M&A monitor 2019 predictions

Why only the strongest will thrive

Freshfields Bruckhaus Deringer

Looking ahead to what will define M&A over the next 12 months.

We believe that deal-making will be about the survival of the fittest. In volatile markets, outcomes are enveloped in economic and transactional uncertainty: political headwinds are growing, regulators are getting tougher and competition for the best assets is fiercer than ever (although pricing dislocations may have unpredictable effects, including for financing). Such conditions are not for the faint-hearted, and the businesses that thrive will include those with supportive stakeholders, courage in their convictions and the ability to make clear decisions.

Slower, tougher, more uncertain – navigating CFIUS

In the current climate, fortitude is a prerequisite for overseas companies looking to do deals in the US. Recent reforms of Washington's foreign investment laws mean that any non-US business buying into a new list of 'critical technologies' now has to lodge a mandatory declaration with the Committee on Foreign Investment in the United States (CFIUS). The committee, which was already struggling to deal with an explosion of cases that have arisen in recent years, now finds itself faced with myriad new notifications that would not have previously entered the system. As a result, foreign acquirers will have to ready themselves for a more uncertain – and surely longer – M&A process from here on out.

CFIUS has defined 'critical technologies' by reference to certain export control categories split across 27 industries for which strategically motivated foreign investments could pose a threat to US technological superiority or national security.

The committee has the option to approve transactions submitted via a mandatory declaration at the end of a 30-day review, but will do so only if it is certain the deal raises no concerns (an unlikely outcome given its resource constraints). If it has identified any potential issues by the end of this stage, it can either request that the parties submit a formal filing or initiate a review itself.

The most likely scenario, however, is that nothing happens, essentially telling buyers and sellers that they have complied with their mandatory filing obligations but the committee does not have enough information to give an affirmative approval. Some parties with lower risk profiles might be comfortable with closing their transactions without a formal clearance. The alternative is to force CFIUS to reach a conclusion by voluntarily submitting a traditional notification from the outset, in theory capping their exposure to CFIUS risk at five to six months.

In response, deal-makers will need to budget even more time for the CFIUS process. Early-stage due diligence now requires a detailed understanding of whether any aspect of the target's business is involved with one of the committee's key industries and, if so, what specific export controls apply. Failure to comply with the new mandatory filing obligations risks penalties that can be as large as the deal value itself.

CFIUS is also increasingly focused on third-party risk (in private equity deals this can involve probing limited partners' links to foreign regimes and their level of influence over the general partner), so buyers with complex ownership structures might face difficult and intrusive disclosure requests.

On the brighter side, the committee's staffing gaps may soon be addressed. The latest round of reforms allocated CFIUS a dedicated budget of $20m, but change will not happen overnight. Until it does, buyers will have to hang in there to get their transactions over the line.

CFIUS's dedicated budget

Predicting the unpredictable – the future of transatlantic antitrust enforcement

Antitrust litigation under the Trump presidency

Merging parties	Agency	Type of deal	Outcome
Wilhelmsen/Drew	FTC	Horizontal	FTC won
Tronox/Cristal	FTC	Horizontal	FTC won
Sanford Health/Mid Dakota	FTC	Horizontal	FTC won
Otto Bock/ Freedom Innovations	FTC	Horizontal	Decision pending
AT&T/Time Warner	DOJ	Vertical	DOJ lost, appeal pending

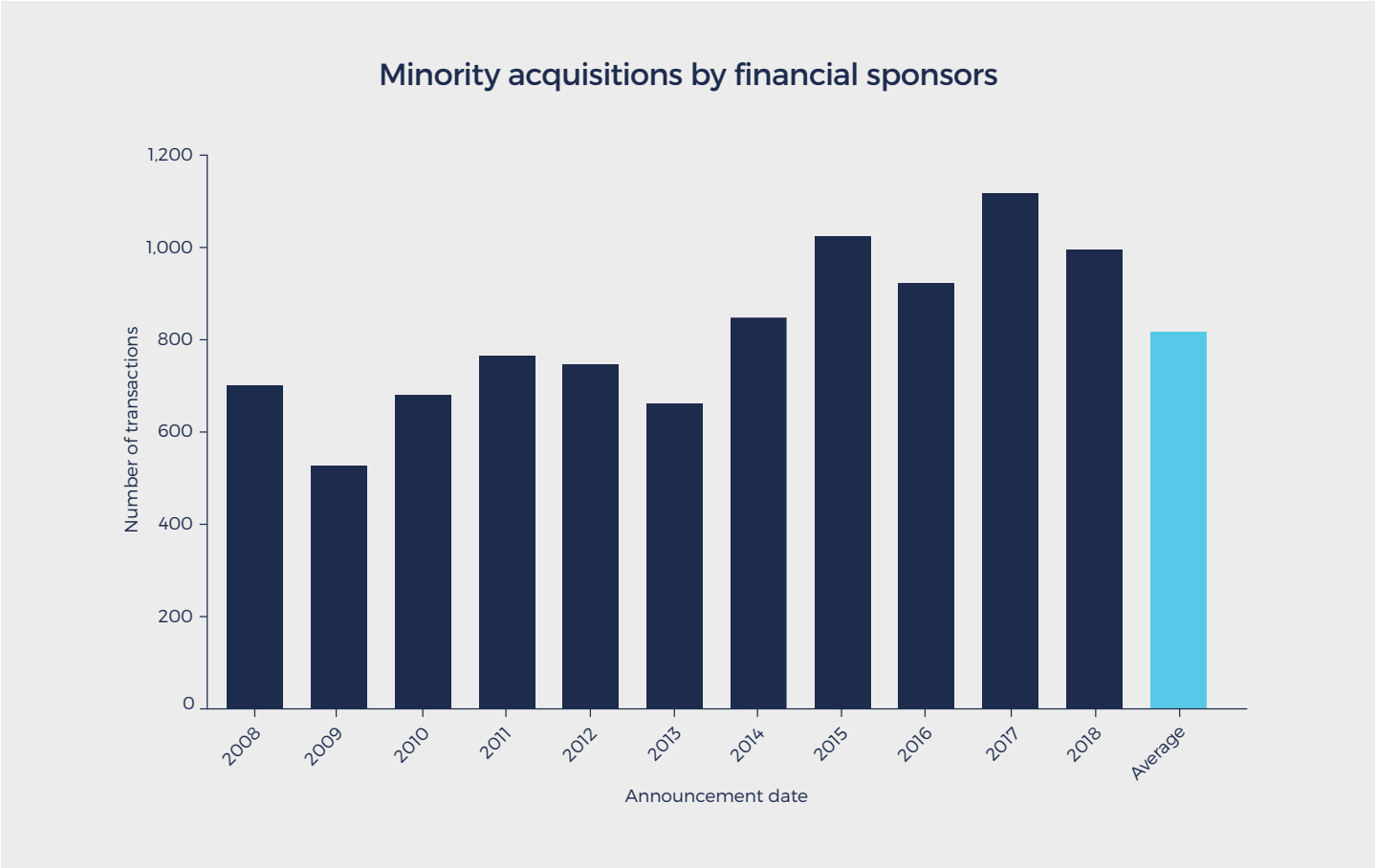
Cross-border deals have become more politicised in recent years, with antitrust enforcement one of the principal battlegrounds.

In Europe, the Commission has signalled that buyouts involving big tech companies will continue to be scrutinised over their impact on consumers, markets and innovation. The authority has long tried to curb the power of tech giants and is considering new measures to aid its cause. At present, parties are only required to submit a merger filing if certain revenue thresholds are met. But in future, the price of the target may be used as an additional trigger (acknowledging that even smaller tech deals can have a distorting impact on competition). The European Commission's chief economist, Tommaso Valletti, has also suggested reversing the burden of proof in these 'killer acquisitions' by obliging 'super large companies' to demonstrate the efficiency benefits of the transaction to secure clearance. Although legally questionable, if his ideas are taken up in practice it will place significant demands on acquirers.

In the US, it is harder to generalise because two agencies with what appear to be very different enforcement philosophies are responsible for reviewing deals. Under the Trump presidency, the Federal Trade Commission (FTC) has taken a robust, traditional approach by focusing on horizontal mergers. Its work has so far been validated by the courts; of the four cases it has litigated, three have been won and a ruling on the fourth is pending. By contrast, the Department of Justice (DOJ) has directed much of its attention towards a single vertical merger (AT&T/Time Warner), the only time in 40 years such a transaction has been challenged.

As for horizontal tie-ups – which are predominately the deals that antitrust enforcers care about – the Trump DOJ is yet to take one to trial (it did challenge a very small aspect of Parker Hannifin/ CLARCOR but the case was settled). Looking ahead, the outcome of the DOJ's investigation into the T-Mobile/Sprint merger may therefore provide some insight. The head of the agency's antitrust division, Makan Delrahim, has said that he sees little wrong in reducing the number of players in the mobile market from four to three, and if the deal is passed it could lead to further consolidation in key industries.

Why financial investors are starting small



The story of Ant Financial's year reveals two trends set to continue into 2019.

In August, Alibaba's payments arm pushed back its hotly anticipated IPO, proving that even the fastest-growing companies can find it tough to list in the current climate. Yet it also launched the biggest ever funding round by a private business (pulling in more than $14bn from the likes of Warburg Pincus), demonstrating the increasing appetite from financial sponsors for VC-style growth investments.

As the table above shows, such interest in minority stakes has been on the rise in recent years (arguably returning many funds to their VC-pedigree roots). Deal volumes hit a 10-year high in 2017, and activity in 2018 was not far behind by early December. In Ant's case, investors were attracted by the chance to gain financial exposure to one of Asia's biggest success stories (its value has more than tripled to $150bn since 2015). And with a listing expected, they have an exit point in their sights.

Exit dynamics are one of the biggest issues for buyout firms playing in this space. These are funds that have defined horizons to deliver returns, unlike typical growth investors whose approach is more open-ended. The strongest players may be able negotiate an obligation that the business will be sold or listed within a given timeframe – or agree rights that enable them to force their way out. But those that can't are increasingly taking multiple minority stakes as a route to overall control, effectively turning buyouts into a two- or three-stage process.

Minority investments offer fewer board seats, although with directors being driven to act independently, even controlling positions may not enable owners to influence strategy to the extent they did in the past. This is particularly so in regulated sectors, but the Securities and Exchange Commission's hard line with Elon Musk suggests that autocratic leadership styles are on borrowed time in every industry. It is also harder to raise leverage from a minority position (where dividends may be the only source of security), meaning sponsors are increasingly chasing businesses with the highest growth potential.

Culture – the impact of diversity

When market conditions are challenging, it puts greater pressure on businesses to make the right decisions.

Senior executives are expected to generate growth whatever the prevailing winds – and when asset values are high, acquisitions tend to be more closely scrutinised.

One way companies may be able to tackle this challenge is by building more diverse deal teams. Governments and investors are pushing for greater gender, ethnic and social balance on boards, and diversity has been shown to deliver tangible returns.

A 2018 McKinsey study, *Delivering through Diversity*, analysed more than 1,000 companies and found that those with the most diverse executive teams were 21 per cent more likely to outperform on profitability and 27 per cent more likely to demonstrate superior value creation. Academic studies suggest homogenous teams act to marginalise dissenting voices and promote 'herd mentality', overconfidence and 'empire-building' (where the consolidation of executive power takes precedence over what is best for the business). In the context of M&A, less-diverse companies have even been found to pay more for assets, in part because decision-makers may overestimate their ability to drive synergies.

We spoke to senior decision-makers in three industries – healthcare, finance and tech – to gauge whether these theories apply in practice. All our interviewees valued the ability of diverse teams to 'cover every angle and identify potential pitfalls' during deals. Mixed teams are less likely to be dragged into the 'ego-driven' aspects of a negotiation (where minor points are fought over 'simply to win the argument'), and are less likely to harbour cliques that can monopolise discussions. One also pointed to the benefits of cultural diversity in breaking down deferential hierarchies and enabling teams to tackle subjects that might otherwise be off limits.

> The most diverse executive teams are more likely to outperform on profitability.

Bonus thoughts – other trends we are monitoring

Carve-outs, spin-offs and other portfolio-optimising transactions

We expect these to continue – not least because of the ubiquitous nature of the activist investor, regardless of target size or industry, and regardless of region.

Volatility in energy prices

All part of the new normal – not just for the resources sector, but for the rest of the industrial economy.

The shift back towards a focus on corporate governance and controls

The market has generally favoured less risk-averse boards over the past five years, so will high-profile conduct (accounting, bribery and corruption, individual behaviour) scandals lead to a more conservative approach to transactions?

Digitisation – what's next?

This is obviously a major driver of M&A activity – we are looking hard at the secondary and tertiary layers here, including enhanced antitrust enforcement, ethical tech and continued efforts to 'best practice' the cyber security crisis.

For further insights, please visit our Transactions blog.

Global M&A YTD activity by sector

Sector	$bn	%
1 Telecoms, media and technology	865	24
2 Energy and power	645	18
3 Industrials and materials	490	13
4 Consumer *	417	12
5 Healthcare	399	11
6 Real estate	321	9
7 Financials	320	9
8 Infrastructure and transport	135	4
Total	**3,592**	**100**

Sector	Vol	%
1 Telecoms, media and technology	10,872	25
2 Consumer *	9,276	22
3 Industrials and materials	7,825	18
4 Financials	4,392	10
5 Healthcare	3,339	8
6 Real estate	3,148	7
7 Energy and power	2,818	7
8 Infrastructure and transport	1,110	3
Total	**42,780**	**100**

*Includes retail

Global M&A YTD – value and volume

(Company nationality is determined by HQ location.)

Global

M&A value
$3,592bn

M&A deal volume
42,780

Top 3 deals

Shire/Takeda Pharmaceutical	$76.9bn
Express Scripts Holding/Cigna Corp	$68.5bn
Energy Transfer Partners/Energy Transfer Equity	$61.8bn

Inbound: most targeted markets

USA 11,317 deals	$1,560bn
China 5,250 deals	$418bn
UK 2,855 deals	$212bn

Outbound: most acquisitive markets

USA 10,870 deals	$1,530bn
China 5,221 deals	$433bn
UK 2,756 deals	$225bn

USA*

M&A value
$1,560bn

M&A deal volume
11,317

Top 3 deals

Express Scripts Holding/ Cigna Corp	$68.5bn
Energy Transfer Partners/Energy Transfer Equity	$61.8bn
Sprint/T-Mobile US	$58.7bn

Inbound: markets investing into US companies

USA 9,065 deals	$1,289bn
Canada 454 deals	$69bn
Japan 102 deals	$33bn

Outbound: markets US companies are investing into

USA 9,065 deals	$1,289bn
UK 337 deals	$68bn
India 116 deals	$21bn

Europe*

M&A value
$897bn

M&A deal volume
12,240

Top 3 deals

Shire/Takeda Pharmaceutical	$76.9bn
Sky/Comcast	$48.4bn
Abertis Infraestructuras SA/Abertis Infraestructuras SA SPV	$41.5bn

Inbound: markets investing into European companies

UK 2,342 deals	$182bn
USA 861 deals	$127bn
Japan 99 deals	$97bn

Outbound: markets European companies are investing into

UK 2,253 deals	$124bn
Germany 1,130 deals	$116bn
USA 612 deals	$100bn

Asia-Pacific*

M&A value
$873bn

M&A deal volume
15,101

Top 3 deals

Flipkart Group/ Walmart	$16bn
Coles Group/ Shareholders of Wesfarmers	$11bn
Yantai Wanhua Chemical Industry/Wanhua Chemical Group	$10.2bn

Inbound: markets investing into Asia-Pacific companies

China 5,013 deals	$395bn
Japan 2,659 deals	$79bn
Australia 1,090 deals	$69bn

Outbound: markets Asia-Pacific companies are investing into

China 5,110 deals	$391bn
Ireland 14 deals	$77bn
Australia 1,135 deals	$77bn

*Includes domestic deals

NB: All deal volumes include net debt of target.

Financial sponsor M&A – top 3 deals with financial sponsor involvement

1. **$58.7bn** – Sprint/ T-Mobile US
2. **$29.6bn** – EDP Energias de Portugal/ China Three Gorges (Europe)
3. **$26.6bn** – Dr Pepper Snapple/ Keurig Green Mountain

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Source: Thomson One (Deals). Data as at 10 December 2018