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Mergers and Acquisitions — 2018

With a Brief Look Back

M&A vastly accelerated in the fourth quarter of 2017, as confidence increased in the likelihood of U.S. tax and regulatory reform. U.S. M&A in particular had a very strong fourth quarter, with the volume in that quarter accounting for more than a third of the full year's volume and up 75% from the third quarter. The three largest deals of 2017 (both in the United States and globally) were announced in November and December, creating momentum into 2018.

Total deal volume in 2017 reached $3.7 trillion globally (roughly equivalent to 2016), making it the fourth busiest year on record. The volume of deals involving U.S. targets was just over $1.5 trillion and represented a share of total global M&A volume comparable to 2016. There continued to be a number of large deals, with 46 deals over $10 billion (compared to 45 in 2016) and 3 deals over $50 billion, all announced in the fourth quarter (compared to 4 in all of 2016). Also as was the case in 2016, a large volume of announced friendly deals were withdrawn or terminated in 2017, with $715 billion of U.S. M&A deals falling into this category.

Some of the catalysts for M&A in 2017 were similar to those at play in 2016. U.S. equity markets soared, with the Dow Jones Industrial Average increasing by more than 5,000 points, the largest ever absolute increase in a single year. As in 2016, interest rates remained low, enabling acquirors to obtain attractive financing for transactions, despite the Federal Reserve's decision to raise rates at the end of 2017.

With 2018 just beginning, several factors (positive and negative) are likely to affect dealmaking throughout the year, including a general sense of confidence in the strategic benefits of M&A in the business community, significant changes to the U.S. tax code, increased concern with political and regulatory issues, including increased scrutiny by the Committee on Foreign Investment in the United States (CFIUS) and an uncertain antitrust enforcement environment, developments in China, record levels of dry powder held by private equity funds, possible geopolitical developments and concerns about when the current bull market may run its course. On balance, 2018 seems poised to be another strong year for M&A, as many of the trends that resulted in a strong fourth quarter in 2017 are expected to continue into 2018, but dealmakers will need to closely monitor trends and events as the year unfolds.

Below, we review some of the key themes driving M&A activity in 2017 and expectations for 2018.

Tax Reform

Earlier in 2017, some companies delayed or chose not to pursue large-scale M&A transactions, amid uncertainty regarding the nature of possible U.S. tax reform, and whether or when it even would be enacted. This uncertainty appeared to be less of an impediment in the fourth quarter as the new tax legislation began to take shape.

The tax reform bill enacted at the end of 2017, commonly referred to as the "Tax Cuts and Jobs Act," ushered in the most expansive changes to business-related federal income tax in more than three decades. As we discussed in our recent memorandum "What the New Tax Rules Mean for M&A," the new law is expected to have far-reaching implications for domestic and multinational businesses, as well as domestic and cross-border transactions, affecting the structure, pricing and, in some cases, viability of broad categories of deals. For example, the law vastly reduces the incentives for U.S.-parented multinationals to hold cash offshore, which is expected to free up cash for M&A activity (as well as other uses, such as capital expenditures, debt repayment and stock buybacks). The reduction in the corporate tax rate from 35% to 21% may free up additional cash, though the impact of the rate reduction on certain companies may be offset by limitations on certain deductions and other revenue-raising measures. The law also includes provisions deterring inversions by increasing the excise tax on insider stock compensation, increasing the tax rate applicable to the deemed repatriation of foreign subsidiary earnings, and taxing dividends paid to noncorporate domestic shareholders as ordinary income (although inversions had already decreased substantially following earlier actions taken by the Obama administration to curtail their tax benefits). Tax reform also will likely change the calculus for certain transactions involving significant acquisition financing, by limiting net interest expense deductions to 30% of an amount that approximates EBITDA (and, beginning in 2022, EBIT).

Given the breadth and complexity of tax reform, its effects may unfold in unpredictable ways. Dealmakers will need to closely monitor how the new law is interpreted and its impact on the M&A environment.

Industry Trends: Tech M&A Setting the Pace

Technology was the most active industry in terms of volume of M&A activity in 2017, with real estate/property and healthcare as the next most active industries for M&A. The largest deal announced in 2017 was Broadcom's proposed $130 billion acquisition of Qualcomm, which, if consummated, would be the largest deal on record in the technology industry.

One significant reason for the rise in tech M&A is the increased use of digital technologies in industries outside the technology sector. For example, Walmart's acquisition of the e-commerce business Bonobos was in part driven by its desire to capitalize on Bonobos's existing technology platform rather than develop a similar e-commerce platform in-house. Amazon's $14 billion acquisition of Whole Foods is another example of M&A combining technology and non-technology companies, albeit with the tech company as the buyer. Amazon/Whole Foods also was notable for its knock-on effects, as entire industries have reacted to the transaction. Similarly, CVS's proposed acquisition of the insurer Aetna was reportedly spurred in part by rumors of Amazon's potential entry into the pharmacy industry.

Another significant trend has been the expansion of technology companies into new operating segments. For example, Intel acquired Mobileye, which produces technology used in self-driving car systems, in order to expand Intel's product offerings and reach new customers. In the cross-border realm, Chinese companies are likely to continue to pursue technology investments outside of China, both on their own initiative and as a result of China's "One Belt, One Road" initiative — the country's plan to connect Asia, Europe, the Middle East and Africa with a logistics and transport network, which includes promoting technology. In addition, SoftBank and its Vision Fund have substantial cash available for technology investments and acquisitions, were involved in a number of large technology transactions in 2017, and will likely continue to play an interesting role in global tech M&A.

Companies considering M&A in the technology sector should carefully evaluate the current landscape, including, for foreign acquirors, the possible impact of review by CFIUS. Many of the decisions by CFIUS in 2017 to block deals were based on perceived cybersecurity risk. Parties also should consider the particular challenges associated with technology deals, including that private technology companies may not have the same degree of intellectual property protection, regulatory compliance or management infrastructure as more mature public companies, that valuation multiples for technology companies are frequently substantially higher than the multiples of non-tech acquirors (and therefore such an acquiror may not get commensurate credit in its stock price for a higher multiple paid for a tech target), and that conducting diligence on technology companies requires careful review of potentially complex governance arrangements, capital structures and investment agreements relating to founders or large private investors.

Unsolicited M&A

2017 was a significant year for hostile and unsolicited M&A deals, with $575 billion of unsolicited bids, representing 15% of total global M&A volume, including Broadcom's proposed $130 billion acquisition of Qualcomm. The percentage of hostile and unsolicited bids out of total M&A deal volume in 2017 was greater than both 2015 (11%) and 2016 (9%). We expect the percentage will continue to remain high, given that the stigma once associated with pursuing unsolicited transactions is long gone. It is still possible to defeat a premium, hostile bid with a thoughtfully executed defense, as illustrated by Rockwell Automation's successful defense against Emerson Electric's $29 billion unsolicited offer. That defense focused on the value of Rockwell Automation's long-term prospects and the inadequacy of the consideration offered.

Shareholder Activism

Shareholder activism also played a significant role in M&A activity in 2017. For example, activist involvement at Whole Foods played a role in its decision to sell to Amazon. The year was also noteworthy for activist campaigns targeting acquirors in strategic stock-for-stock mergers, such as the recent successful scuttling of Huntsman and Clariant's proposed $20 billion deal and SandRidge's proposed $750 million acquisition of Bonanza Creek Energy. Other deals were completed notwithstanding strong and prominent shareholder opposition, such as Sabra Healthcare REIT's $7.4 billion merger with Care Capital Properties. EQT's successful completion of its $6.7 billion acquisition of Rice Energy in the face of an aggressive activist proxy fight seeking to block it illustrates the importance of having broad engagement with shareholders before and during the deal, a focus on long-term investors and value-creation strategies and a strong rationale for the particular transaction.

Shareholder activists also remained busy outside of the M&A context in 2017. Though the number of proxy contests fell compared to 2016, the average size of the target in a proxy contest was the highest in the past nine years. In addition, 2017 saw three of the four largest proxy contests since the 2008 financial crisis (Procter & Gamble, General Motors and ADP), again showing that companies are never too large to be targets for activism. Several large European companies were also targeted, including Nestlé and Danone. The year also saw prominent companies fight back and defend against a proxy contest, rather than settling early. Trian's campaign at Procter & Gamble is noteworthy for seeking to add only Nelson Peltz to the board, and not to change Procter & Gamble's other board members or management. Though Trian ultimately lost the vote after the final ballot recount, Peltz was later offered a seat on Procter & Gamble's board. As in the prior few years, the number of situations in which an activist succeeded in getting at least one director on the board (whether through an election win or a settlement) remained high, but below 50% for the third consecutive year. Nine activist campaigns, or 39% of the total, resulted in an activist succeeding in getting at least one director on the board, as compared to 48% of campaigns in 2016.

Even as a number of high-profile activists, like Pershing Square, have had a challenging year from a performance perspective, we expect that activists will continue to be a major force in 2018 and beyond, both inside and outside the context of M&A. Companies should continue to carefully review their exposure to activism and be prepared to respond promptly to activism.

Cross-Border M&A: Spotlight on China-Outbound M&A

Cross-border activity represented a significant component of global M&A transactions in 2017, accounting for over $1.3 trillion of activity and approximately 35% of total volume. China-outbound M&A volume in 2017 was $141 billion, far above 2015's $86 billion, but significantly below the $230 billion of activity in 2016. There were several identifiable reasons for the substantial decline.

Following the height of China-outbound M&A activity in early 2016, the Chinese government sought to reduce the outflow of its currency by imposing significant limits on the movement of its currency outside of China, including for M&A activity. This resulted in a large reduction of China-outbound M&A in 2017, especially for transactions that, from the Chinese government's standpoint, would not necessarily be beneficial to China. The U.S. government's receptivity (and perceptions of that receptivity) also played a major role. CFIUS was and is also more active in blocking deals generally. For example, in September 2017, President Trump issued an executive order blocking Lattice Semiconductor's $1.3 billion acquisition by a Chinese private equity fund, Canyon Bridge Capital Partners, based on CFIUS concerns, only the fourth time a U.S. President has issued such an order. In the most high-profile Chinese deal to be stymied by the Trump administration, on the second day of 2018, MoneyGram and Alibaba affiliate Ant Financial terminated their proposed $1.2 billion deal, following failure to gain

CFIUS approval over concerns about protection of personal data. In addition, proposed legislation introduced in November 2017, if enacted, would expand the number of transactions subject to CFIUS review and would be the most significant change in the last ten years to the U.S. framework for reviewing foreign investment transactions.

Looking ahead, China's "One Belt, One Road" initiative is likely to be a tailwind for China-outbound M&A. In November, Beijing issued a set of draft guidelines to encourage outbound deals related to this initiative, including in infrastructure, natural resources, agriculture, trade, culture, logistics, food safety, healthcare, and equipment and technology manufacturing. This initiative is also likely to hasten China-outbound M&A in jurisdictions beyond its traditional focus in the United States and the United Kingdom.

The substantial appetite for foreign investment by China, as well as Chinese and U.S. government policies toward such transactions, are likely to be significant factors in M&A activity in 2018 and beyond.

Bank M&A

Bank M&A continued at a solid pace in 2017, with the largest deals of the year announced in the first half of 2017 and the second half of 2017 dominated by smaller transactions. The sense of optimism is high for 2018, with a more benign regulatory environment, a rally in bank stock prices, increasing interest rates and economic growth spurred by corporate tax reform. Although regulatory changes have taken longer to materialize than had been hoped in the industry, looking ahead to 2018, bank M&A activity should benefit from leadership changes at the financial regulatory agencies. Specifically, at the Federal Reserve Board, a new Chair will join the recently appointed Vice Chair for Supervision to usher in more industry-friendly regulatory initiatives. A new Chair will also lead the Federal Deposit Insurance Corporation. These changes come alongside recent leadership changes at the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau and the Financial Stability Oversight Council.

As a new regulatory environment takes hold, we expect that an increasing number of banks will be let out of the regulatory "penalty box" to pursue acquisitions. An increase in able buyers combined with a more expedited regulatory approval process should spur bank M&A activity. Legislative proposals to raise the asset thresholds at which various compliance requirements are imposed on banks should provide an additional stimulus. Strategically, industry consolidation is likely to continue to be driven by the benefits of achieving broader scale to better enable investments in technology and compliance. As a result of these institutional and industry-related changes, M&A activity should be strong in the financial services industry in 2018.

Acquisition Financing

Certain of the changes to the corporate tax code described above could affect acquisition financing activity in 2018. Reduced income tax rates and changes to the treatment of offshore cash that free up funds for M&A activity, as well as limitations on deductibility of interest expense, may lead to a reduction in the use of debt to finance acquisitions. On the other hand, strategic acquirors, who have taken to the acquisition-related debt markets with gusto in recent years, will likely continue to enjoy the full tax benefits of interest deductions other than in very large and heavily leveraged transactions. Increases in the after-tax cost of debt financing could have particular significance for leveraged buyouts by private equity firms, possibly leading to greater focus on transactions with lower overall leverage levels. On balance, we would see these developments as further supporting the competitiveness of strategic acquirors in the auction context over the typical private equity model, with the potential tax dis-synergy for private equity firms further widening the return gap (and therefore increasing the valuation gap) between strategic bidders and private equity acquirors.

While for several years, both lenders and private equity firms have been concerned about the leveraged lending guidelines, the regulatory environment overall seems more friendly to highly leveraged transactions than in recent years. The percentage of leveraged transactions financed with debt in excess of 6x EBITDA was higher in 2017 than at any time since 2007, fueled in part by a perceived relaxation of U.S. bank regulatory guidance that set 6x as a targeted maximum since 2013.

Private Equity Trends

We expect that private equity firms will continue to experience the "capacity" concerns that were evident at the beginning of 2017. As in 2017, funds under management by private equity firms remained at very high levels, with a record-breaking $954 billion of dry powder available as of September. In part, this was due to decreases in buyout activity, as high stock market valuations continued to limit the pool of attractive targets for private equity buyers. Fundraising in 2017 was also significant, reaching the highest levels since the 2008 financial crisis, with much of the capital being raised by a few, established alternative asset managers, including Bain Capital, CVC Capital Partners, KKR and Apollo Global

Management. Simply put, the financial capacity of the world's largest private equity firms to execute transactions will far outstrip even another record-setting dealmaking year in 2018. This supply/demand disparity reality for deals in which a financial sponsor can and does succeed would suggest valuations at the high end (as sellers stoke competition), despite some negative implications from the deductibility of acquisition financing as noted above.

Another pressure point for financial sponsor dealmaking is the fact that sponsors have seen strong returns of capital to their limited partners in 2017. Recognizing seller-friendly valuations and cooperative financing markets in 2017, private equity firms have been skillful sellers of assets in the current valuation setting. Even the sometimes-fickle private equity IPO market was reasonably strong in 2017, allowing for further returns (or near-returns, with public-market valuations of assets) of capital to limited partners.

The new year's challenge, in sum, for private equity firms is not showing the money, but finding the deals. Targets should not be surprised to see financial sponsors rise to the occasion. These firms have become even more expert at identifying "bespoke" transactions of many types — developing long-term relationships with owners of private firms and CEOs of public companies, being willing to take more closing certainty risk through go-shop provisions in order to get a first look at a deal and seeking other dealmaking advantages, such as partnering with activists looking to spark a deal or strategic acquirors in need of capital. Given the capital they would like to put to work, we expect that financial sponsors will turn up the volume of this ground-laying work in 2018.

Additional Clarity on Appraisal Rights

In recent years, there have been several judicial decisions in Delaware on appraisal rights, which allow a stockholder to forego receipt of the merger consideration in a transaction and instead seek an award from a Delaware court of the "fair value" of the stockholder's shares. A significant development in 2017 was the Delaware Supreme Court's decision in *Dell* v. *Magnetar*, reversing the lower court's ruling that fair value was substantially in excess of the negotiated deal price and affirming the importance of market evidence in determining the fair value in appraisal actions. The Delaware Supreme Court also emphasized the significance of the deal price as evidence of fair value (while declining to adopt an across-the-board presumption in favor of deal value in appraisal cases) in *DFC* v. *Muirfield.* In addition, two decisions by the Delaware Court of Chancery concluded that "fair value" was less than the deal price, illustrating that pursuit of appraisal is not a risk-free proposition.

Although appraisal risk should be considered in the context of each particular transaction, these decisions will hopefully reduce the risk of appraisal awards in excess of the deal price, which should be particularly helpful in private equity deals, where the risk of an outsized fair value determination could threaten the viability of the transaction.

Antitrust Enforcement

Another trend to follow closely in 2018 will be the Trump administration's approach to antitrust enforcement. Some observers have predicted that a Republican administration would be less aggressive on enforcement than during the Obama years, paving the way for certain deals that may have been difficult to get done in prior years. To date, no large change from prior years has been observed, with antitrust staff continuing its analysis along traditional lines, including the Department of Justice's lawsuit seeking to block AT&T's $85 billion acquisition of Time Warner on a vertical harm theory. That said, overall, antitrust enforcement trends are still too early to call, with many appointments either being recently completed or not yet filled. While we do not expect the change in administration to affect the enforcement decisions in the vast majority of deals, it is possible that the personnel switch may over time lead to changes in the remedies that are necessary to resolve any anticompetitive concerns.

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Signs are pointing toward an active 2018 M&A environment, with macroeconomic, political and regulatory considerations high on the list of factors that can swing activity. As always, dealmakers should conduct sober assessments of the benefits and risks of M&A, taking into account not only the financial and strategic aspects of any particular transaction but also the broader market dynamics and economic, political and legal landscape.

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