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August 08, 2018

The Current M&A Environment: Trends for 2018 and Beyond

By the PWP Diversified Equities Strategy Investment Team

"Unless they invest in the difficult task of creating new things, American companies will fail in the future no matter how big their profits remain today," Peter Thiel writes in Zero to One. From Blockbuster to Borders, the corporate graveyard is littered with companies that failed to heed this warning. But to the extent that disruptive technologies and trends are a threat, they are also opportunities for those who respond with foresight and flexibility. And while Thiel probably had R&D in mind when he penned this note, an alternative may be found in M&A: Companies can forego creating new things by acquiring them instead.

The Changing Landscape

M&A serves as a powerful tool for companies contending with disruption, especially in the face of technological change. A 2018 Deloitte survey of corporate executives and portfolio managers found that tech acquisition was cited – for the first time in the survey's history – as the primary reason for recent M&A (20%).[1] The same study found that 68 percent of corporations and 76 percent of private equity firms in the sample group expect increasing deal flow in 2018. These findings are consistent with an observable trend of consolidation across both tech-oriented sectors and historically non-technical ones. Today, the pervasive reach of "new things" has extended far beyond Silicon Valley and pressures incumbents of all sectors.

The proliferation of M&A in non-technical sectors may be owed in part to the "Amazon Effect" and, more broadly, the deflationary nature of online business. Beginning as the self-proclaimed "Earth's Biggest Bookstore" in 1995, Amazon has since amassed a number of diverse consumer- and enterprise-facing verticals. The platform boasts more than 100 million Prime subscribers and a distribution network that touches hundreds of millions more. This growth has come at the expense of traditional retailers. Across the spectrum, economies of scale are accruing benefits to the largest, most innovative firms and widening their slice of the respective market. Some even suggest that technology cultivates a "winner takes all"

[1] S. Dettmar, M. Garay, and R. Thomson, "The state of the deal M&A trends 2018," Deloitte & Touche, October 2017.

model of industrial organization.[2] Nonetheless, incumbents are fighting back stronger than ever before. Faced with both declining revenues and shrinking margins, traditional retailers have started to acquire their way into the future.

Disruptors themselves also risk falling victim to complacency; for these players, M&A is way to stay future-proof. According to data compiled by PitchBook, FAANG have averaged 40 acquisitions per year since 2007 to secure platform synergies and long-term growth[3]. Delineating boundaries between tech sectors is becoming increasingly difficult as a result. Value chains have become multifaceted as tech companies involve themselves in a wide range of products and applications. All the while, these companies are perpetually engaged in a race to deliver the next new thing. With cash reserves numbered in the trillions, they are ready to acquire anyone or anything that shows potential.

We are living through transformational times. So far in 2018, more than $2T in deal flow has been announced. Cigna-Express Scripts ($67 billion), Takeda-Shire ($62 billion), and E.On-Innogy ($27 billion) number among the largest.[4] Hotbeds of M&A activity include software, healthcare, retail, media, and semiconductors, but the general undercurrent of consolidation is sector-agnostic. The stage has been set for robust M&A activity thus far in 2018, and we remain bullish on future opportunities in this space.

Tailwinds to Consolidation

Amazon's announcement to acquire Whole Foods in June of 2017 unleashed a flurry of M&A activity in the grocery industry: Albertsons acquired meal kit service Plated (September 2017), Target bought grocery delivery platform Shipt (December 2017), and Kroger added meal delivery startup Home Chef (May 2018). The incumbents' response demonstrates a legitimate concern over the e-retailer's entrance in this space. While traditional grocers have strong supply chains and extensive brick and mortar presence, they often lack the technological infrastructure to reach customers in the same way that Amazon can.

The same phenomenon is playing out in pharmaceuticals. Consider CVS' proposed acquisition of Aetna for $69B in December 2017; according to Aetna's press release, the transaction "presents a unique opportunity to redefine access to high-quality care in lower cost, local settings."[5] Indeed, CVS has seen its gross margin fall from 19.2% in 2012 to 15.4% in 2017. M&A may therefore ease the pain of margin contraction, which tends to afflict maturing sectors. Additionally, CVS may have anticipated Amazon's foray into pharmaceuticals. In June of this year, Amazon announced a $1B acquisition of PillPack, an online pharmacy delivering pre-sorted doses of medication to homes. Pharmaceutical distribution is itself fraught with logistic challenges and risks, but Amazon can leverage its existing distribution network to modernize this product category.

One might also look to telecom and media for further evidence. Here, however, industry incumbents are using M&A to catch up to exponentially-growing tech players like Netflix and, to a lesser extent, Amazon. Recent deals include AT&T-Time Warner ($109B) and Disney-Fox ($71B). We believe the competitive threat towards Netflix is mounting, and we continue to express concern over the margin implications of its content spend. Currently, the only clear winner to have emerged from this competition is the consumer: We are living in a golden age of content breadth and ease-of-access. It remains unclear how consumer choice will fare once the tides of consolidation have settled. Until then, companies will continue to acquire new technology when doing so is more cost-effective and timely than building it natively.

[2] "2018 Global M&A Outlook," J.P. Morgan, January 2018.
[3] Putz, Adam, "Sinking their teeth in: The M&A activity of the FAANGs," PitchBook, October 2017.
[4] LaMonica, Paul, "Companies have spent a stunning $2 trillion on mergers so far this year," CNN Money, May 2018.
[5] "CVS Health to Acquire Aetna; Combination to Provide Consumers with a Better Experience, Reduced Costs and Improved Access to Health Care Experts in Homes and Communities Across the Country," Press Release, Aetna, December 2017.

In addition to transformational technology, changing consumer tastes are driving disruption across sectors due to a rising millennial share of GDP. According to an EY survey, three out of four executives consider millennial attitudes and preferences in their M&A decision making.[6] Milennials exhibit distinctly different traits from their parents and grandparents – and businesses must respond accordingly to stay competitive. The age group demonstrates a greater willingness to adopt new technology, budget for intangible experiences over tangible goods, and maintain personal networks over social media applications.[7]

In many ways, the relationship between technology and millennial tastes is reflexive: Various innovations have rendered consumption more convenient than ever before, and therefore further reinforced consumer appetites for convenience. Consumers place their groceries in digital shopping carts rather than metal ones. Restaurant dining rooms lie fallow as diners prefer that their meals are delivered instead. The latest Hollywood productions are viewed not from a reclining theater seat, but rather a home sofa. Convenience no longer fetches a significant premium, for it has become an expectation. Businesses everywhere must respond to these changing customer values.

Regulation

Those who have followed Broadcom-Qualcomm-NXP as closely as us will be familiar with the regulatory uncertainty that cross-border M&A entails. Since August 1, 2008, Chinese policy towards M&A has followed from its Anti-Monopoly Law.[8] The legislation confers Chinese regulatory bodies, including MOFCOM, the right to preside over any transaction that they perceive as anti-competitive.[9] As trade and foreign investment tensions persist between the United States and China, MOFCOM may remain a headwind to international transactions.

Domestic regulatory oversight, while remaining on our radar, is unlikely to pose a significant threat to deal flow in the near future. That being said, heightened national security concerns may require the Committee on Foreign Investment in the United States (CFIUS) to oversee future deals. CFIUS made headlines earlier this year when it intervened in the Broadcom-Qualcomm deal on these grounds.[10] “A weakening of Qualcomm’s position would leave an opening for China to expand its influence on the 5G standard-setting process,” regulators wrote.

Elsewhere, regulation has remained mostly light-touch. Most of the $2.1T in transactions thus far in 2018 have faced little friction in closing. 2018 deal volume is on track to lap the $4.1T announced in 2017; valuations notwithstanding, it is a good time to buy.

Our strategy depends heavily on our ability to respond quickly to announced deals by ascertaining their strategic or financial benefits and – if we like what we see – the likelihood of their closing. Deals requiring both domestic and foreign approval will face the most uncertainty. Of course, the acquiree in such transactions tends to trade at a greater spread from acquisition price, and thus offers the potential of a greater return. We will continue to leverage our decades of experience and multifaceted strategy to seek to capture the most favorable risk-reward opportunities in the M&A space.

[6] Cole, Jennifer, “Three out of four executives consider Millennial attitudes and preferences in M&A decision making, according to EY survey,” Ernst & Young, January 2017.
[7] C. Barton, C. Egan, J. Fromm, and L. Koslow, “Millennial Passions Food, Fashion, and Friends,” Boston Consulting Group, November 2012.
[8] Li, Lei, “Vertical Agreements,” Getting the Deal Through, March 2018.
[9] Damian, Tony, and Jephcott, Mark, “MOFCOM in M&A deals – increasing certainty of outcomes and managing expectations,” Financier Worldwide, October 2015.
[10] Mir, Aimen N., “Re: CFIUS Case 18-036: Broadcom Limited (Singapore)/Qualcomm Incorporated,” Letter, CFIUS, March 2018.

Means of Financing

Evidence of wage inflation has surfaced in recent months, further stoking fears over how the Fed might adjust both its federal funds rate and forward guidance. Currently, the FOMC is guiding a rise in the overnight rate to a range of 3.25 to 3.5 percent by end-of-year 2020, up from its current range of 2.25 to 2.5 percent in 2018. Rising borrowing costs strain acquirers' abilities to finance new deals and pay down the debt of past ones. However, the "era of cheap money" has not yet come to an end. Though interest rates are rising, they still remain near historic lows; years of consistent hikes would likely be necessary for borrowing costs to have a material impact on deal activity.

Should borrowing costs prove prohibitive, management teams have recourse in alternative forms of financing. While 2017 saw a record low in the number of all-share deals financed – with cash profuse and debt still cheap – equity-driven deals may return to favor in a future rate environment.[11] In the past, an acquirer's stock has regularly served as the currency of M&A.

All-cash M&A, on the other hand, is alive and well. Today, U.S. corporations hold record-high amounts of cash. By some estimates, overseas cash and cash equivalents total more than $1 trillion, with IT and health care recording the lion's share.[12] The 2017 Tax Cuts and Jobs Act seeks to free these corporate war chests by reducing tax rates and incentivizing cash repatriation. American companies have already begun to capitalize on this favorable opportunity; in January 2018, Apple announced its intent to repatriate $350 billion.[13] Financial buyers also continue to accumulate record-high amounts of dry powder – the functional equivalent to a strategic buyer's cash balance. 2017 estimates of VC and PE committed capital exceed $1 trillion.[14]

We maintain our outlook that financing potential, on net, remains a tailwind to deal activity in 2018 and beyond. Any headwinds that companies face in their pursuit of inorganic growth are unlikely to concern their ability to pay. In the event of a credit cycle reversal or drawdown, depressed multiples may even render the market for acquisition opportunities more attractive.

Opportunity Set for the Diversified Equities Strategy

Increasing deal flow will provide ample opportunity for our event-driven book in 2018 and beyond. As individual situations grow in complexity, whether by their size or their exposure to regulatory oversight, uncertainty is reflected in prices and spreads widen. We believe our multifaceted strategy lends us an edge in many of these situations, and therefore we will continue to seek meaningful opportunities for outperformance in this space.

[11] Fontanella-Khan, James and Indap, Sujeet, "Companies shunned all-stock mergers in 2017," Financial Times, December 2017.
[12] "Tax Reform – Overseas Cash and Repatriation Implications," Wells Fargo Asset Management, 2018.
[13] Balakrishnan, Anita, "Apple announces plans to repatriate billions in overseas cash, says it will contribute $350 billion to the US economy over the next 5 years," CNBC, January 2018. .
[14] Black, Garett, "The trillion-dollar question: What does record dry powder mean for PE & VC fund managers?," PitchBook, March 2018.

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Mr. David Baker

Partner & Portfolio Manager

Prior to joining the Firm, Mr. Baker served as the Portfolio Manager of an equity long/short portfolio, which has been a part of the Deutsche Bank Proprietary Trading group since May 2005. Prior to this role, Mr. Baker served as Managing Director and Global Head of Portfolio Trading and Index Arbitrage, Global Cash Trading at Deutsche Bank. In this capacity, Mr. Baker managed the risk and investment decisions of multi-billion dollar portfolios and oversaw the infrastructure and technology build-out of these global businesses. Mr. Baker also served as a member of the Global Equity Management Committee and North America Management Committee. Mr. Baker joined Deutsche Bank in 1998 as part of the acquisition of NatWest Markets, where he spent two years as Managing Director of Portfolio Trading responsible for the development of the Portfolio Trading business at the derivatives boutique. Previously, Mr. Baker spent 11 years at Morgan Stanley and rose to become Principal and Head of North America Program Trading. Mr. Baker received a B.S. in Finance and Statistics from New York University.

Mr. Sig Heller

Partner & Senior Analyst

Prior to joining the Firm, Mr. Heller served as a Portfolio Manager/Senior Trader in Deutsche Bank's Proprietary Trading group focusing on consumer and media investments. Previously, Mr. Heller was a portfolio manager at SAC Capital in Stamford. Prior to this, Mr. Heller spent 13 years at Credit Suisse in the equity division, where he held a variety of senior positions in the Institutional Sales division, including Head of Emerging Market Sales in New York. Mr. Heller received a B.A. in Economics and Political Science from the University of Vermont and an MBA from Columbia University.

Mr. Jack Alfandary

Senior Analyst

Prior to joining the Firm, Mr. Alfandary served as a Portfolio Manager/Senior Analyst for five years in Deutsche Bank's Proprietary Trading group focusing on industrials, materials and energy investments. Prior to this role, Mr. Alfandary was a senior analyst and cofounder of Kaia Partners, a long/short hedge fund. Previously, Mr. Alfandary led buyouts of middle market companies in the security and information technology industries, and participated with W Capital in the buyout of corporate VC portfolios. Prior to that, as a strategy consultant with Mars & Company, he assisted Fortune 250 companies in developing and implementing growth strategies and restructuring efforts. Mr. Alfandary began his career as an attorney with Rogers & Wells, a global law firm. Mr. Alfandary received a JD from Fordham University School of Law, and a B.S. and M.S. in Electrical Engineering from NYU Tandon School of Engineering. Mr. Alfandary is admitted to the NY, MA and U.S. Patent Bars.

Mr. Todd May

Analyst

Mr. May has 14 years investment experience as a buy-side research analyst, portfolio analyst, sell-side research analyst, and trader. Prior to joining the Firm, Mr. May worked at Deutsche Bank Alternative Trading as an analyst covering the technology, internet, and telecom sectors since 2008. From 2006-2008, Mr. May managed the Deutsche Bank SOLAR Portfolio. In this role, Mr. May worked with fifty U.S. based sell-side analysts to construct and analyze a model portfolio of the analysts' highest conviction longs and shorts. Previously, Mr. May worked as a software analyst/associate at Deutsche Bank from 2004-2006, and prior to joining Deutsche Bank, on a software research team at RBC Capital Markets. Mr. May received a B.A. from the University of St. Thomas and an MBA from Columbia University.

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