WHITE & CASE

Back in the game: The rise of US M&A

After a number of tough years, US M&A roars back—with megadeals, high prices, ambitious buyers and willing sellers fueling a sense of optimism

MERGERMARKET

US M&A is bouncing back

After a tough few years, acquisitions in the United States have seen a remarkable resurgence

John Reiss
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The first half of 2014 saw a great dealmaking revival in the United States. Deal values are up to their highest levels in five years, the use of shares to finance deals has hit a six-year high and inbound M&A into the United States has posted the best first half on record since H1 2007.

This uptick in activity has been a long time coming. Corporates and private equity firms have been sitting on substantial cash piles for years, and have finally found confidence to pursue expansion through M&A again, along with willing sellers.

The backdrop for dealmaking now looks the most favorable in years. The US economy has delivered steady growth for the last four years, and the S&P 500 has climbed by 96.7 percent since 2009. Shareholder support for deals is more robust. Chief executives and boards are increasingly optimistic and are willing to pay high prices for acquisitions. Growth is important, and when a board sees everyone around them growing by acquisition, there is a competitive imperative for them to do the same.

The regulatory environment has been supportive of M&A, too. Even in a market where regulation has been generally viewed as quite restrictive, buyers are increasingly able to develop rationales that quell regulators' concerns.

However, despite the M&A market looking stronger than at any time since the financial crisis, this is not a time for complacency. A big part of the recovery story has been driven by large corporate-backed megadeals. Deal values are significantly higher as a result, but there has not been a parallel increase in deal volumes. Private equity's share of total dealflow is down. If megadeal activity eases, the rest of the market may feel the repercussions. Overall volume will have to increase before we can confidently say that the US M&A market has recovered fully.

As we go to press, we note that stock markets have been rocky recently, and government action has led the AbbVie board of directors to withdraw its support for the Shire acquisition. Pundits have begun to predict the end of the M&A boom. We aren't so sure. Without the impact of a significant exogenous shock, we expect 2015 to be a very active year for US M&A. The US economy and the US M&A market are in a much better state than they were five years ago—and they are quite strong compared with Europe and Asia.

We hope you find this report informative, and welcome the opportunity to discuss these subjects with you in greater depth.

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The US M&A market roars back to life

HEADLINES

■ US deal values reached a five-year high in H1 2014 ■ Deal volumes have risen by a third in comparison with the same period last year ■ Stable economy and backing from shareholders have been the foundations for the rise in M&A ■ Megadeals have seen the sharpest rise with 69 such deals in Q2 2014—the highest volume of deals worth US$1 billion or more in the last five years ■ Technology, media and telecommunications, and pharma, medical and biotech are the most active sectors

After a period when there seemed to be a slowdown in the US M&A market, dealmaking is back.

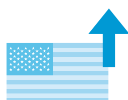
While 2013 gave hints of a recovery, the first six months of 2014 have marked a real turning point for US M&A. Deal values have reached a five-year high, and volumes have climbed by nearly a third compared to the same period in 2013.

There were 2,329 deals worth US$694 billion in the United States in H1 2014, a 30 percent increase in volume and a 98 percent rise in value when compared with H1 2013.

On a quarterly level, the data is also encouraging. Values have increased quarter-on-quarter for the last three quarters, the first such instance since 2012. Indeed, the four quarters from Q3 2013 to Q2 2014 saw deal volumes break the 1,000 barrier in each time period—the first time this has happened in the last five years.

This sustained increase has been due, in part to a greater prominence of domestic deals. There were 2,026 domestic deals in H1 2014, a 35.5 percent increase on 1,495 deals in H1 2013. Both Q1 and Q2 2014 generated more than 1,000 domestic deals each, the first time a quarter has hit 1,000-plus domestic deals since Q4 2012.

"The fundamentals have been in place to support an increase in M&A and the market has expected M&A to return for a few years now. What is surprising is how fast the market has suddenly turned," says White & Case partner Gregory Pryor.



35.5%

increase in domestic US deals from H1 2013 to H1 2014

59%

acquirers whose share prices rose the day after deal announcement this year—the highest percentage in the last five years

Deal drivers

A stable macroeconomic backdrop and broad support from shareholders for companies to pursue deals again have laid the foundation for the deal resurgence.

World Bank figures show that the US economy has been growing for each of the last four years. Debt markets are also functioning better, with leveraged loan issuance reaching record levels in 2013.

On top of this, confidence in stock markets has grown as the S&P 500 gained 23 percent over the last 12 months.

"Growth rates are generally better in the United States than in other parts of the world," says White & Case partner Oliver Brahmst. "It is the largest market on the planet. Even if China overtakes it, the United States will always hold a lot of strategic value for companies."

The reemergence of the megadeal in the United States has supported the increase in overall deal values and suggests that businesses are feeling more comfortable making large, long-term strategic investments.

Mega activity

There were 69 megadeals in Q2 2014, the highest volume of deals worth US$1 billion or more in the last five years. Deal volumes have increased sharply in the US$1 – 5 billion bracket and US$5 – 10 billion bracket. And while the number of US$10 billion-plus deals hasn't risen at the same pace, the overall spike in high-value deals has provided a significant boost to overall deal value.

"Tax inversion strategies and synergistic opportunities have been driving large deals in sectors such as pharma and technology, media and telecommunications (TMT)," Pryor says. "These issues have been driving megadeals. The companies

The United States is the largest market on the planet. Even if China overtakes it, the United States will always hold a lot of strategic value for companies.

Oliver Brahmst, partner, White & Case

59 percent of acquirers' stock rose immediately post-acquistion in H1 2014, the highest figure in five years

involved feel confident enough to make big bets. They would not be doing this without that level of confidence." For example, the two largest deals in the United States in H1 2014—Comcast's proposed takeover of Time Warner Cable and AT&T's pending purchase of DIRECTV, with a combined value of US$134 billion—were consolidation deals in the TMT space. For more on the TMT and pharma sectors, see Sector watch, page 7.

Equity rise

The rise in equity being used in deals also points to greater confidence in markets as a driver.

The number of deals in which sellers accepted equity as part of consideration has been rising steadily since mid-2013, and rose in Q2 2014 to 21 percent, the highest percentage recorded in the last six years. While not definitive, this trend suggests that corporates are happier about prospects for public companies, and expect acquirer stock prices to rise.

"With market caps as high as they are, doing an all-cash M&A deal is risky for a CEO," says Brahmst. "It's just not as risky using equity if you are doing a high-price acquisition."

Fair share

Support from shareholders has underpinned this confidence. In the past, when acquirers have made a bid, their share prices have often reacted negatively to reflect the transactional risk, while the target's share price has usually increased in anticipation of a deal premium.

Since 2012, however, acquirer share price increases on the day after a deal announcement have outweighed acquirer share price decreases, reversing a three-year trend. So far in 2014, 59 percent of acquirer share prices have risen immediately post-deal, the highest percentage in the last five years.

"There is an appetite among shareholders for companies to think about growth and expansion again and look beyond restructuring and cost cutting," according to Pryor. "It has helped that the transactions this year have been marketed as strategic deals rather than opportunistic ones, which perhaps differentiates this market from the frothy pre-crash days.

"There was some skepticism toward megadeals, but what shareholders are seeing now are deals that address long-term strategic issues," Pryor adds. "The perception is that deal rationales are a lot more solid."

Indeed, strategic M&A has been a key driver of many of the United States' biggest deals this year. As well as the Comcast and AT&T acquisitions, foreign buyers have looked to the United States to gain a tactical upper hand. For example, when Japanese beverage producer Suntory bought out spirits maker Beam Inc. for US$15.5 billion in January this year, it stated the company's aim was now to "achieve growth in markets worldwide, including the US, the world's largest spirits market."

Challenges ahead

Although US M&A activity has enjoyed a resurgence in 2014, the deal recovery still faces a number of risks and challenges.

"Europe is still an issue, and economic growth in Asia is slowing down. Geopolitical uncertainty in Eastern Europe and the Middle East could also weigh on confidence," says Brahmst. "However, that said, CEOs seem to be generally less concerned about macroeconomic and political issues that weighed on them as recently as a year ago, such as the EU crisis, military flashpoints and the stalemate in Washington."

Additionally, the encouraging deal figures for H1 2014, especially in terms of value, should be greeted with a degree of caution because of the influence of oversized transactions.

"US M&A is certainly in a stronger place than it was a few years ago, but I would view the activity figures with some caution," Pryor says. "Overall deal values have been pushed higher by the headline-grabbing megadeals, perhaps more than a fundamental rise in deal flow. Volumes are up, but not to the same

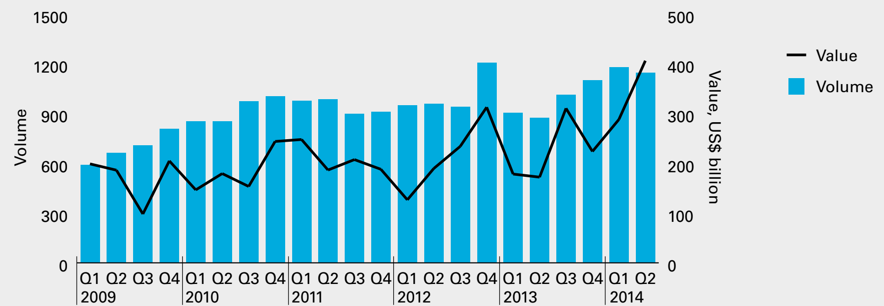
degree as values, and the worry is that if there is any kind of threat or slowdown to megadeals it could slow the rest of the market." Indeed, while H1 2014 activity comfortably outstripped its 2012 counterpart, Q2 2014 deal volumes actually fell 2.8 percent when compared with Q1 2014.

"We also need to watch out for one of the megadeals failing to deliver what was promised," adds Pryor. "If one of these deals busts, there may be a cooling of activity as the market questions whether other deals will work."

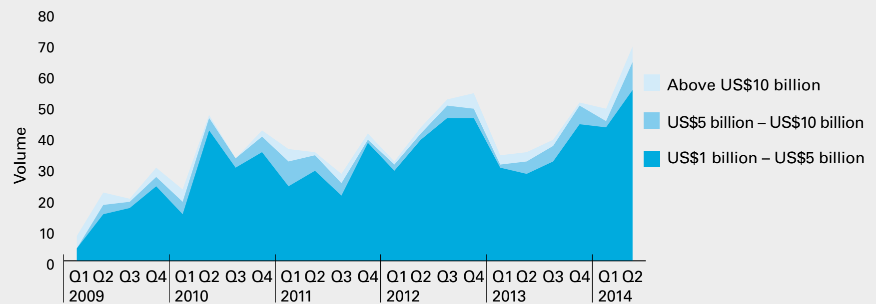
Competition concerns may also inhibit the growth in dealmaking activity. For instance, Dollar General Corp's recent US$8.95 billion bid for rival Family Dollar Stores was rejected out of hand on the basis of not wanting to get to the antitrust stage. "We will not jeopardize the Dollar Tree deal for a transaction with Dollar General that has a high likelihood of not closing due to antitrust considerations," said independent director on Family Dollar Stores' board Ed Garden at the time.

This is an issue that has become even more salient in the TMT sector, where consolidation of markets has been a key driver for M&A activity. For more on TMT, see Sector watch, page 7. Federal Communications Commission (FCC) Chairman Tom Wheeler has recently indicated that the FCC would continue to be skeptical about wireless mergers. Indeed, the demise of the proposed Sprint and T-Mobile merger has been attributed to regulatory opposition.

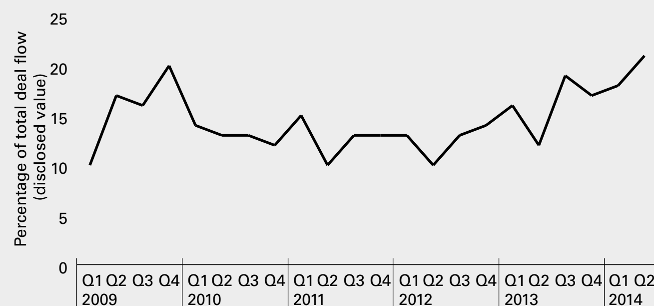
Total US M&A, 2009—H1 2014



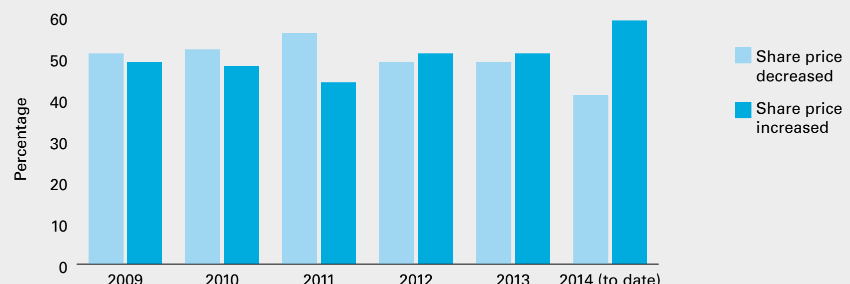
Increased number of billion-dollar deals



Equity element as part of deal consideration



Acquirer share price reaction on deal announcement



Source: Dealreporter

Pharma, medical and biotech was the second most active sector in H1 2014

Sector watch

HEADLINES

■ TMT most active sector in H1 2014, accounting for 34 percent of M&A activity by value ■ M&A driven by consolidation of broadband, TV and mobile services as well as growing demand for spectrum due to explosion in wireless use ■ Pharma, medical and biotech second most active sector, accounting for 22 percent of activity by value ■ Activity driven by replenishing of product pipelines and desire for R&D synergies and tax savings ■ Pharma, medical and biotech also at forefront of rising use of M&A for tax inversions

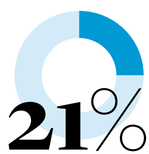
The US M&A revival has been in some part driven by a series of game-changing megadeals in the technology, media and telecommunications (TMT) sector and the pharma, medical and biotech sector.

Deals in these two sectors accounted for six of the ten largest deals in H1 2014. In TMT, the largest deal of the period was Comcast's proposed US$68.5 billion takeover of Time Warner Cable, while Canada-based Valeant's pending US$44.4 billion acquisition of Allergan was the largest in the pharma, medical and biotech sector. TMT accounted for 34 percent of total deal value in H1 2014, and pharma, medical and biotech represented 22 percent of combined deal values.

Deal volumes, however, indicate that other sectors have also benefitted from the deal recovery. While TMT still topped the list, accounting for 21 percent of deal volume, industrials and chemicals (18 percent), business services (13 percent) and pharma, medical and biotech (10 percent) also accounted for a significant share of deal volumes in the first half of 2014.

TMT in focus

By a distance, TMT was the most active sector for M&A in the first half of 2014. Deal values of US$233.7 billion and deal volumes of 497 in the first half of 2014 represented the highest level of activity in the last five years.



21%

of US M&A volume was accounted for by TMT deals in H1 2014

497

TMT deals in the US in H1 2014, 33.9 percent up year on year

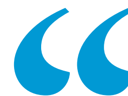
Values for H1 2014 are up 177 percent from the US$84.2 billion recorded in H1 2013, and deal volumes have climbed by 33.7 percent from 371 transactions. Of the four largest transactions recorded in the United States in the first half of 2014, three have been in the TMT sector.

Consolidation in telecoms has been the main driver of TMT deal activity, including megadeals such as Verizon's US$124 billion acquisition of Verizon Wireless from UK's Vodafone, AT&T's US$65.5 billion pending bid for satellite TV provider DIRECTV and Comcast's US$68.5 billion pending takeover of Time Warner Cable.

Wild for wireless

Another major driver of this consolidation has been the growth of wireless. According to wireless industry group CTIA, there are now more connected devices in the United States than people. CTIA estimates that penetration rates in the United States now stand at 104 percent. Revenues of wireless service providers in the United States increased by 17 percent from the beginning of 2009 through the middle of 2013, according to research house MoffettNathanson.

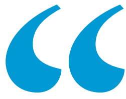
This rapid increase in the use of wireless devices and the rising demand for broadband have sparked a scramble to acquire the capacity to serve demand. This has pushed the convergence of telephony, wireless and wired broadband and television.



AT&T, T-Mobile, Verizon and Sprint all need to acquire more spectrum. There is a spectrum auction scheduled for mid-November, but the capacity required by these companies will be greater than what is on offer.

Dan Dufner, partner, White & Case

"Demand is likely to continue to grow as more devices, such as cars, and home automation technologies, such as thermostats and other appliances, all start requiring a way to connect to the Internet," says White & Case partner Dan Dufner. "You can now adjust the pool temperature or set the home security alarm from a smartphone, and the market is just beginning to see the increase that these new technologies have on finite spectrum resources."



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US$150.2 billion

Value of pharma deals in H1 2014, compared with US$50.3 billion in H1 2013

Merging interests

In order to build scale, protect existing customer bases and grow without raising antitrust concerns, telephone, Internet and satellite cable companies have encroached upon each other's turf.

For example, the rise in use of wireless devices has seen the lines between broadband and television blur. Cable companies have watched as customers are increasingly streaming content on wireless devices and are expressing great interest in subscribing to "over the top" packages where they can buy specific content rather than being required to subscribe to the full range of channels. Telephone and broadband providers have needed to broaden their range of activity to gain customers and remain competitive.

"People between the ages of 20 and 25 are unlikely to buy a full cable package. They are watching TV on Netflix and, in many cases, would prefer buying a package of a few channels," Dufner says.

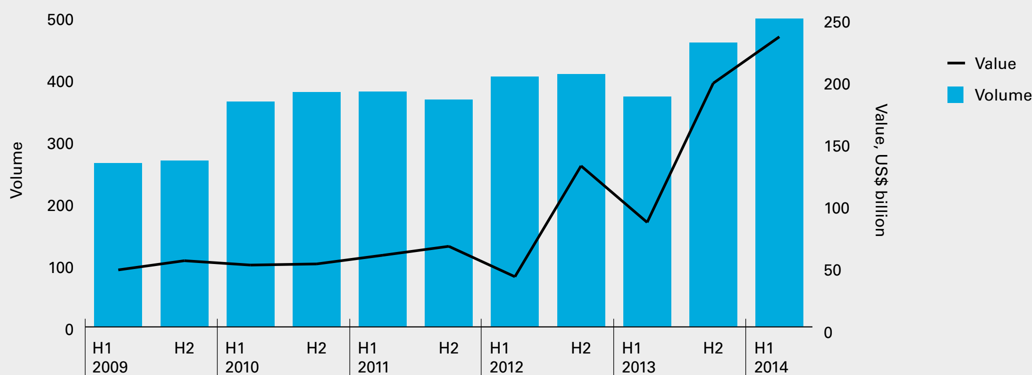
In AT&T's pending acquisition of DIRECTV, for example, AT&T opted to expand its historically small market share in television. "This is a unique opportunity that will redefine the video entertainment industry and create a company able to offer new bundles and deliver content to consumers across multiple screens—mobile devices, TVs, laptops, cars and even airplanes," said AT&T Chairman and CEO Randall Stephenson after the announcement of the proposed transaction.

According to White & Case partner Morton Pierce, this grouping together of services to reduce costs is helped by M&A. "The same line into the home provides video, Internet and telephone services, and companies attempt to win more customers by offering these services as a bundle," he says. "Size is very important for these companies. It requires a large amount of capital to build these systems and infrastructure, and if you try and do that on your own, you risk taking on too much debt."

Although the market has already absorbed a flurry of large deals and regulators are concerned about antitrust issues, there is still potential for more transactions in the sector.

"Demand for wireless is going to continue growing. AT&T, T-Mobile, Verizon and Sprint all need to acquire more spectrum. There is a spectrum auction scheduled for

US TMT M&A, 2009—H1 2014



mid-November, but the capacity required by these companies will be greater than what is on offer, so companies are likely to turn to more M&A in order to combat their spectrum shortages," Dufner says.

Foreign buyers could also have a role to play in future dealmaking. France's Iliad and Japan's SoftBank, which acquired Sprint in 2013, are both eager to gain exposure to the growing wireless market. Iliad has made public offers to acquire T-Mobile (although Iliad recently dropped its plans), while SoftBank recently struck a deal with fellow Japanese technology company Sharp to develop smartphones specifically to target the US cellphone market.

On the domestic front, other companies that may be looking to do deals include DISH Network Corporation—which has amassed a great deal of wireless spectrum and has publicly shown interest in T-Mobile—Chicago wireless provider US Cellular, and Internet, landline and television provider CenturyLink. Amazon, Apple and Google, which have their own suite of wireless devices and services, could also be players in future deals. As an example of this, in August 2014 Amazon paid US$970 million for video-game streaming service Twitch.

Outside of the deal flurry in telecoms and cable, another hot sub-sector within TMT has been social media. Microblogging site Twitter achieved a US$25 billion valuation when it listed in New York, and Facebook paid US$19 billion for messaging service Whatsapp in its largest deal yet.

"Social media groups have achieved huge valuations, but the growth in these companies and the success of the technology all comes back down to wireless and the long-term growth in this area," Dufner says.

Pharma in focus

Deal activity within the US pharma, medical and biotech sector increased significantly in the first six months of the year as US businesses pursued deals domestically and were also targeted by acquirers from abroad. In H1 2014, the sector saw 246 deals worth US$150.2 billon. This compares with 175 deals worth US$50.3 billion in H1 2013 and 223 deals worth US$46.8 billion in H2 2013.

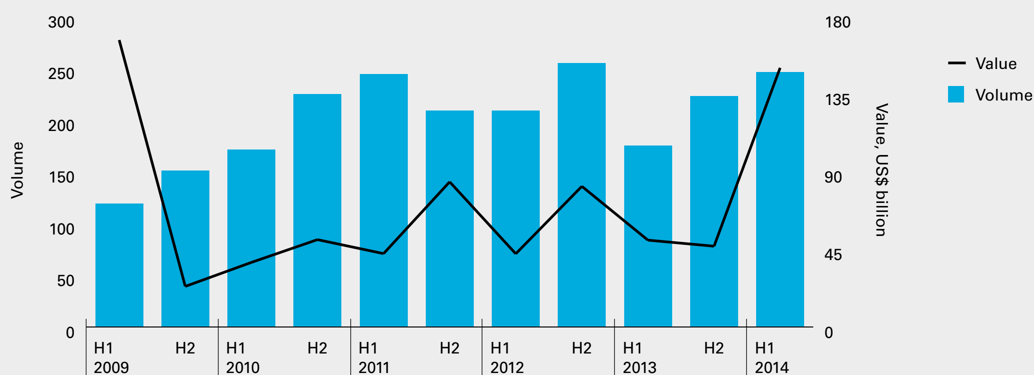
In terms of deal value, the sector hit its highest level in five years in H1 2014. This can be attributed, in part, to a wave of megadeals, with five of the ten biggest deals by value in the sector over the last five years being announced in the first half of 2014. These include Ireland-based Actavis' US$23.1 billion takeover of Forest Laboratories, and German firm Bayer's acquisition of Merck & Co.'s consumer care arm for US$14.2 billion.

Patent problems

Pharma, medical and biotech businesses are using M&A to position themselves for the long term. The diseases for which companies are now seeking cures are more difficult to treat, and discovering new medicines is taking more time and investment. Companies are therefore pursuing deals that will replenish and diversify their portfolios and focus their businesses on core markets where they can be market leaders.

"Bigger is better in the pharma sector," says White & Case partner Morton Pierce. "As drugs move off patent, companies are searching for the next blockbuster drug. R&D is expensive and requires large-scale investment, so companies need to find efficiencies and work economies of scale."

Pharma, medical and biotech M&A, 2009—H1 2014



Building pipelines

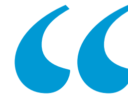
In addition to seeking improved profitability through synergies and reduced R&D costs, companies are buying smaller biotech businesses to replenish pipelines. Larger acquirers will then use their in-house expertise to take new drugs through clinical trials and marketing. For instance, in August Swiss drug giant Roche purchased California-based biotech firm InterMune for US$7.5 billion, helping it gain control of a pipeline of respiratory and fibrotic disease therapies.

For any deal, the companies involved are looking at what the mix of drugs will be when the two businesses are put together. This increasingly includes a detailed look at the lifespan of the merged portfolio. "Everybody wants to buy the next blockbuster drug at the beginning of its lifespan. However, that is unlikely to happen, so what companies are looking to do is build a portfolio in a chosen area that has a range of drugs at different phases in their life spans," says Pierce.

Corner your markets

Big pharma groups are also structuring themselves so that their businesses are focused on specific industry niches. In the past six months Valeant, for example, which has a strong portfolio of skin and eye care products, has chosen to pursue Allergan, which is strong in dermatology and cosmetics, in order to strengthen its position in its chosen industry. Companies will look to take leading positions in a specific treatment area and also increasingly choose to focus on either prescription or over-the-counter medicines.

In addition to factors specific to the pharma sector, the recent pickup in pharma sector M&A can be attributed to the stabilization in the US economy and returning confidence in financial markets. This leads to less expensive debt that is more widely available, and greater use of high-valued stock as consideration currency. "When you are operating in a difficult economic environment, you are not worried about expansion. You are focused on your core business and preparing for the next earnings call to explain how you have been protecting your business," Pierce explains. "Now that the economic climate is improving, the confidence is there for the pharma sector to do deals again."



When you are operating in a difficult economic environment, you are not worried about expansion. You are focused on your core business and preparing for the next earnings call.

Morton Pierce, partner, White & Case

Consolidation in telecoms has been the main driver of deal activity

THE INVERSE RELATIONSHIP

White & Case's William Dantzler explains why government action on inversions has not swept them off the table as a viable strategy

Tax inversion deals, where US businesses acquire foreign companies and transfer their tax domicile to secure lower tax rates, have been one of the key deal rationales behind large outbound M&A deals in 2014. AbbVie's proposed US$54 billion acquisition of Shire (which has now been abandoned in light of the regulatory changes highlighted below), Medtronic's US$45.95 billion purchase of Ireland's Covidien and Actavis's takeover of Warner-Chilcott for US$8.4 billion are all tax inversion deals. These deals have the potential to unlock substantial savings for US acquirers.

This momentum was curtailed, however, when a US Treasury notice issued in September 2014 introduced regulations that will restrict some of the advantages associated with tax inversions.

The changes have affected a key reason for inversions, namely, the acquirer's ability to access trapped cash without incurring US tax. Many US companies have cash offshore that they cannot bring back to the United States without being taxed, even though foreign-based companies are allowed to earn cash offshore and bring it back to their parent company tax free.

Tax inversions were a way for US companies to use this trapped cash, but most of the provisions in the Treasury notice are aimed at strategies that an inverted company would use to access that trapped cash. In short, the Treasury has shut this avenue down.

Yet while some commentators saw the notice as signaling the end to these types of deals, the reality is that inversions still provide an attractive proposition for US companies in two different ways—neither of which has been affected by the rule change.

Building abroad. A tax inversion allows a company to grow future businesses offshore and out from underneath a US parent. The Treasury notice has had no impact on this potential benefit. And while this has not been a key driver during this round of inversions, this recent action could mean it becomes an attractive motive for future deals.

Leverage. The main attraction of an inversion is the ability to leverage up the US operations and deduct interest against the US taxable income. Foreign-based multinationals have always been able to do this up to certain limits. Inversions allow US business to enjoy the same tax benefits.

The new regulations will have no impact on this rationale for pursuing an inversion. The Treasury notice does not touch tax deductibility of interest. The deduction for interest is in the Internal Revenue Code. Only Congress can change that. And while this remains the case, the size of this advantage means there will still be plenty of deals out there that make sense, even when the trapped cash advantages are taken away.

The regulations issued by the Treasury will have some impact on the appetite for inversions. However, the fact that interest deductibility and building businesses offshore remain untouched means that inversions still offer companies some significant advantages.

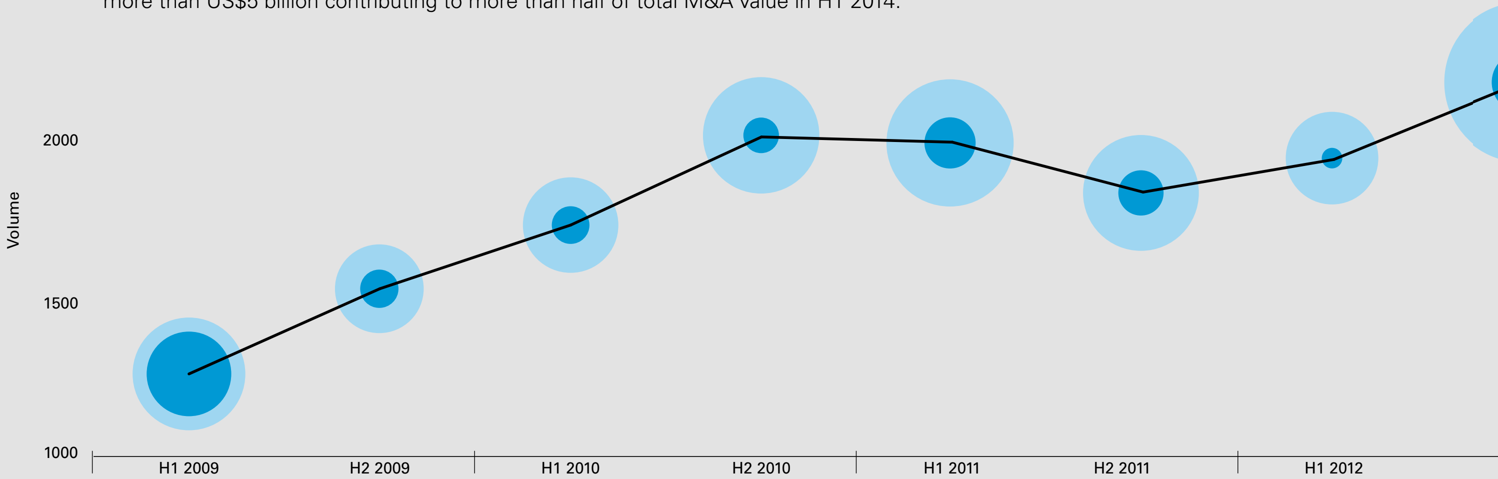
The big question about the future for companies is what Congress will do on the back of this. The Treasury only took action because Congress wouldn't—and is unlikely to do so this session—but there is a prevailing fear that the new Congress, which starts next year, will do something effective January 2015.

This is a major concern. For instance, an inversion deal involving two public companies can be, at least, a four- or five-month process. If they are facing the risk throughout that period that Congress may take action and rescind the advantages, it can put the whole transaction in jeopardy. The future for inversions will only be resolved when the uncertainty in Washington is resolved. And that will only come with time.

The US M&A picture

Total US M&A volume and value

Dealmaking in the United States has increased substantially since 2009, both in volume and value. A key trend driving this is a resurgence in very large deals, with deals worth more than US$5 billion contributing to more than half of total M&A value in H1 2014.



US M&A by industry, H1 2014

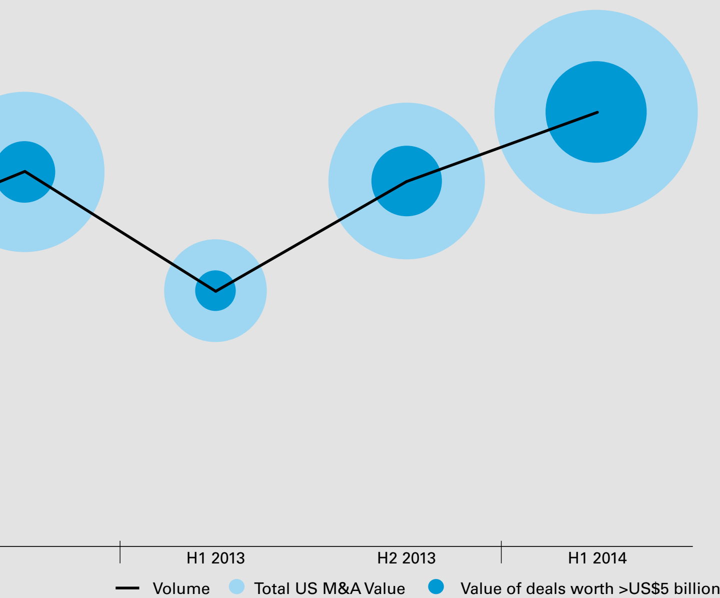
The TMT sector dominated the US M&A market in H1 2014, seeing deal volumes increase by 33.9 percent year on year. Its value also increased greatly by 177 percent to $233.7 billion over the same period. The pharma, medical and biotech industry also saw a deal boost, with overall value in the sector in H1 2014 reaching its highest level in the last five years.

Value, US$ billion

250
200
150
100
50
0

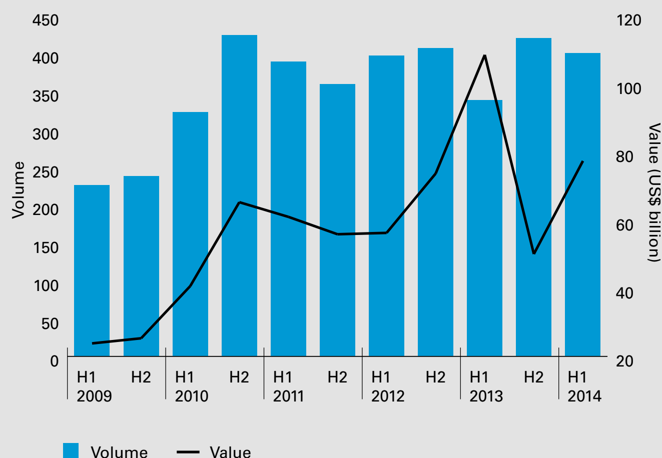
TMT
Pharma
Energy, mining and utilities
Consumer
Industrials and chemicals
Financial services
Business services
Leisure

Volume indicated by size, where TMT accounts for 497 deals

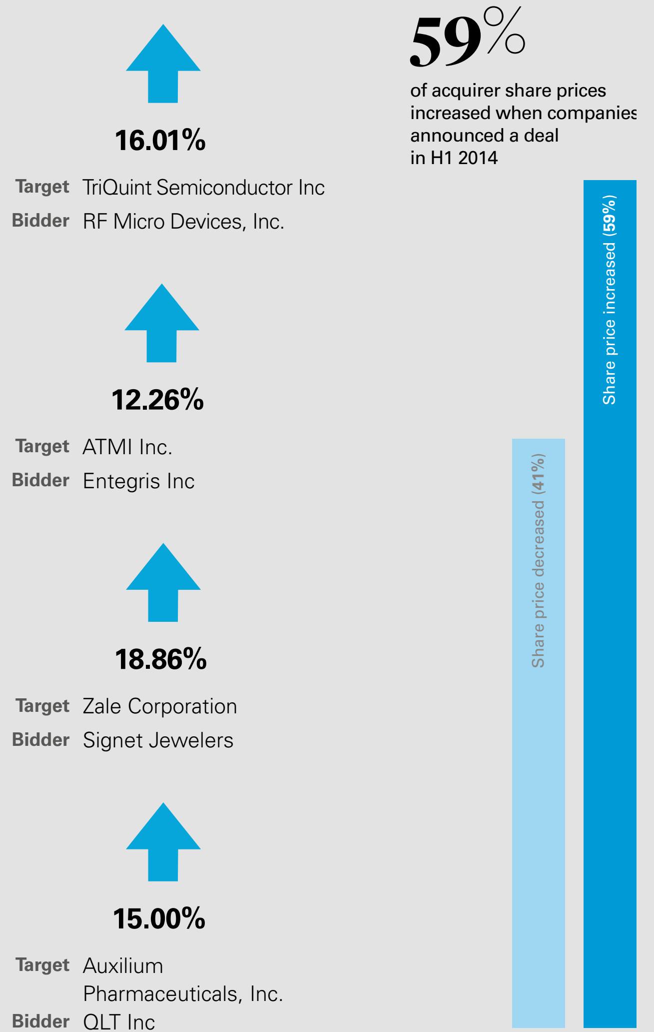


Private equity exits, 2009—2014

Private equity buyouts, 200—2014

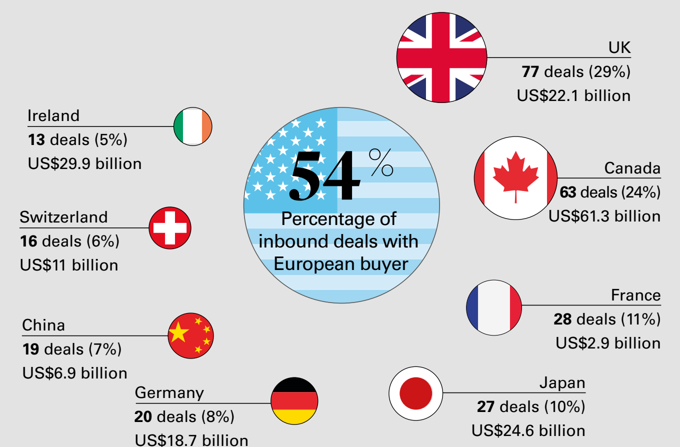


Case study: acquirer share price reactions



Source: Dealreporter

Inbound M&A by country, H1 2014



Old Street 135
ARRIVA

Inbound monitor

HEADLINES

■ US inbound M&A values hit seven-year high in H1 2014 ■ European takeovers in the United States are up more than a third so far in 2014 ■ Chinese acquisitions in the United States reach record high ■ Low costs and strategic opportunities are attracting foreign buyers ■ UK overtakes Canada as most active foreign acquirer in the United States

In H1 2014, inbound M&A into the United States hit a post-crisis high, with 365 deals worth a total US$190.9 billion. This represents a 29 percent increase by volume and a 302 percent rise by value in comparison with the same period in 2013.

Recovering global M&A markets (where deal values hit US$1.6 trillion, a 60 percent increase on H1 2013) combined with a stable US economy and appetite from foreign buyers for assets in the hot pharmaceuticals and TMT sectors have helped to spark the strong inbound deal recovery.

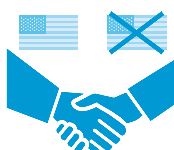
"Global M&A has risen across the board, and that has driven a significant increase in US inbound M&A, especially when compared to last year," says Dan Latham, White & Case M&A partner. "Although the US economy is not booming, it is stable and has been so for a while. Unemployment and consumer confidence are both heading in the right direction, and a feeling of cautious optimism is returning."

This appetite for US assets is evident around the world, with bidders from Europe, Asia and the rest of the Americas all pursuing deals. In terms of volumes, firms from the UK, Canada, France and Japan have been the most active foreign buyers in the United States in H1 2014. Inbound deal volumes from each of these countries were also up on their respective figures from the first half of 2013.

"Since double-digit growth has slipped away from emerging markets, people have looked more closely at those regions and seen behind the curtain somewhat, and seen that they could be a greater risk," explains White & Case partner Oliver Brahmst. "Profit and growth in a solid jurisdiction, such as the US, may in certain times be more attractive than profit and growth in an unstable environment."

In terms of value, bidders from Canada, Ireland, Japan, the UK and Germany have been making the biggest investments in the United States, and for each of these countries deal values for the first half of 2014 were higher than in the same period of 2013.

"Corporates around the world are sitting on excess cash, and shareholders are no longer satisfied with buybacks and dividends," Latham says. "They want to see strategies for growth. The United States offers a stable economy, access to a large market and high-quality M&A targets. For businesses that have cash to invest, doing a deal in the United States makes sense."



365

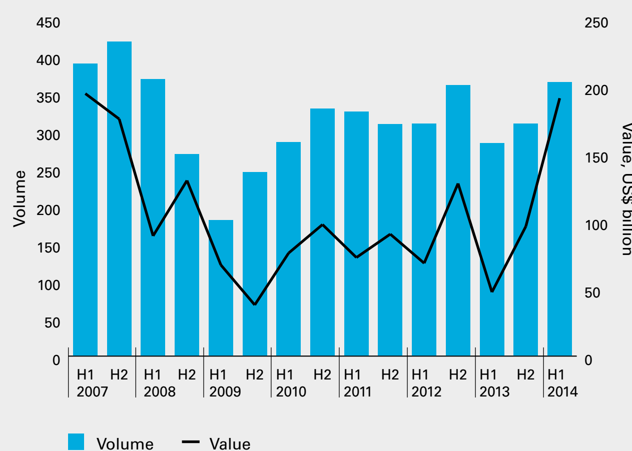
deals

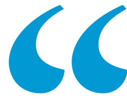
for US companies by foreign acquirers in H1 2014, the highest post-crisis

60%

increase in volume of US deals with UK acquirers from H1 2013 to H1 2014

US M&A inbound trends, 2007—H1 2014





The United States is the largest developed economy in the world and its relative growth rates and risk profile make it a key market for any corporate that wants to expand internationally.

Oliver Brahmst, partner, White & Case

Europe recovers

Deal activity by European acquirers in the United States has rebounded after a lull in H1 2013. Then, there were only 142 inbound deals from Europe into the US, worth a total of US$13.6 billion—the lowest half-year value in the last six years

In contrast, inbound US deal volumes from Europe for H1 2014 came in at 196, a 38 percent increase on H1 2013 and almost a fifth higher than H2 2013. Deal value of US$90.9 billion in H1 2014 is more than six times the deal value for H1 2013 and 67 percent up on H2 2013.

Cash-rich European corporates that have navigated the worst of the European sovereign debt and banking crises were previously risk averse, but are now turning their attention to growth once more.

In terms of countries, the UK, France and Germany have all been extremely active in seeking out acquisitions in the US market. UK deals into the United States rose 60 percent from H1 2013 to H1 2014, while France and Germany saw increases of 47 percent and 54 percent, respectively, over the same period.

The United States has been a key overseas geography to target for these investors, thanks to its size and economic stability. For European businesses operating in specific sectors, the United States also offers important strategic opportunities.

German manufacturers, for example, have been attracted to competitive US energy prices. As recently as last year, the Association of German Chambers of Commerce and Industry (DIHK) said that its research had shown that German companies were increasingly willing to move some of their operations to the United States looking for better conditions. Indeed, DIHK chief Martin Wansleben said at the time: "The United States has become much more attractive to companies than Europe. Germany is in the process of getting sandwiched between eastern Europe with its low labor costs and the United States with low energy costs."

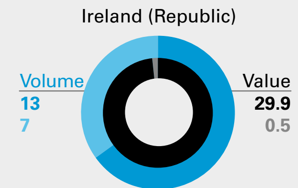
This trend is still showing, with examples this year including Bayer's US$14.2 billion takeover of Merck & Co.'s consumer care branch, and car parts manufacturer Continental purchasing Veyance Technologies for US$1.9 billion.

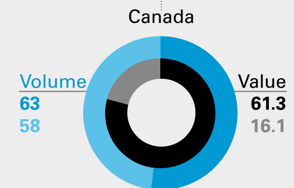
"European companies that have invested in the United States have taken a strategic decision to enter this market," says Brahmst. "The United States is the largest developed economy in the world and its relative growth rates and risk profile make it a key market for any corporate that wants to expand internationally."

China calling

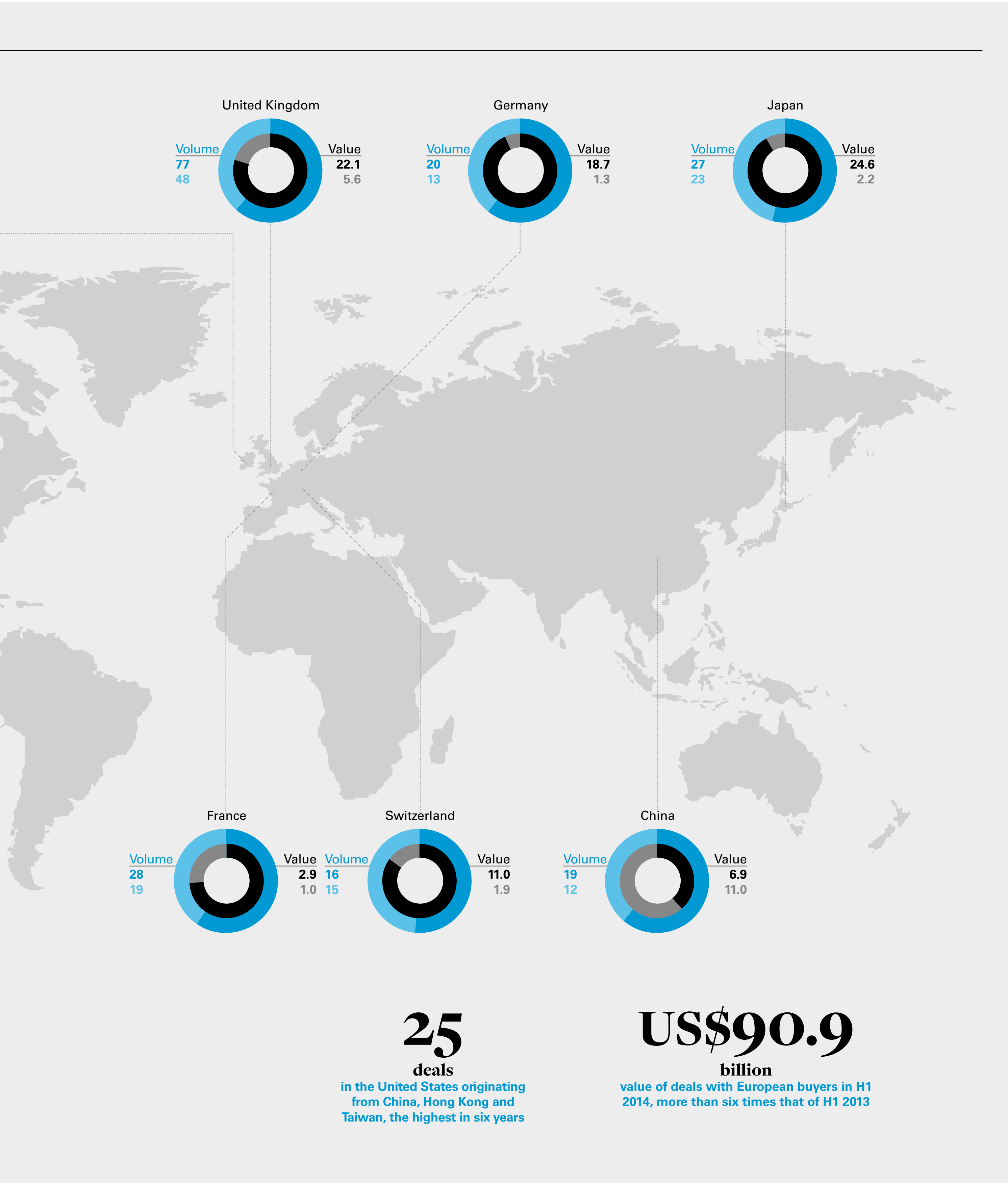
The volume of Chinese deals in the United States reached its highest level in six years in the first half of 2014, with 25 deals for US targets originating from China, Hong Kong and Taiwan.

Top eight bidders by volume and value





Legend
- Volume, H1 2014
- Volume, H1 2013
- Value (US$ billion), H1 2014
- Value (US$ billion), H1 2013



25
deals
in the United States originating from China, Hong Kong and Taiwan, the highest in six years

US$90.9
billion
value of deals with European buyers in H1 2014, more than six times that of H1 2013

This builds on momentum from H2 2013, when 23 inbound deals from Chinese buyers were announced, and is more than twice the number of deals in H1 2012. Prior to the last six months of 2013, there had not been more than 17 inbound deals from China in any half-year period in the last six years.

The value of this investment is also on an upward trend. The US$7.1 billion-worth of deals in H1 2014 was more than three times higher than H2 2013 and the second highest deal value figure for six years. Notable deals include Lenovo Group's US$2.1 billion acquisition of IBM's x86 server business, as well as its US$2.9 billion acquisition of Motorola Mobility from technology giant Google.

"While the Chinese have been very active in Asia, I also feel that they believe they can't afford not to be in the United States as well," says Brahmst.

The steady increase in Chinese deals into the United States can be attributed to several factors. Firstly, regulations in China have been reformed in order to make it easier for companies to raise money for investment abroad and pursue cross-border deals. Secondly, there is a gradual narrowing of the cultural differences between Chinese and US dealmakers. Chinese investors are adapting to the pace and deal structures in the United States, and US targets are more familiar and comfortable with Chinese acquirers.

Chinese businesses have also recognized the value of establishing a US footprint. "Chinese companies that are investing in the United States are already successful in China and are looking to take the next step and diversify internationally. The United States is an obvious market to move into," says White & Case partner Francis Zou. "There is a perceived slowdown in Asian economies and companies see opportunities to secure a better return on capital abroad, and the United States is very attractive in that regard."

With regards to regulation, the Chinese government has relaxed the approvals required for outbound deals of less than US$1 billion and reformed IPO rules in order to make it easier and quicker for issuers to raise money for cross-border deals.

"The ability of Chinese investors to do deals abroad was hindered by regulation. This put acquirers from China at a distinct disadvantage when competing with other bidders who did not have the same constraints," Latham says.

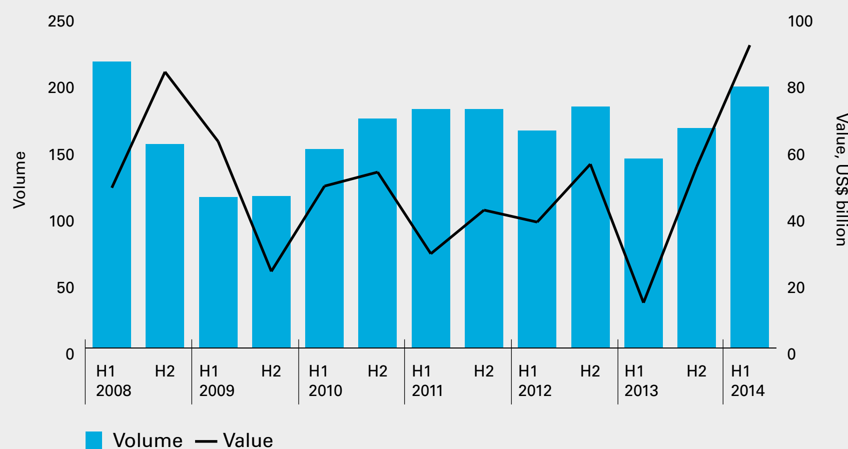
However, the Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee authorized to review transactions that could impact the national security of the US, does remain a potential obstacle for Chinese deals in the United States.

China is now the country with the highest number of deals being scrutinized over national security concerns and CFIUS has gradually looked at a broader range of sectors, such as food and pharmaceuticals, when determining whether national security is at risk.

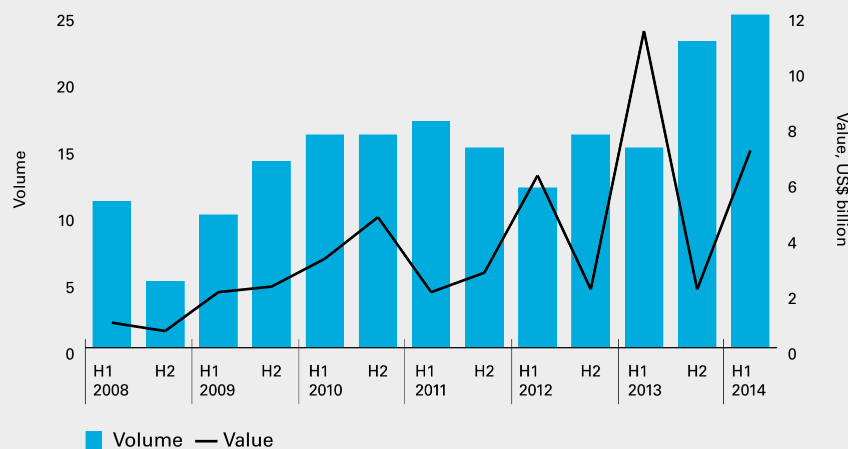
But although CFIUS is still an issue in Chinese deals, it is becoming less of a hindrance as four out of five transactions scrutinized do receive clearance.

"In the past, China had quite a few issues with CFIUS," says Brahmst. "Many companies did not really understand how it worked until about two to three years ago." For more on CFIUS, see Navigating CFIUS, page 19.

European M&A into the United States, 2008—H1 2014



China, Hong Kong & Taiwan M&A into the United States, 2008—H1 2014



38%

increase in US inbound deals from Europe in H1 2014 from H1 2013

28

deals from France, the third-biggest foreign buyer of US companies

From a US target's point of view, being acquired by a Chinese buyer is not as uncertain or unfamiliar as it used to be, making it easier for Chinese acquirers to get a foot in the door.

"Overall I think there is recognition that China could become the biggest economy in the world and that acquisitions by Chinese businesses will become a fact of life," Latham says. "Chinese acquirers are not buying assets and then sending over an army of their own people to run them. They are taking a strategic view and looking to form partnerships. Perceptions and fears of Chinese ownership are changing and are now less of a concern."

Differences in deal culture are also narrowing, and Chinese buyers have recognized the importance of moving faster when pursuing a US target.

"The market is challenging for Chinese buyers, especially newcomers who face a steep learning curve when adjusting to faster auction processes and negotiating strategies," Zou says. "Those challenges are being overcome, however, as large numbers of Chinese citizens who have studied and lived in the United States join Chinese companies and help to navigate deal processes."

Navigating CFIUS

White & Case partner Richard Burke discusses factors Chinese companies should bear in mind when trying to acquire US assets

In its most recent annual report to Congress, the Committee on Foreign Investment in the United States (CFIUS) reported that China now has more foreign investments undergoing US national security reviews than any other country. Here we highlight four imperatives for Chinese investors contemplating transactions that might warrant CFIUS review.

Be proactive. The United States is open for business, but politics dictates that Chinese investors need to plan carefully to succeed. This means not only consulting and filing voluntary notices with CFIUS at the onset of the review process, but also communicating with key US stakeholders when needed. CFIUS has a formal mechanism in its regulations for prior consultation. A number of proposed takeovers by Chinese companies have faced criticism from the US Congress. More effective outreach to both supporters and opponents in Congress could potentially have curbed some opposition.

Be cautious. As the dealmaking landscape changes, so does the nature of the CFIUS national security risk test. With this in mind, Chinese investors need to consider all aspects of a deal to determine if it warrants CFIUS review, from whether a deal involves the acquisition of critical infrastructure or technologies, to whether it could be targeted due to its geographic location. A Presidential order blocked Delaware-based Ralls Corp—which is owned by Chinese nationals—in its attempt to purchase four wind-farm projects because the farms were "all within or in the vicinity of restricted air space at Naval Weapons System Trading Facility Boardman in Oregon." Ralls had chosen not to submit its original investment for CFIUS review. Careful due diligence can enable companies to better understand the considerations that might be of sensitivity to CFIUS.

Be flexible. Very few deals ultimately face CFIUS opposition. CFIUS will often, however, impose conditions prior to clearing a transaction. The increasing number of conditional approvals granted by CFIUS means that Chinese investors will need to be flexible and practical in how they structure their transactions to assuage concerns and to maximize their chance of obtaining clearance. For example, US investment targets may include lines of business with sensitive government contracts or defense-related work. Such business remains problematic for Chinese acquirers from a CFIUS perspective. Preemptively excluding such sensitive operations from a deal has enabled CFIUS to approve Chinese investments that otherwise may have been blocked.

Stay informed. Sensitivities, justified or not, regarding Chinese investment affect the regulatory environment. The acquisition by Shuanghui International Holdings of Smithfield Foods, for example, triggered concerns about food safety. This, in turn, contributed to legislative efforts to make CFIUS review more restrictive. A bill was recently introduced in Congress that would, among other things, extend the scope of CFIUS review to include an analysis of "net benefit" to the United States based on criteria such as economic activity, employment, productivity, industrial efficiency, tech transfers, public health and safety, and well-being of US consumers. The consensus is that this bill will not be enacted in the current Congress, but could be the precursor of similar efforts in the future. It is important that investors stay informed of these developments and factor them into their strategy.

The exit era: US private equity

HEADLINES

- Private equity exit values reach highest level in last five years
- Exit volumes rise 55 percent from H1 2013 to H1 2014
- Trade sales break US$100 billion mark in first half of 2014
- Healthy debt markets balanced by concerns over high valuations
- Secondary buyouts in H1 up 45 percent on H1 2013 levels

There has perhaps never been a better time to sell a portfolio company for US private equity (PE) firms. Since the beginning of 2013, the volume and value of buyout-backed exits has climbed sharply, allowing PE firms to exit businesses for high valuations and strong returns.

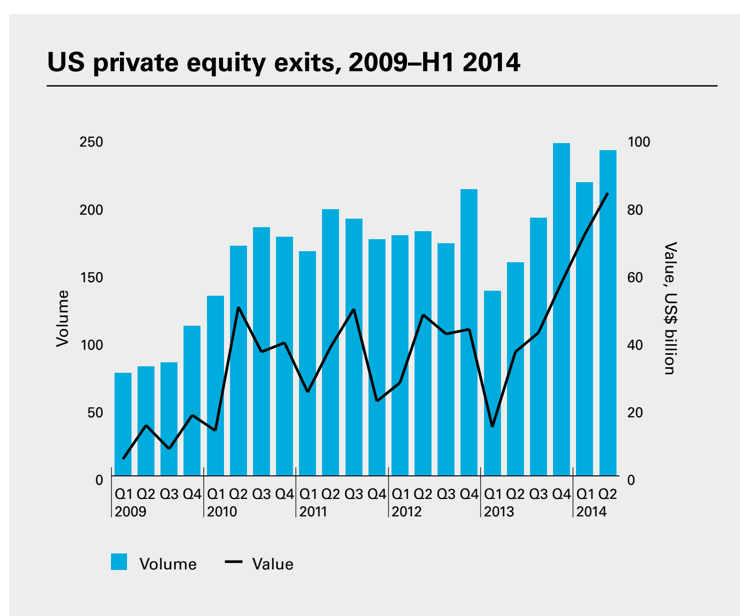
In Q2 2013, US PE firms sold 158 companies worth US$36.7 billion. By contrast, the second quarter of 2014 saw the industry reap 241 exits worth US$83.7 billion—an increase in value of 128 percent. Indeed, when compared with the asset class's Q1 2009 performance, when only 76 exits worth US$5 billion closed, Q2 2014 value was 16 times higher. This demonstrates how strongly PE has rebounded since the credit crisis.

"Valuations and contract terms favor the selling sponsor in today's market much more than over the past number of years. As a result, sponsor hold periods are shortening to take advantage of the favorable market," says White & Case M&A partner Carolyn Vardi.

A number of factors are driving this dynamic. Stronger portfolio company performance, the return of well-funded strategic buyers to M&A markets, increasing competition between PE firms in the mid-market and readily available debt financing have combined to drive the strong run of exits.

Matthew Kautz, White & Case M&A partner, says many buyout firms that held onto portfolio companies through the downturn—when deal activity and valuations slumped—are now bringing these assets to market.

"There were a number of portfolio companies that were unable to thrive during the period between 2008 and 2011, even though they didn't really have any fundamental issues," Kautz says. "PE firms, especially those in the mid-market, have seen performance spike up significantly since then. These companies are now primed for exit, and buyout firms are ready to sell."



The return of cash-rich corporates to M&A markets has created an increased appetite for these PE-owned assets. According to figures from the US Federal Reserve, non-financial US businesses have been sitting on more than $1.8 trillion in liquid securities. And this year, corporates have started to invest these cash war chests, with PE portfolios being an important source of deals.

PE firms sold 284 companies worth US$105.7 billion to corporates in H1 2014, up from 215 deals worth US$42.9 billion in H1 2013.

"Corporates are back in the middle market. They have cash at their disposal, they are more confident in the economy and their shareholders want them to start growing their businesses again," Vardi says.

Corporate buyers haven't been the only game in town for sellers. An increasing number of PE firms are bidding for deals as well. There were 115 secondary buyouts (PE-to-PE deals) in H1 2014 worth US$41.5 billion, up from 79 exits to other PE firms worth US$8.1 billion in H1 2013.

Cash piles up, bargains down

Buyout houses are being put off by optimistic valuations, yet increased capital is putting pressure on PE firms to spend.

Strong exit and debt markets have had an impact on new buyout deals. Last year saw the highest values for buyouts for the past five years, and this trend is set to continue with deal values for H1 2014 higher than any other half-yearly figure with the exception of 2013.

In terms of deal volumes, there were 400 PE buyouts (worth US$77.3 billion) in the first half of 2014—beating the 338 buyouts in H1 2013. The largest PE deal in the United States for 2014 so far saw the Blackstone Group purchase US-based engineering firm The Gates Corporation for US$5.4 billion from Canada's Pension Plan Investment Board and Onex Corporation.

These continued high valuations are driving fears that competition is bidding up prices too much. "PE firms are doing very well from exits and it is good for the PE model to have debt markets that are functioning again, but it is a double-edged sword. Auctions are very competitive and there are concerns that valuations are too frothy," says White & Case partner Oliver Brahmst.

Spending power, seller power

According to Triago, a placement agent, the amount of unused capital available to PE firms globally is sitting at a record US$1 trillion. There is, therefore, a large amount of capital chasing a limited pool of deals, which is prompting increased competition between buyout houses. Larger PE firms dipping down into the mid-market, as corporates dominate megadeal activity, has also upped the ante. "There are more funds in the mid-market than there have been over the past number of years and fewer companies to go around. It is very competitive," says Vardi.

52%

increase in volume of US PE exits from Q2 2013 to Q2 2014

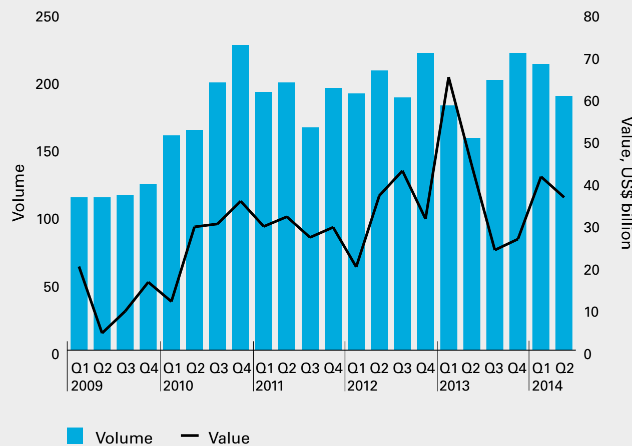
45%

increase in number of secondary buyouts in H1 2014 year on year

400

PE buyouts in H1 2014, the second-highest figure in the last five years

PE buyouts 2009—H1 2014



Healthy debt markets (a record US$605 billion of leveraged loans were issued in the United States in 2013, according to Standard & Poor's) have allowed buyout firms to bid aggressively for portfolio companies owned by rivals, which has also pushed valuations higher. Indeed, secondary buyouts made up a greater proportion of exits in H1 2014 than in H1 2013.

As a result of the increased competition, PE buyers are becoming increasingly aggressive in their attempts to prevail in auctions and secure deals. "We have seen a number of firms try to preempt auctions in order to secure deals. In auctions, firms will put in bids ahead of the timetable that are fully priced and on very good terms in order to shut down the process as much as possible because there are so many funds involved now," Vardi says.

Terms of negotiation

The strong exit market has placed sellers in a position of strength in negotiations, and deal terms have moved in to reflect this.

The increasing use of representations and warranty insurance, which protects parties from liabilities arising from inaccuracies in transaction documents, is one example of how deal negotiations are shifting.

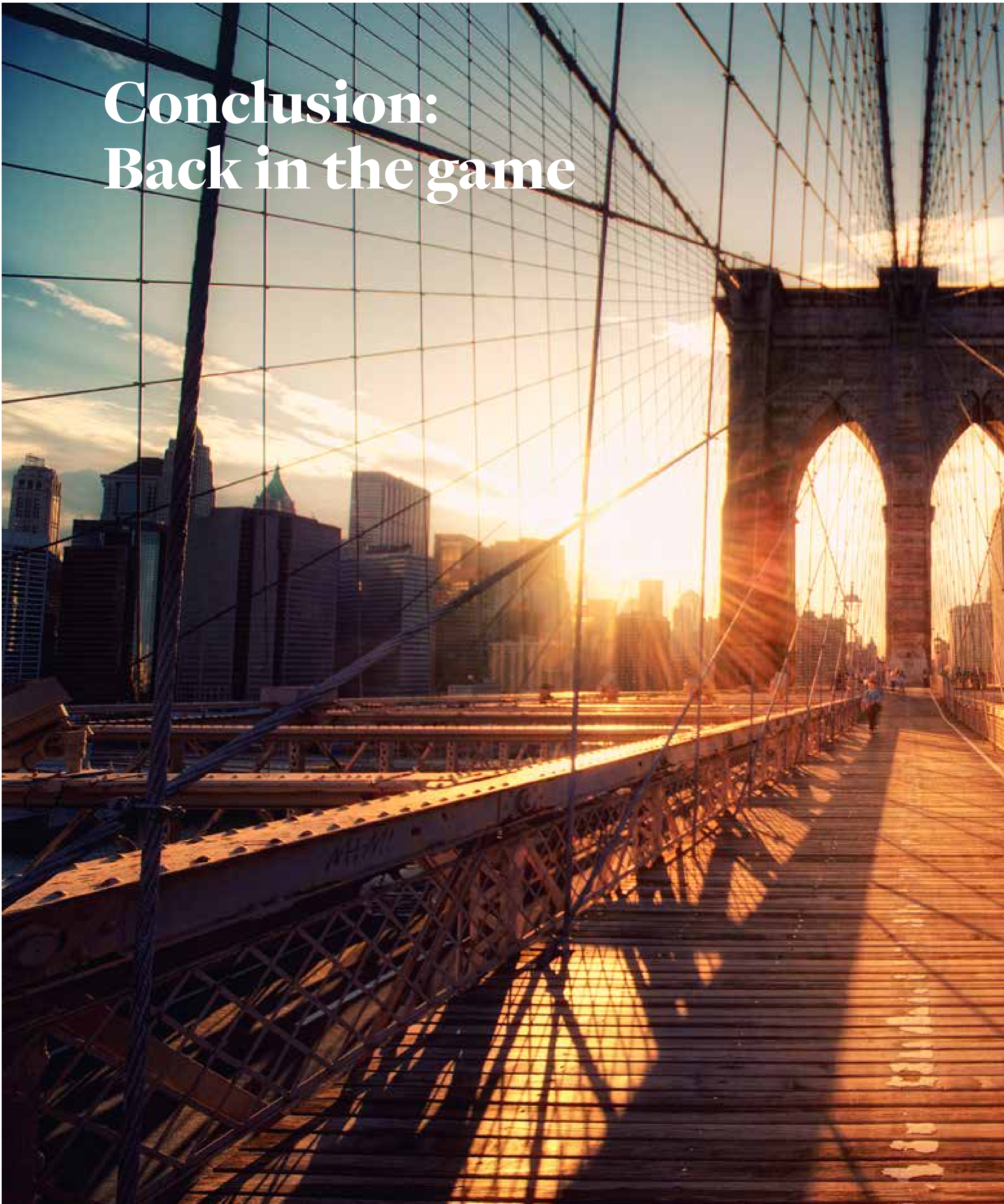
"We are seeing new ways of negotiating risk allocation. In the last year to 18 months, we have seen a huge uptick in the use of representations and warranty insurance by buyers and sellers," Kautz says. "Sellers are suggesting buyers have the insurance in order to limit exposure once the deal has closed. Buyers are coming into auctions with insurance to negotiate lower caps on indemnity post-deal because they have the insurance in place."

Even when representations and warranty insurance is not used, sellers are still in a position to negotiate attractive caps on post-closing indemnities on transactions.

"The seller's post-closing exposure is almost at an all-time low," says Kautz. "Buyers are willing to live with low caps."

Corporates and buyout firms still have large pools of capital to invest, but sellers will continue to benefit from high valuations and favorable deal terms. Given this environment, competition for good deals is likely to remain intense for some time to come.

Conclusion: Back in the game



Confidence in the US M&A market has been renewed in 2014

The figures show that US M&A markets have roared back to life in 2014. Deal volumes are up by close to a third, and deal values are at a five-year high.

On the back of a growing economy, along with rising corporate and shareholder confidence, attention is turning from cost cutting and restructuring to growth and long-term strategy.

A number of trends point to this renewed confidence. The number of hostile takeover attempts is up, megadeal volumes are at a six-year high and companies are increasingly using equity to fund deals. Increasing inbound activity and a strong run of exits for private equity firms further underscores the positive sentiment toward US M&A.

There are still opportunities for megadeals, particularly in the TMT and pharma sectors, which have been the main drivers of large deals so far. Shareholders remain supportive of acquisitions, something reflected in the stable stock prices of business that announce acquisitions. Meanwhile, overseas buyers, especially those from China, are becoming more comfortable with the US deal culture and regulatory processes such as CFIUS.

The drivers that have underpinned the resurgence in US M&A in the first half of 2014 remain in place to continue supporting M&A through the rest of this year and into 2015.

The outlook for the US economy is positive, with the IMF forecasting faster growth for 2014 than the previous year. The housing market has recovered, and jobless claims are falling.

But although the M&A market has rebounded and the outlook is positive, companies pursuing M&A should still act with a degree of caution.

Megadeals have accounted for a large portion of the increase in deal values, and a dip in large deal volumes could check momentum. Dealmakers should also keep an eye on the performance of large deals. If one of the blockbuster deals fails to deliver, M&A activity could ease as corporates reassess their strategies. On the regulatory front, changes to legislation on tax inversions could knock sentiment, and although antitrust and CFIUS issues have become less prevalent, they remain risks.

Against this backdrop, corporates seeking to make the most of the returning deal flow to the United States should keep the following in mind:

Think through your strategy. Shareholders want boards to turn their attention to growth and are broadly supportive of M&A. They will only back deals, however, that are based on solid deal rationales. Opportunistic deals, done simply because a target is available and there is cash on the balance sheet and debt available, are unlikely to receive the blessing of investors.

Focus on due diligence. The S&P 500 has been hovering at near-record highs and valuations are full. As prices reach these record highs, and contracts favor sellers, the risk of missteps increases and the protections provided by due diligence become more and more critical.

Diversify your sources of acquisition capital. When prices are full it is worth mitigating risk by using a variety of acquisition capital to fund a transaction. Paying with stock means a target shares some of the risk, and although many corporates are cash rich, debt is available and attractively priced. It is worth using it.

Watch the regulators. Regulation has not had much of an impact on dealmaking in 2014 but that trend may very well shift. CFIUS remains an obstacle for foreign investors, and tax inversions are a high-profile issue, with a recent change in the rules around them being introduced. Antitrust impediments have not been a feature of deals, but the TMT sector, one of the major engines of M&A growth, is receiving more scrutiny as the industry consolidates and the number of service providers shrinks.

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