The Harvard Law School Forum on Corporate Governance and Financial Regulation

Mergers and Acquisitions — 2013

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As we enter 2013, a number of signs – including the strong finish to 2012, macroeconomic factors that appear to be reducing business uncertainty, and intensifying competition in many critical sectors – provide cause for optimism that the breadth and depth of M&A activity will be significantly greater in the coming year than in 2012. Global M&A activity dropped 17.4% in the first three quarters of 2012 compared to the comparable period of 2011, reflecting the European sovereign debt crisis, political uncertainty in the United States and slower economic growth in China and India. But M&A activity turned sharply upward in the fourth quarter: Global announced deal volume for the quarter was the highest in four years, and a number of transformative transactions were announced, including Freeport McMoRan Copper & Gold's $9 billion acquisitions of Plains Exploration Company and McMoRan Exploration, and ICE's $8.2 billion acquisition of NYSE Euronext.

As we noted last year, the continuing, post-recession emphasis on deleveraging and strengthening corporate balance sheets makes cost-saving M&A synergies particularly valuable. This is especially true for the many companies that have already exhausted their own cost-cutting opportunities, even as they have accumulated arsenals of deployable cash. And global market pressures, economic volatility and industry-specific factors across a wide array of industries put pressure on corporations to increase scale, diversify their asset base, seek operational synergies and spread costs across larger platforms. These trends were particularly apparent in 2012 – and are poised to continue – in the health care and energy sectors, with transactions including Aetna's $7.3 billion deal to acquire Coventry Health Care, Walgreen's acquisition of a 45% stake in Alliance Boots with an option to acquire the balance, a $27 billion transaction, Sunoco's sale to Energy Transfer Partners for $5.3 billion, and CNOOC's $15.1 billion pending takeover of Nexen. In addition, the debt markets have been extremely friendly to corporate issuers, allowing

companies such as United Technologies and PVH to upsize bond offerings and finance strategic transactions at extremely low yields.

Confidence – or at least some clarity – about the future, is a critical driver of M&A activity. The high levels of economic and business uncertainty witnessed over the past five years appear to have decreased, at least on a relative basis, in several important respects, including continuing growth and recovery in the U.S. economy, the partial resolution of the "fiscal cliff," and a sense that the Eurozone situation, while not resolved, is unlikely to trigger another global financial crisis. Unfortunately, on an absolute basis, uncertainty and lack of forecasting ability remains high. The slowing of growth in China, Brazil and other globally important countries has implications for the global economy generally and for specific industries, particularly energy and natural resources. Facing these uncertainties and risks, but also anticipating greater incentives or greater industry imperatives to merge or acquire, M&A participants are approaching transactions with greater determination and creativity. In addition, the ability to move fast when required became ever more important, as Kellogg showed when it agreed to acquire Pringles from P&G just after P&G's earlier spin-merge with Diamond Foods fell apart, as well as when Knight Capital Group closed a $400 million recapitalization only days after suffering a serious trading loss.

Looking ahead to 2013, we believe that perseverance, creativity and speed will continue to be critical as parties seek to manage risk in an environment that is likely to remain volatile and unpredictable, often abruptly so. At the same time, activism by short-term shareholders and the virtually guaranteed prospect of deal litigation and judicial review of transaction processes underscore the crucial importance of the basics – above all, that the board of directors be actively involved in corporate decision-making in general and M&A planning in particular.

Below, we review some trends that we expect to continue in 2013.

Tax-free Spin-offs and Other Divestitures

Tax-free spin-offs remain popular means to unlock value and restructure operations. Notable recent spin-off announcements include Murphy Oil's and Valero's planned spin-off of their respective retail businesses, Pfizer's planned spin-off of its animal health business, News Corp's planned spin-off of its publishing business and Penn National Gaming's planned spin-off of its real estate assets into the first-ever casino REIT. In addition, 2012 saw a number of very large and well-received spin-offs, including ConocoPhillips' spin-off of its refining and marketing business ($21 billion), Tyco's spin-off of its home security business ($8.5 billion) and Abbott's spin-off of its proprietary pharmaceuticals business ($55 billion). With historically low yields, corporate borrowers have been able to optimize their capital structures and reduce their financing

costs. For example, AbbVie (which was formed from the spin-off of Abbott's proprietary pharmaceuticals business) conducted a $14.7 billion bond offering, the biggest ever investment-grade corporate bond deal in the U.S., and locked in a weighted average interest rate on such debt of approximately 2%. With low interest rates in the U.S. expected to continue through 2013, spin-offs will continue to be an attractive means for providing distinct businesses with capital structures tailored to their particular needs.

In addition to providing each of the parent and the spun-off corporation with a "pure play" acquisition currency, another important benefit of a spin-off is resulting public companies that are typically more focused, with businesses more easily understood by investors. Such separated businesses, in turn, may be more attractive acquisition targets. For example, after Sunoco spun off its non-core metallurgical coke business at the beginning of 2012, it was approached by several interested parties and was ultimately acquired by Energy Transfer Partners for $5.3 billion. Caution should be used, however, when considering the acquisition of a corporation that has been involved on either side of a recent spin-off, so as to avoid any actions that could jeopardize the tax-free nature of the spin-off. Occasionally, the announcement of a planned spin-off – even if not completed – may attract a buyer of the business to be separated. This was the case when McGraw-Hill began the process of spinning off its education business and then reached an agreement to sell the division to a private equity buyer for $2.5 billion.

Tax-free spin-offs can take a variety of forms, including a 100% spin-off, an IPO followed by a spin-off, an IPO followed by a split-off or a "reverse Morris Trust" structure that results in a combination of two businesses. For example, in a transaction similar to the Acco Brands – Mead Westvaco deal we mentioned last year, PPG Industries will use a "reverse Morris Trust" structure to split off its chlor-alkali business and then combine that business with Georgia Gulf in a tax-efficient manner. The reverse Morris Trust structure generally requires, among other things, that the merger partner be smaller than the spun-off business (i.e., that the shareholders of the divesting company own a majority of the stock of the combined entity). Companies considering a tax-free divestiture (including a reverse Morris Trust structure) may be able to structure the divestiture, in whole or in part, as a split-off, which is an exchange offer in which the parent company uses stock of the spun-off company as currency to repurchase parent company stock, but that requires careful planning and familiarity with the securities laws applicable to issuer tender offers. In addition, such transactions, and other M&A activity close in time to a tax-free spin-off, will require careful tax analysis and planning.

The popularity of tax-free spin-offs is expected to continue in 2013. And, subject to the constraints of applicable tax rules, the resulting more focused stand-alone companies may continue to be active participants in M&A activity.

Similarly, non-spin-off divestiture activity reached a multi-year high in 2012, as companies sold off assets acquired in previous transactions, in some cases to respond to antitrust regulators, and exited noncore businesses. United Technologies divested a number of businesses in connection with its 2011 acquisition of Goodrich, including its Hamilton Sundstrand Industrials and Rocketdyne divisions, to repay debt, and agreed to divest other businesses as a result of a July settlement with the U.S. Department of Justice Antitrust Division and in response to other antitrust regulators. Pfizer sold its infant nutrition business to Nestle for $11.9 billion, and Chesapeake Energy sold the vast majority of its Permian Basin assets and midstream business.

Careful planning is essential to making the most of a tax-free spin-off or other divestiture. Among other things, these transactions provide the unique opportunity to craft afresh (rather than on-the-fly) the “new” company’s capital structure, market identity and corporate governance. Companies that get these points right have much better odds of thriving post-transaction. Spin-offs and divestitures can be transformative for the parent company as well; companies engaging in these transactions must carefully assess their post-transaction strategic, financial and governance positioning as well as their post-transaction exposure to unsolicited takeover activity.

Regulatory Uncertainty Goes Abroad

Deals have become increasingly global, and in 2012, so did the regulatory challenges. Regulators both in the U.S. and around the world became more assertive, creating fresh sources of uncertainty for M&A market participants. Regulators in both the U.S. and Europe blocked major transactions on antitrust grounds in 2012, and China’s Ministry of Commerce (MOFCOM) has been particularly aggressive, generally taking longer than other regulators to review, and imposing more conditions on, for example, Google’s $12.5 billion acquisition of Motorola Mobility, where it required Google to commit to keep the Android OS free for five years. MOFCOM also conditioned its approval of United Technologies’ acquisition of Goodrich on a divestiture. China’s antitrust laws require that MOFCOM review any acquisition if the combined company would have approximately $63 million in Chinese sales and $1.5 billion in global sales. This low threshold for Chinese sales puts many U.S. or European deals squarely within MOFCOM’s jurisdiction. China’s laws also give MOFCOM broad latitude in selecting remedies and the timing of review. In addition, the clock only starts ticking after MOFCOM accepts the filing, which can take weeks or months at MOFCOM’s discretion.

In light of the heightened global emphasis on antitrust enforcement, even more attention must be paid to the antitrust-related provisions contained in transaction agreements, including the so-called “efforts” clauses, cooperation obligations, termination provisions and reverse termination fees. The trend toward sizeable antitrust-related termination fees in strategic transactions, such

as the $2.5 billion reverse termination fee in 2011's Google – Motorola Mobility transaction, continued in 2012. ICE's pending acquisition of NYSE Euronext – following regulatory rejection of two previously proposed transactions – included a $750 million reverse termination fee, or approximately 9.1% of the equity value of the transaction.

In addition to the size of the fee, there are a number of other important issues to consider in developing a reverse termination structure and fee tailored to a particular transaction, including the nature and extent of efforts that must be used by the parties to obtain antitrust clearance before the agreement may be terminated and the fee paid, and whether control of the approval-seeking process will be joint, or led by the buyer. Parties can and should be flexible and creative in developing an approach suited to the particular circumstances and risks at hand.

National-security reviews similarly continue to inject uncertainty and complexity into cross-border deals. Although non-U.S. investment in the U.S. remains generally well-received, politicians and regulators in the U.S. and in other countries that are usually hospitable to off-shore investors focused more attention in 2012 on acquisitions by state-owned or state-connected enterprises. President Obama forced Chinese company Ralls Corp to divest its interests in four wind farms near a U.S. naval facility. Canada's government initially blocked the $5.2 billion bid by Malaysia's Petronas for Progress Energy Resources on the grounds that it would not create a net benefit for Canada before approving a revised bid. And CNOOC's acquisition of Canadian oil company Nexen has been held up by the need to secure U.S. national security review, even though only a small percentage of Nexen's production and reserves is in the United States and the transaction has been approved by Canadian regulators.

As more jurisdictions implement national security reviews, it is critical to consider the impact of these reviews on the timing and ultimate success of the transaction. Advance analysis and planning is critical for transactions in industries that are sensitive, or could potentially be perceived to be. Identifying divisions and businesses with competitive overlap or national security concerns ahead of time and lining up potential buyers for these units or otherwise proactively developing politically acceptable solutions and structures may provide valuable comfort to regulators and government officials.

The Search for Exits

The challenging M&A environment and weak IPO market for most of 2012 has pushed companies and private equity firms toward creative transaction structures to monetize their investments and meet their liquidity goals. Non-traditional transaction structures require careful tax planning and frequently give rise to complex post-transaction governance and control

concerns. M&A market participants who become familiar with negotiating and executing the structures developed in 2012's challenging environment will have the advantage of an expanded M&A toolkit for 2013 and beyond.

Shareholder Activism – Opposition, Accommodation and Overreaching

The high level of shareholder activism seen in 2012 shows little sign of abating in 2013. Activists have broadened their sights beyond the U.S., as Danone and Canadian Pacific Railway discovered, and targeted larger and larger companies, including most recently P&G. But several significant victories by boards of directors and corporations over activists could reduce hedge funds' appetite for activism or alter their tactics or target selection criteria. AOL, Forest Laboratories and Cracker Barrel all successfully defended against months-long proxy fights. In AOL's case, the dissident nominees for director had the backing of ISS. AOL management, with the support of independent directors, took their case to investors to persuade them that the dissident had no long-term business plan for the company, and that investors would be better off if the company executed its long-term plan for success. AOL was also able to leverage strong relationships with key portfolio managers that it had developed before the dissident showed up. Shareholders of Forest Laboratories rejected three out of four dissident nominees, despite ISS's recommendation in favor of two of the nominees. And Cracker Barrel defeated a proxy campaign by Sardar Biglari for the second year in a row. Companies have succeeded in proxy fights by focusing on their business strategy, highlighting positive changes, whether financial or in corporate governance, and pointing out when the dissident had no long-term business strategy.

Companies have also become increasingly adept at responding constructively to shareholder activism, and activists have frequently responded less confrontationally than in the past. Companies that engage with activists in the first instance are more likely to have an acceptable result from both the corporate and the activist perspective. In many cases, activists are more concerned that their opinions be heard and that the board be open to new ideas than they are concerned that any particular ideas are being acted upon. Companies that can build constructive engagement with the activist are better able to diffuse potentially confrontational situations before they become public, bloom into a full-fledged fight or result in the company being put "in play".

Signs are promising for increased M&A activity in 2013. But regardless of the absolute level of activity, the more salient truth is that today's M&A environment is significantly more challenging and complex than it was just five years ago. Successful execution in 2013 will require greater persistence and determination, greater creativity to address uncertainty and transaction-specific risks, greater foresight as to regulatory and political obstacles, and greater internal execution discipline, board involvement and procedural integrity than ever before.