weeks and months ahead.

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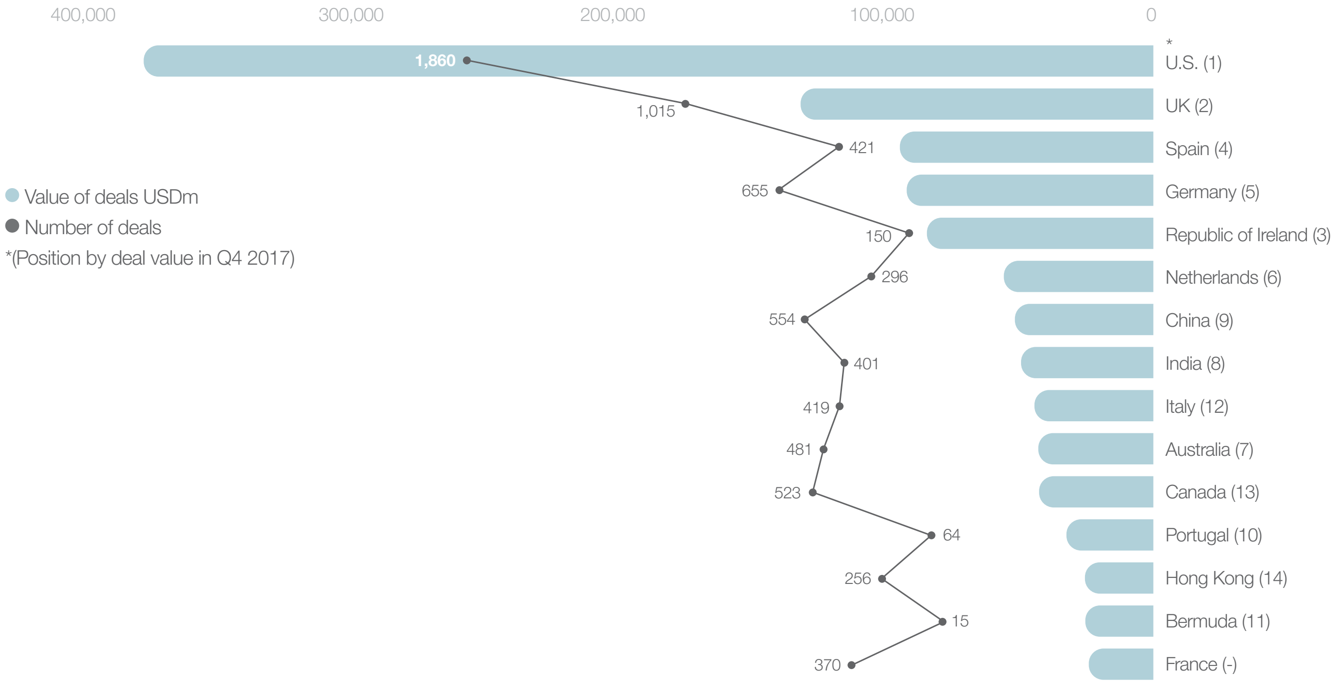
Global deal flows

Inbound target markets



01 Stability the key to India's growth

The long-predicted upsurge in M&A activity in India has finally arrived in 2018 with deal volumes climbing by 17% and deal values up by an impressive 92% in the year to date.

Although Walmart's USD16bn acquisition of a majority stake in India's largest online shopping group, Flipkart, is clearly the dominant transaction of recent months, we are seeing an increasingly diverse range of deals and investors across many sectors. Indeed, there have been some 13 transactions worth more than USD1bn so far this year and around 60 transactions in excess of USD100 million – proof that the wider market is in robust health.

Most of the activity is focused on domestic transactions both by national players and inbound investors. Consolidation within key sectors, operational restructuring, distressed sales, a welcome injection of growth capital from PE funds and moves by investors to cash out have all played a part in driving activity.

2018 has also seen something of a recovery in outbound activity, led by players in the technology, pharmaceuticals and metals sectors. This follows a long period of inaction after a string of earlier outbound deals proved far less successful than hoped and required extensive remedial work.

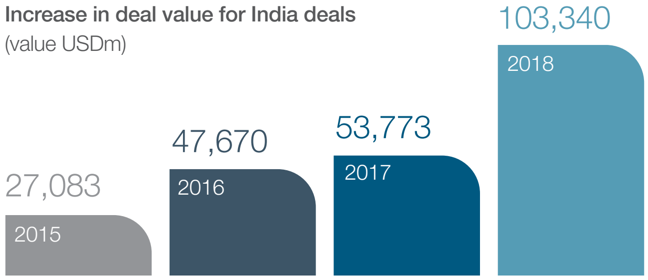
Economic reforms introduced by Narendra Modi's majority government have played a role in stimulating activity, not least the relaxation of controls on foreign investment in some key sectors.

However, perhaps the most important stimulus has come from a protracted period of political stability, absent in many other markets where investors are looking to deploy capital, coupled with continued and consistent strong economic growth.

The big question is whether the Prime Minister has done enough to win a second term in office when India goes to the polls, probably in April or May next year.

There has been a clear paradigm shift in Indian economic policy in the last four and a half years. However, will voters endorse Mr Modi's record or conclude that – given his powerful mandate – he could have done more to reform the economy and to stamp out corruption? For now though, investors are taking advantage of a period of relative certainty.

Increase in deal value for India deals
(value USDm)



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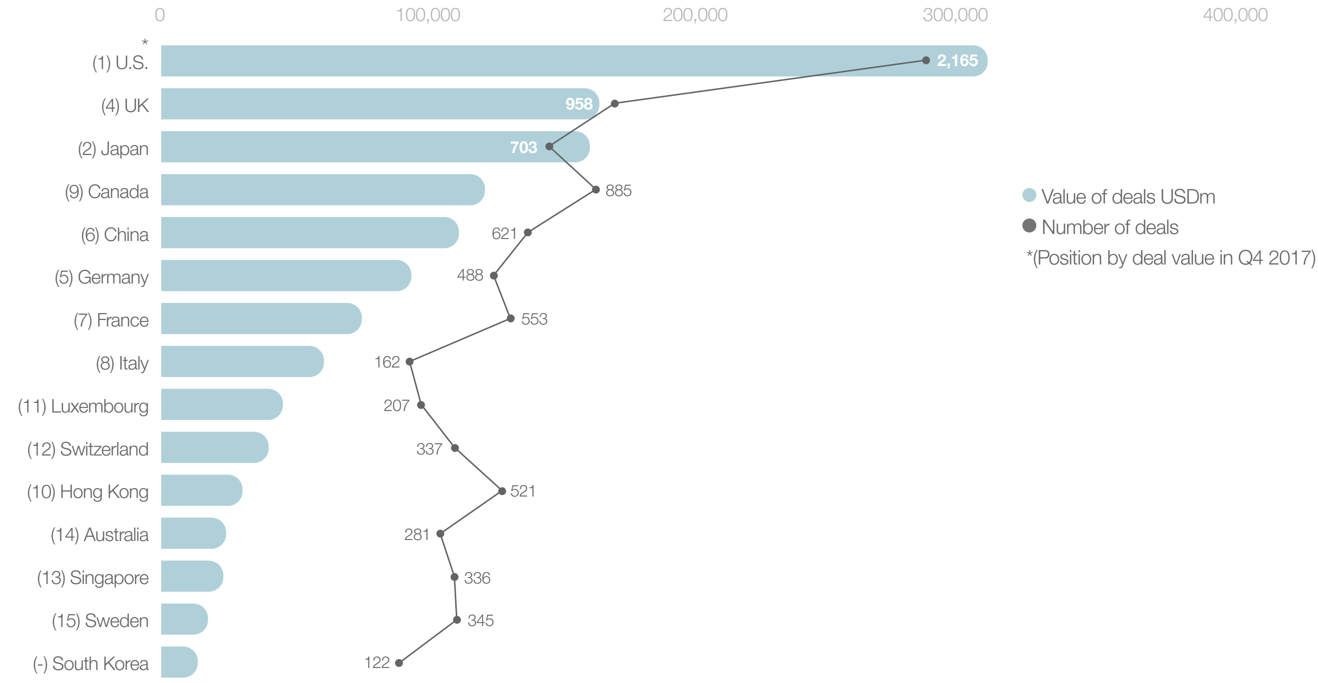
Outbound acquirers



02 Uncertain outlook despite growth in key CEE markets

While the value of transactions in Central and Eastern Europe has risen strongly, investors remain uncertain about the outlook.

The Polish market remains strong across many sectors, with consolidation in the banking sector a highlight, and this is likely to continue following acquisitions by Santander, BNP and Bank Millennium of Portugal in the last 12 months. The retail sector has been lively too. There are some concerns about rising Government intervention, with the PFR development fund targeting strategic sectors like energy, transport and high tech, often as a co-investor.

The Czech Republic and Slovakia have seen more mid-sized deals in 2018 spread across a number of sectors, making Sanofi's sale of the Prague-based generics drugmaker, Zentiva, to Advent an exception. Consolidation in banking and insurance is particularly active. Rising property prices in Hungary have revived competition in loan portfolio sales processes, including the recent sale of Aegon Credit and its mortgage portfolio.

The threat of further U.S. and possibly UK sanctions continues to hang over the Russian M&A market, although investors have grown used to the existing regime. Alternative investment from the Middle East and Asia is being won – as Qatar's investment in oil giant Rosneft proves – but at a slower pace than expected.

03 Germany – one of the leading markets for PE investment in Europe

Germany has become one of the leading markets for PE investment in Europe, with deal values up by over 32% in the year to date, although volumes are lower reflecting a surplus of cash chasing a relative shortage of assets.

As Europe's most stable economy, Germany is increasingly portrayed as a "safe haven" for investment, a title that has gained added currency in the light of Brexit.

Family-owned Mittelstand, or 'hidden champion' companies, across real estate, engineering, automotive, chemicals, technology and healthcare are proving attractive targets for either partial or full buyout, as are occasional carve-outs of industrial business units from large corporates. With sovereign wealth and pension funds increasingly prepared to invest alone rather than in partnership with PE Funds, competition for assets is intense, with valuations rising.

Small, mid and large-cap funds have traditionally been dominant, but mega-funds could increasingly make their presence felt in 2019 and beyond. With huge accumulated firepower, they need new opportunities to deploy capital and appear ready to pursue opportunities in Germany that traditionally have been out of reach for PE investors.

GLOBAL PRESENCE

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