HERBERT SMITH FREEHILLS

M&A IN A CHANGING WORLD: OPPORTUNITIES AMIDST DISRUPTION

WRITTEN BY: The Economist Intelligence Unit

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The Economist Intelligence Unit bears sole responsibility for the content of this report. The findings and views expressed in the report do not necessarily reflect the views of the sponsor. Paul Burgin is the author of the report and Melanie Noronha is the editor.

Foreword

The world is facing a period of unprecedented and unanticipated political change. The developed world's consensus of capitalism and globalisation is itself under question from new political movements and popular sentiments. At the same time, the acceleration of technological developments, and the new ways that technology is being used, has created a powerful disruptive force both in the economy and in society.

M&A, and those senior executives and advisers who lead it, prefer certainty—in politics, in the economy and in society. Where the conditions for that certainty are not present, M&A can either stall, or M&A strategies can adapt. Strategies adapt where businesses cannot afford to stand still, in the face of disruptive challenge or otherwise. Strategies adapt where agile and bold players seek to take advantage of new opportunities thrown up by uncertain conditions.

This report asks whether any consensus has been reached in current M&A markets - has a "new normal" yet been found? The headwinds in M&A are clear, in particular the global phenomenon of increased political involvement in M&A activity. The opportunities are clear too, including corporations' hunger for data and technology, prized commodities that some M&A deals are seeking to capture. It is also clear that the key players in the M&A world influencing the direction of travel will continue to include Chinese buyers and activist shareholders.

In this context, we are pleased to present "M&A in a changing world - Opportunities amidst disruption", written by The Economist Intelligence Unit (the EIU) and sponsored by Herbert Smith Freehills.

The EIU's report assesses the current state of play in global M&A, focusing on Asia-Pacific, Europe and North America. It is based on extensive research and interviews with senior executives, advisers and other M&A market participants over the summer of 2017. We are grateful to all of those who were interviewed for this research project for their valuable contributions to this thinking.

We hope that you find the report as interesting and thought provoking as we do.

Gavin Davies

Partner, Herbert Smith Freehills LLP
October 2017

Executive summary

Corporate and shareholder sentiment towards M&A has rebounded since the dark days of 2008. Low borrowing costs have coaxed many new buyers, including acquisitive Chinese conglomerates, into the market. The prices of prized assets have risen accordingly. It remains a seller's market in technology-driven deals, particularly in the consumer-goods, financial services, and media and telecommunications sectors. Some acquirers need to buy competitors to increase their revenue and profits; others are looking to change their product portfolios to boost profits.

A number of forces are at play in the global M&A market, influencing the level and types of deals taking place. This report takes a closer look at the strongest such drivers, including the macroeconomic environment, increased regulatory scrutiny, emerging technologies and merger models.

Key findings of the report

Valuations are very high

Low interest rates and strong corporate cash positions have meant that there is too much money chasing deals. In many cases, multiples are too high for private-equity groups, which are not able to benefit from the synergies that industry players gain from M&A. Deals need to have strong fundamentals, targeting growth opportunities or cost efficiencies. Shareholders favour M&A strategies that boost top-line revenue, bottom-line profits and their regular dividends.

Expert consensus indicates a "new normal" for Chinese outbound M&A activity

Chinese outbound deals fell sharply year on year in the first half of 2017, despite a slight uptick in the second quarter. The expectation is that tight capital controls and scrutiny by regulators will continue. Deals that fit in with China's broader economic development plan, particularly in sectors such as industry and emerging technologies, are likely to move forward.

The "globalisation of equity" has been a key factor in driving up the volume and value of international deals

It has become easier for firms to tailor a mix of shares and cash for international transactions. But uncertainty over US tax policies has left many corporations unable to plan their next move, and this may temporarily dampen cross-border deals.

In addition to changing business models, emerging technologies are altering merger models in key sectors

There are more M&A deals between retailers and e-commerce platforms as shopping moves online, and financial firms are absorbing financial technology as customers now expect a rich online experience. In media and telecoms, vertical deals are combining content and distribution as traditional players look to retain customers and maintain revenue.

There are reasons for optimism about an uptick in M&A, with strong levels of activity expected in 2017 and into 2018

An economic recovery and relative political stability in Europe, despite uncertainty over Brexit, are making the market more attractive. A growing middle class and the emergence of innovative business models in Asia-Pacific mean that many players are on the prowl for deals in the region.

Confidence restored

The global M&A scene looks a lot healthier today than in the years immediately following the 2008 financial crisis. Worldwide, M&A deals in 2016 totalled US$3.6trn, according to Thomson Reuters.[1] Last year the North American market was up over 50% from its 2008 peak, and it remains the largest regional market, exceeding in size those of Western Europe and Asia-Pacific (see definitions for M&A deals considered for this paper, in Appendix). Expectations of interest-rate rises and US tax policy changes could accelerate domestic deal-making in the US.

The annual value of deals in Asia-Pacific has increased significantly since 2008, driven by the appetite for acquisition demonstrated by Chinese firms. But the first half of 2017 saw a sharp downturn in outbound Chinese deal flows as capital controls tightened and regulators—in international markets and at home—scrutinised deals more closely, signalling tougher times ahead.

M&A activity in Western Europe lagged in the years after the 2008 financial crisis on account of a protracted economic slowdown. But deal levels look positive in the first half of 2017 when all announced deals are included.

There are also a number of sector-specific trends shaping M&A activity. In consumer goods and services, Amazon's US$13.7bn offer for Whole Foods signals another phase in the global scramble to respond to changing shopping habits and distribution channels.[2] The wide market reach of financial technology (fintech) has caught the attention of established financial services companies that are seeking to adapt their business models. In media and telecommunications, deals to marry content with distribution are emerging.

While technology titans such as Amazon and Google have the cash to spend, not all deals make sense and not all are certain to reach completion. Low interest rates and corporations flush with cash have been fuelling higher valuations, but shareholders are paying close attention to deal fundamentals—securing growth opportunities and cost efficiencies through synergies.

Overall, experts interviewed for this research are optimistic. With the European economy finally back on track, all regions could experience a busy 12 months as buyers seek growth through acquisition, technological prowess and brands that fit their long-term strategies. In the chapters that follow, we will first explore broad trends influencing the levels and types of M&A activity across sectors and regions, followed by sectoral deep dives into consumer goods and services, financial services and media and telecoms.

Figure 1: Asia-Pacific, an active M&A market
Volume of deals in target region, 2008-Q1 to 2017-Q2 (no. of deals)

Source: Bureau van Dijk

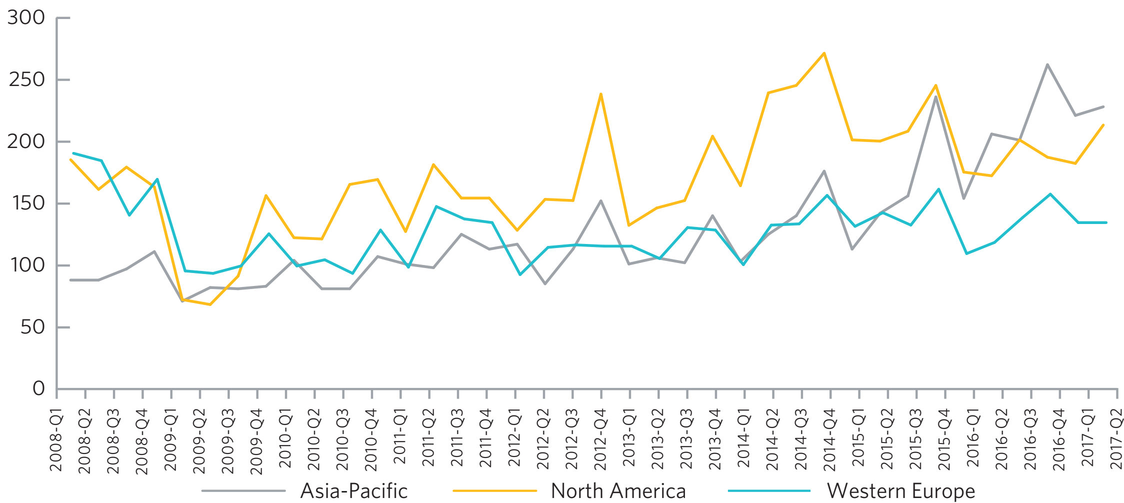
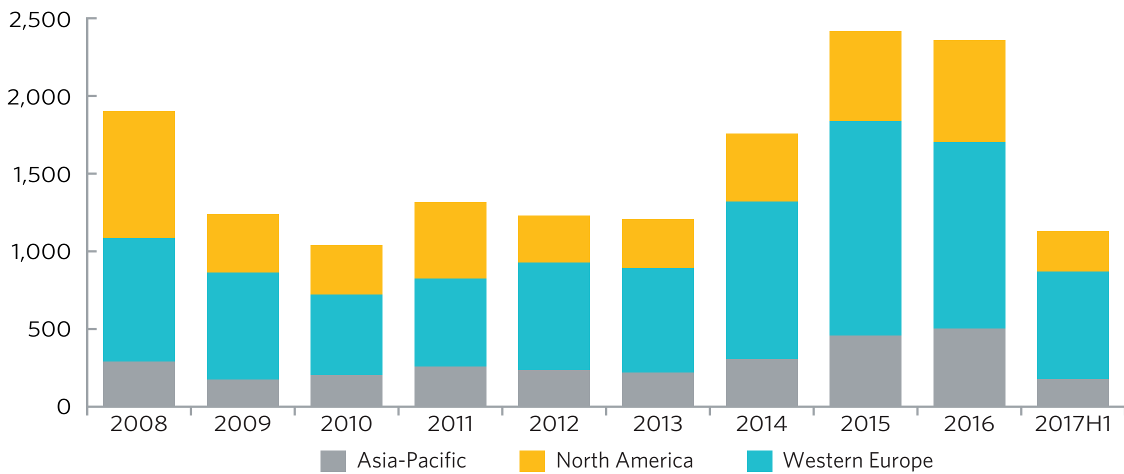


Figure 2: North America holds the lead
Value of deals in target region, 2008 to 2017-H1 (US$ bn)

Source: Bureau van Dijk



1 http://share.thomsonreuters.com/general/PR/MA_4Q_2016_E.pdf

2 Amazon Inc. http://phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=2281414

An outstanding year?

Experts interviewed for this research expect strong levels of activity for calendar year 2017, continuing into 2018, although full-year figures may be down slightly on 2016. Across North America, Western Europe and Asia-Pacific, deals worth over US$950bn are pending (including those awaiting regulatory and shareholder approval), according to Bureau van Dijk's database. Half of these are in North America.

The consensus is that there is increasing activity in the middle market – that is, deals valued between US$100m and US$1bn. "There are fewer mega-transactions that are happening now—I see the middle market as being very robust," says Matthew Gooch, head of European banking at William Blair, an investment banking and asset management firm.

This trend is being fuelled by a combination of low interest rates and strong corporate cash positions. Excluding financial firms, US corporates have a record US$1.84trn in cash, led by Apple, Microsoft, Google, Cisco and Oracle.[3] Private-equity funds are not short of money either. They raised US$269bn in the first seven months of 2017 and are estimated to have dry powder of US$613bn, according to data from Preqin.[4]

As a result, valuations are currently very high. Mr Gooch explains: "If you used to pay seven, eight or nine times earnings before interest, tax, depreciation and amortisation (EBITDA), you may now be paying 11, 12 or 13 times EBITDA." Ellen Itskovitz, senior director, US corporates at Fitch Ratings, points out that multiples[5] in consumer sectors, including retail and restaurants, have doubled in the past 15 years. Some experts point to similarities with pre-crisis trends. "Not to say there's about to be another financial crisis, but just that it feels like multiples are really inflated," says Mr Gooch.

Many firms have already lowered their expected returns as a result. Internal rates of return have dropped from around 22% in 2010 to a range of 15-16%, Mr Gooch calculates.

For a successful deal with a strong rate of return, therefore, the fundamentals—cost efficiencies or growth opportunities—must be in place.

> "In general, you see that most of the activity now is industry activity. In most of what I see, the multiples have gotten too lofty for the returns to make sense for private equity. You really need the synergies of an industry player"
>
> **ELLEN ITSKOVITZ, SENIOR DIRECTOR, US CORPORATES, FITCH RATINGS**

Corporations have been able to justify these high multiples to shareholders when looking to stimulate growth and transformation, particularly for M&A deals with emerging technology firms and competitors in international markets (explored further in the next chapter). And corporations have become more sophisticated buyers, according to PwC's partner for transaction services, retail and consumer, Lisa Hooker: "Often, particularly in consumer goods, private equity is good at completing quickly and often outpaces corporates. Now corporates are definitely far more agile at getting deals done," she says.

Figure 3: A healthy pipeline
Pending M&A deals by value (US$ m)

Source: Bureau van Dijk

	PENDING FROM:		
Region	**2015**	**2016**	**2017**
Asia-Pacific	48,036	102,758	75,183
North America	62,827	265,441	197,413
Western Europe	4,010	84,476	110,208
Total	**114,872**	**452,675**	**382,804**

3 Moody's Investors Service, July 19th 2017. https://www.moodys.com/research/Moodys-US-corporate-cash-pile-grows-to-184-trillion-led--PR_369922?WT.mc_id=AM~UmV1dGVyc05ld3MyX1NCX0NWX1JhdGluZ19OZXdzX0FsbA%3d%3d-20170719_PR_369922

4 Preqin, July 27th 2017. https://www.preqin.com/docs/press/Mega-PE-Funds-Jul-17.pdf

5 Purchase price divided by expected annual earnings.

> "There is [now] much more forthright dialogue between companies and their institutional investors in relation to M&A"
>
> **DOMINIC LEE, PARTNER, GLEACHER SHACKLOCK**

Activist investors

Activist investors are now playing a bigger role in driving M&A deals. An activist investor can be defined as an individual or group that purchases large numbers of a public company's shares and/or tries to obtain seats on the company's board with the goal of effecting a major change in the company. Traditionally a North American phenomenon, these days powerful activist funds are demanding divestments to boost shareholder returns in Europe and also in Asia.

The most successful—and feared—activist funds are larger now, and their ambitions are global. Last year, private-equity group 3G pushed Kraft Heinz to bid for its rival, Unilever—an offer that was swiftly rebuffed.[6] Now, another activist investor, Third Point wants radical change at Nestlé, Europe's largest firm, and is urging it to rationalise its product lines and sell its stake in L'Oréal.[7]

Traditional investors are being more proactive too, as they look to boost returns for their fund holders. "There is [now] much more forthright dialogue between companies and their institutional investors in relation to M&A," says Dominic Lee, a partner at Gleacher Shacklock, an investment banking firm.

Activist investors are also proactive in lobbying concerning M&A regulation. In the Netherlands, big fund houses including Fidelity International and Allianz Global Investors have opposed government plans to hinder bids by foreign companies.[8]

Corporate attitudes towards activists are changing. Dialogue with an activist can be a good way for chief executives to table boardroom discussions about strategic decisions that are usually considered taboo, like divesting core assets.

Standpoint

Christoph Nawroth and Mark Bardell, Herbert Smith Freehills

Shareholder activists: raiders or settlers?

Shareholder activists remain commonly viewed as short-term, opportunistic, aggressive, foreign "corporate raiders", seeking new targets in Europe after rampaging through the US, having already picked-off the easier targets on the other side of the Atlantic. However, like many raiders over the centuries before them, have shareholder activists now settled in Europe permanently?

Arguing whether activism is on the rise, has peaked or is falling in Europe is to miss the point: shareholder activism is now well-established in Europe. After the arrival of the larger activist investors from the US, who have been increasingly looking beyond their borders for new areas of investment, it is now the European investors who are, more and more, pursuing an activist agenda. These European investors are: seeking more active engagement with the companies in which they invest, using activist methods and allying themselves with, and even investing in, activist funds.

Activism is now a permanent feature of the European markets, which means that for all listed European corporates, no matter how large or venerable, being prepared to respond to an activist campaign is imperative. More than that, boards of European listed corporates must be prepared to engage in a constructive dialogue with activists, recognising that this can be in the best interests of all shareholders and in fact welcomed by even the most traditional of shareholders. Activists are here-to-stay: they have now become part of and forever changed the investors around them.

Standpoint

Mark Robinson and Tony Joyner, Herbert Smith Freehills

Data - risks and reward

Data is now one of the most valuable commodities in the world. Everything we do each day now leaves a digital trace, able to be collected, analysed, manipulated and sold.

Their soaring value, use and issues of control have caught the attention of the world's governments and regulators, not to mention the communities from whom they are largely extracted without payment.

Recently, AI has transformed data use, with constantly evolving algorithms extracting far more value from our actions and opinions online than was possible from the static personal data of old.

New legal controls are already being unveiled, particularly stricter compliance, privacy and security laws for data collectors and manipulators, possibly even a requirement for 'supply chain' verification.

Antitrust and market regulators worldwide are rewriting the rules to address the cross-border data monopolies already apparent, possibly requiring divestment and restructuring within the major players and tight new rules to limit the giants buying upstarts.

Practically, expect more national control of collection, storage and use, resulting in a boom in local data centre construction and investment, and requirements for access and inspection. Also, expect enhanced monitoring for algorithmic share price prediction and manipulation.

Economically, data still lacks a functioning and transparent marketplace; one that recognises the brief value point in today's data flows – they're only valuable when they are fresh – and that the primary producer is currently not being paid for its labour. Public activism is steadily rising in this area, and governments, regulators and companies will be forced to respond within this dynamic space.

6 https://www.ft.com/content/d846766e-f81b-11e6-bd4e-68d53499ed71

7 https://www.ft.com/content/723b4a78-59e8-11e7-b553-e2df1b0c3220

8 https://www.ft.com/content/45f217e6-50f9-11e7-bfb8-997009366969

Cross-border deals

In general, acquirers have largely looked for targets close to home. North American companies acquired US$3.4trn-worth of local firms between the second half of 2013 and the first half 2017, ten times their purchases abroad. But international deals have been on an increasing trend, being accessible these days even to mid-sized firms owing to what Dominic Lee of Gleacher Shacklock refers to as the globalisation of equity. Global firms now find it easier to tailor the mix of shares and cash that they offer in a deal. Cross-border deals predominantly used cash in the past, says Mr Lee. But it is now relatively easy to issue shares in London, New York and Tokyo at levels of US$5bn or less. He attributes this change to a fall in costs and a loosening of restrictions on cross-border stock transactions.

Figure 4: Local deals still predominate
M&A deals by value (US$ bn), 2013-Q3 to 2017-Q2

Source: Bureau van Dijk

	TARGET REGION		
Acquirer region	**Asia-Pacific**	**North America**	**Western Europe**
Asia-Pacific	1,308	186	139
North America	39	3,743	280
Western Europe	42	721	1,493

Figure 5: High cross-border activity
Value of outbound M&A deals from North America, Western Europe and Asia-Pacific (US$ bn)

Source: Bureau van Dijk

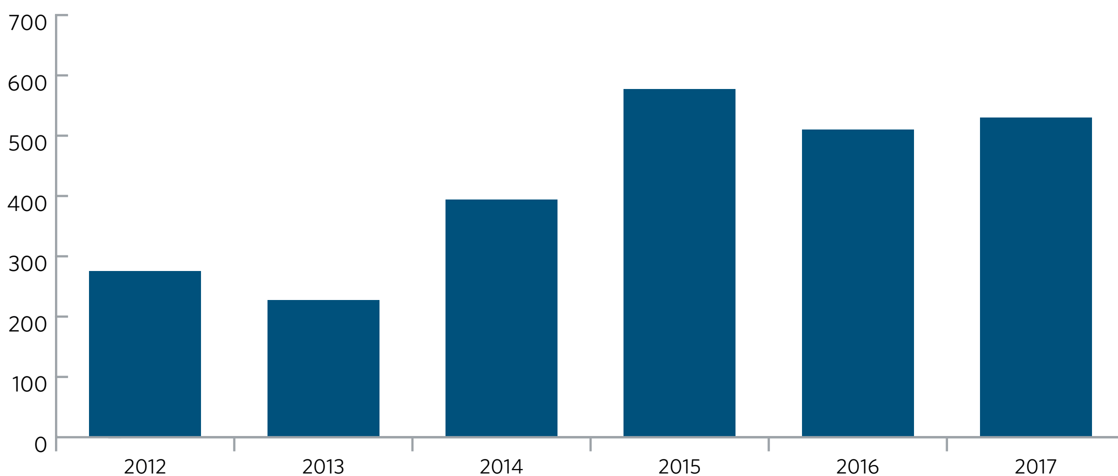
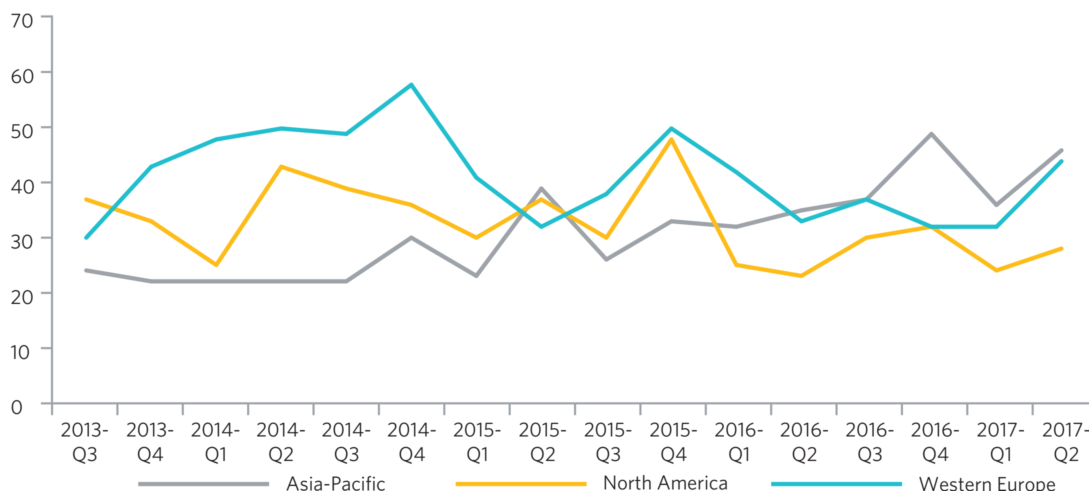


Figure 6: Asia rising
Volume of outbound M&A deals by acquirer region, 2013-Q3 to 2017-Q2

Source: Bureau van Dijk



A lot of attention has been given to the volatility of Chinese outbound activity in 2016 and 2017. Outbound M&A from China amounted to US$221bn in 2016, according to Thomson Reuters[9], but declined sharply in the first quarter of 2017.[10] However, as Chinese buyers acclimatise to the tighter capital controls, the Americans, Europeans and Japanese are becoming eager acquirers in Asia-Pacific. "Asia is extremely active right now, even though since the capital controls have come in it is very difficult to sell to the Chinese," says William Blair's Mr Gooch. In Asia-Pacific, Japanese corporates are increasingly keen on international deals. A shrinking population at home is squeezing their revenue and profits, while the negative cost of capital is prompting Japanese corporations to look to Australia, Europe and North America for growth.

Activity in the Australian market has slowed, despite Australia's having been a net seller of resources and privatised infrastructure over the past decade, explains James Tam, Asia Pacific head of M&A at Morgan Stanley. He expects fewer megadeals on the continent. Despite this, the Australian market remains relatively favourable for foreign investors, according to Greg Peirce, co-head of M&A advisory, UBS Investment Bank APAC. "I'm actually reasonably positive about the outlook for the next 12 months. I think we'll continue to see activity, including in infrastructure, financial services and resources." Foreign buyers—particularly Chinese, Japanese and US acquirers—will continue to be a significant factor in the Australian market, he says.

Europe's various crises and prolonged recession have deterred many foreign buyers in recent years. But many experts point to the region's recent economic recovery and relative political stability (primarily citing Emmanuel Macron's presidential election victory in France) as portents of M&A activity to come. Europe's economic recovery is also encouraging buyers to look at opportunities outside core markets. PwC's Ms Hooker explains that there has been a pick-up in countries that went a bit quiet after the financial crisis, such as Spain and France. But that trend does not extend to the UK. "If there was an economy that I was most negative about, it would be the UK," says Mr Gooch, citing the economic and political uncertainty surrounding Brexit.

The largest volume of inter-regional M&A activity is that between Western Europe and North America, but the figures may just reflect the large number of multinational companies that are headquartered in the US. Some of the largest of these deals are a result of US companies moving operations offshore for tax purposes.[11]

Among those interviewed, two factors dominate the M&A narrative: the uncertainty over tax policies in the US, and the China factor (encompassing tighter capital controls and greater regulatory scrutiny). We explore these in more detail next.

9 http://www.reuters.com/article/global-ma-deals/deals-corporate-makeovers-drive-corporate-takeovers-in-2016-ma-bonanza-idUSL1N1EE12J

10 https://www.ft.com/content/f40ea726-82cb-364f-8e5f-03a35b49ad70

11 https://www.ft.com/content/ddcd9ad6-a5cf-11e4-ad35-00144feab7de

Policy promises in the US

Early threats of border taxes on imported goods dampened deal activity late in 2016 and early 2017, but these now seem unlikely to materialise. Uncertainty over policy has left companies unable to plan their next moves for cross-border M&A.

One such area of uncertainty is the policy on repatriation of cash held abroad to avoid big corporate tax bills at home. The US administration has been trying to encourage the likes of Apple and Google to repatriate the trillions of dollars that they have been holding offshore. Some of the experts interviewed feel that a one-off allowance for repatriation may see US companies spend more of that cash for M&A at home than abroad. However, at present such an offer looks distant.

Another area of uncertainty is the proposed rollback[12] of former president Barack Obama's "inversion" rules, which stopped companies moving their headquarters overseas to lower-tax countries. US drugmaker Allergan and Ireland-based Pfizer cancelled their US$160bn merger when the inversion rules were enacted.[13] Scrapping the restrictions could encourage more multi-billion-dollar cross-border deals, but such flagrant corporate tax avoidance may infuriate voters.

> "We don't know what the resolution of the tax holiday for repatriation of offshore assets is going to be. And we also don't know if there will be a reversal of the inversion policy that the Obama administration implemented. That is interfering with the ability of buyers to correctly put together pro formas for the companies they want to buy"
>
> **ROY BEHREN, CO-MANAGER OF THE MERGER FUND, WESTCHESTER CAPITAL**

Thus, this uncertainty may temporarily dampen cross-border deals with US companies.

Despite this, the co-managers of The Merger Fund think that the outlook for M&A activity is favourable in the US, for two reasons. First, buoyed by low interest rates, stockmarket prices continue to rise, leading to a reduction in "buyer's remorse". Second, the general view is that Donald Trump's administration and the Republicans who control the US House of Representatives and Senate will prove more business-friendly than the previous administration. But the new administration has a growing backlog of deals to scrutinise, and successful bids may take longer to close.

The dragon tamed?

The number and value of Chinese overseas deals fell sharply in the first quarter of 2017, in response to tighter capital controls and increased scrutiny from US and European regulators.

The pressure is most acute in financial services, thinks James Tye, partner, transaction services at PwC. Increased regulatory scrutiny—or the fear of it—has led to a rise in the number of deals being scrapped. Know-your-client (KYC) rules have been tightened, and anti-money laundering (AML) rules are now tougher too. Anbang Insurance recently walked away from a US$1.6bn takeover of Fidelity & Guaranty Life after Iowa and New York insurer regulators raised concerns.[14]

> "Regulation has been a barrier for certain overseas capital coming into the financial services market, where potential investors cannot satisfy regulators' KYC and AML requirements, or regulators cannot determine the origination of funds or indeed the competency to run regulated targets. We have seen a material uptick in regulator challenges to Chinese activity over the last year, in a market that overall is pretty buoyant"
>
> **JAMES TYE, PARTNER, TRANSACTION SERVICES, PWC**

Standpoint

Veronica Roberts and Alex Kay, Herbert Smith Freehills

Political influence in M&A

Foreign investment protectionism is in flux. The OECD's Regulatory Restrictiveness Index measures statutory barriers against foreign investment in over 60 countries. Although many nations in Asia are liberalising, countries such as Russia, China and India still tend to feature at the most restrictive end of the index. While most European countries have historically been positioned at the least restrictive end, this has started to change: Germany recently expanded its government's ability to investigate foreign acquisitions in a wide range of critical infrastructure and supporting IT services. In the UK, the election manifesto of the current Conservative administration signalled an intention to widen the scope of the applicable regime, and the government intervened recently on national security grounds for the first time in years, imposing conditions on Chinese company Hytera's acquisition of Sepura, which provides radio to the UK's emergency services. The EU itself has recently announced plans to introduce a general framework for screening foreign direct investments, for those EU Member States who wish to participate. Even countries sitting in the middle of the OECD's index, such as the US and Australia, have shown a willingness to intervene and impose conditions on deals, or sometimes block them. Although it is hard to predict, the current US administration's focus on "America First" could well increase this tendency.

Even the prospect of investigation by the Committee on Foreign Investment in the United States (CFIUS), a US government group that investigates the national-security implications of proposed foreign investments in US companies, can scare away Chinese investors. In 2016, Unisplendour dropped plans to buy a minority stake in Western Digital, while Fairchild Semiconductor turned down a Chinese offer, citing an "unacceptable level of risk" that CFIUS would reject the deal.[15] As of October 2017, it appears that the US$1.2bn bid for MoneyGram International by Ant Financial, part of tech giant Alibaba, is also at risk. Indeed, the regulatory pressure has become such a problem that insurers have spotted a gap in the market: they now offer cover for break-up fees if CFIUS puts the brakes on Chinese bids.[16] As a result, investment bankers are less keen these days to lure Chinese buyers to the table as the regulatory and oversight risks increase.

The squeeze is also coming from China itself, where tighter controls have been put in place on leverage and capital flight. Aggressive buyers such as Anbang Insurance, Dalian Wanda, Fosun International and HNA Group face greater attention on their financing. Calendar year 2016 may prove to have been the peak for outbound Chinese M&A as the government exerts pressure on banks to curb their lending to acquisitive firms. Share prices have already tumbled as expansionist wings have been clipped.[17] Local officials have also warned against trophy purchases that appear to have no strategic value to the buyer.

Following a slump in the first quarter of 2017, there was a slight uptick in Chinese outbound activity in the second quarter.

> "The average deal is still happening and there is still a very strong strategic rationale for those deals to happen"
>
> **JAMES TAM, ASIA-PACIFIC HEAD OF M&A, MORGAN STANLEY**

He expects this lower level of outbound M&A activity to be the "new normal", referring to the 2016 surge as "a little bit of a bubble". Mr Peirce of UBS in Australia concurs: "Chinese counterparts that we were dealing with have become more reluctant to engage in public market M&A. However, even though the capital controls are there, we still see large, sophisticated, strategic Chinese interest." Deals that fit in with China's broad economic strategy are the ones most likely to get the green light.

Standpoint

Matt Emsley, Nanda Lau and Karen Ip, Herbert Smith Freehills

Chinese outbound M&A

Following a surge in China's outbound investment in 2016, the Chinese government has taken steps to tighten outbound capital controls and increase regulatory scrutiny of M&A transactions. In late 2016 the National Development and Reform Commission, the Ministry of Commerce, the People's Bank of China (the central bank) and the State Administration of Foreign Exchange enhanced the administration of outbound investments, supporting genuine transactions while increasing supervision of "irrational" investments. In August 2017, several ministries issued the Notice on Further Guiding and Regulating the Direction of Outbound Investment (the Guidelines), classifying investments into "encouraged", "restricted" and "prohibited" categories. The "encouraged" category includes infrastructure investments under the Belt and Road initiative, investments promoting the development of high-technology manufacturing and those in agriculture, trade, culture, logistics, energy and resources. Investments that do not align with state foreign policy, and those in real estate, hotels, cinemas, entertainment and sports clubs or made by certain investment funds, are restricted. Prohibited investments include those involving the export of technologies prohibited for export, those prohibited by international treaties and those that may harm state interests. The Guidelines require an initial assessment of investment authenticity, guidance during the investment process and a post-investment enforcement regime, while also providing for favourable policies for encouraged investments, guidance for restricted investments and effective control of prohibited investments. Although they bring welcome clarity, the Guidelines still provide only high-level guidance and leave many outstanding questions requiring further clarification. The State Council (China's cabinet) is reportedly leading an initiative to draft new rules to replace the existing ministerial-level guidance. In the meantime, advance consultation with regulators will be important.

12 https://www.thestreet.com/slideshow/14222919/1/as-treasury-moves-to-bring-back-inversions-here-are-seven-of-the-biggest-recent-deals.htm

13 http://uk.reuters.com/article/us-allergan-m-a-pfizer-idUKKCN0X3188

14 http://www.scmp.com/business/companies/article/2088225/anbang-insurances-fidelity-guaranty-acquisition-likely-fail

15 https://www.wsj.com/articles/u-s-puts-chinese-deals-on-ice-1500664800

16 http://www.reuters.com/article/china-deals-insurance-idUSL1N1DC1BX

17 https://www.nytimes.com/2017/06/22/business/dealbook/china-banking-deals-stocks-fall.html

Going digital through M&A: A sectoral review

While several of the factors discussed in the previous chapter impact M&A activity across sectors, there are some conditions that are influencing the levels and types of activity in certain sectors. We have explored distinct drivers of strategic M&A deals in three key sectors: financial services; consumer goods and services; and media and telecoms. These have been among the top sectors for announced and completed M&A activity in recent quarters.

Figure 7: Consumer companies and financial services remain popular
Target sectors for M&A deals by value in North America, Western Europe and Asia-Pacific, 2015-Q3 to 2017-Q2

Source: Bureau van Dijk

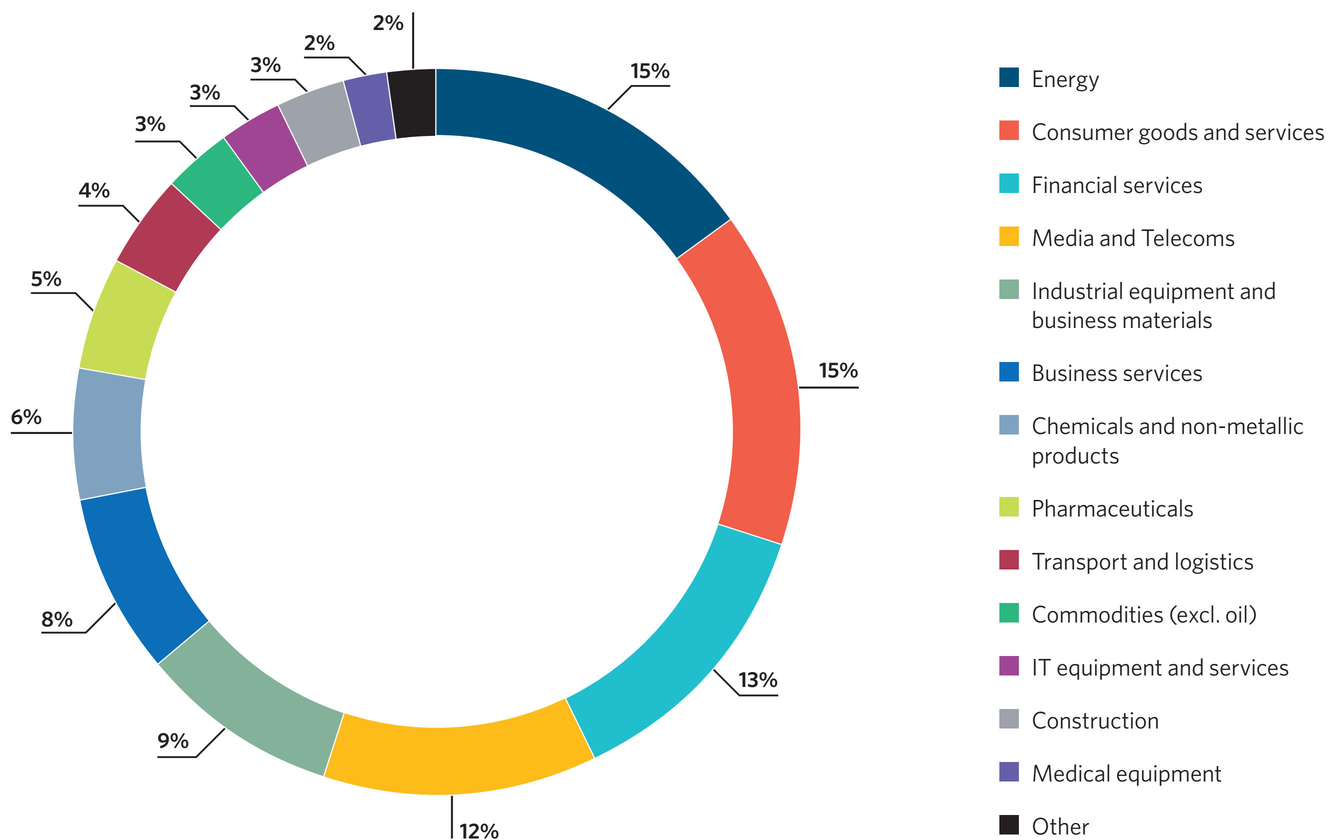
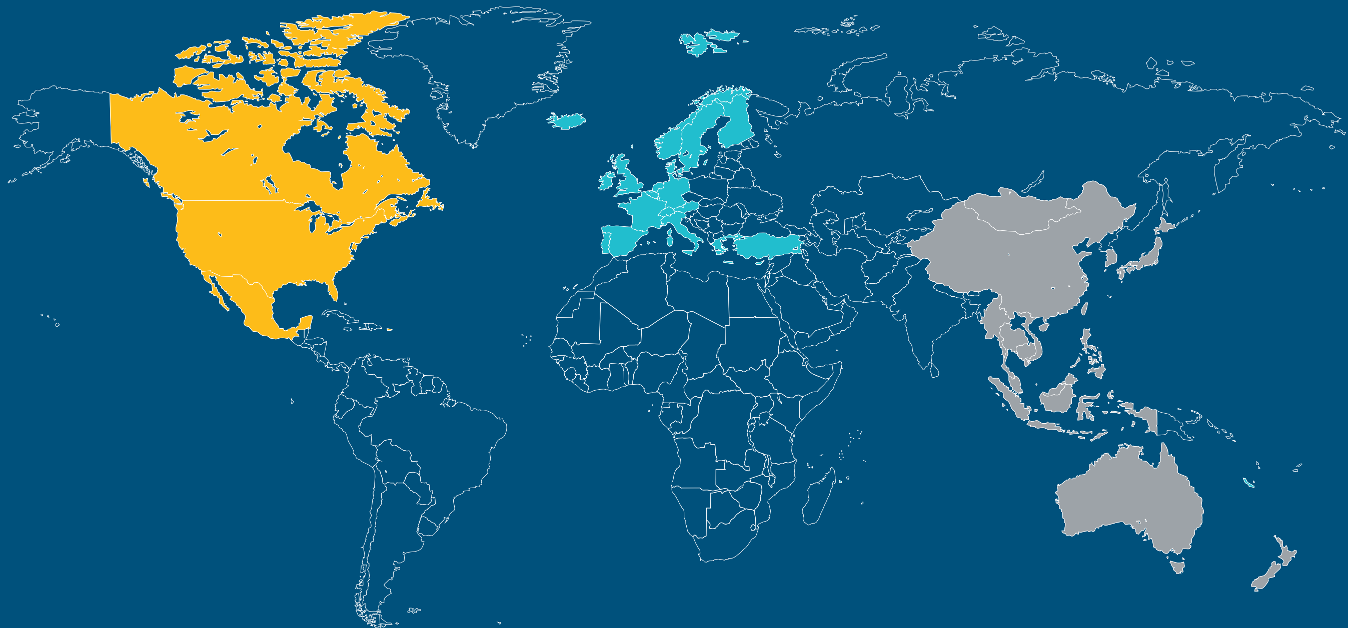


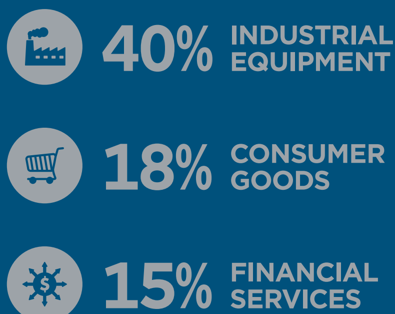
Figure 8: International buyers are selective
Top three sectors by acquirer region, 2015-Q3 to 2017-Q2



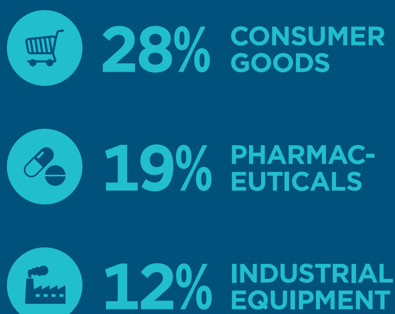
Investor region

In North America:

Asia-Pacific firms are buying

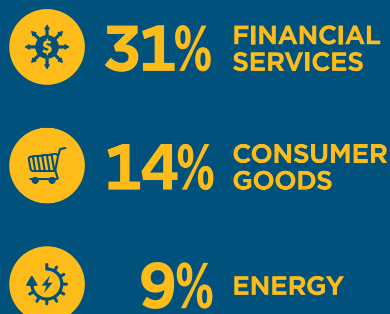


Western Europe firms are buying

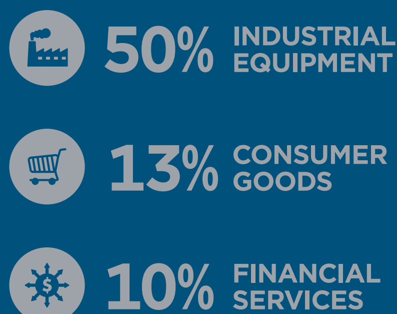


In Western Europe:

North American firms are buying

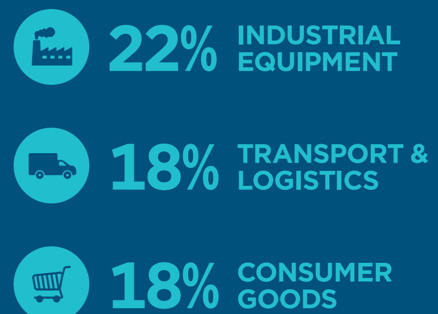


Asia-Pacific firms are buying



In Asia-Pacific:

Western Europe firms are buying



North American firms are buying

Source: Bureau van Dijk, The Economist Intelligence Unit

Consumer goods and services: The online battle

For much of the past decade, producers and retailers have endured sluggish economies and reluctant shoppers, so that companies have had to grow through acquisition deals rather than organically. This shift is generating a "portfolio transformation", says Ellen Itskovitz of Fitch Ratings.

Big players are shedding unnecessary brands to cut costs and boost profits. In 2015 Procter & Gamble (P&G) sold its struggling beauty lines, including Wella and Clairol, to Coty for US$12.5bn.[18] Mid-sized players are concentrating on their core strengths. Reckitt Benckiser recently offloaded its North American food division, including the iconic French's mustard brand, to focus on its health-related products. McCormick paid a substantial US$4.2bn to spice up its share of the condiments market.[19] Says Lisa Hooker of PwC: "You look at Nestlé, Unilever, Reckitt: mostly, their strategy is buying into a plan and getting rid of everything that does not fit. The cards are being handed around because a lot of them are buying and selling to other corporates, often based in emerging territories."

Ms Itskovitz sees big structural changes occurring too, as retail rapidly moves online. "The channel shift is one that people are grappling to deal with. In consumer products, online growth is probably in the mid-single-digit areas. But everyone expects it to increase dramatically," she says. M&A has been a core part of the corporate strategies to adapt to this change.

Corporates need e-commerce bolt-ons with two clear components. First, they need the logistical and technological expertise to enable them to adapt their distribution chains—Walmart, for example, paid US$3.3bn for Jet.com, an online retailer, to assist in its battle against tech giant Amazon.[20] Second, bigger players need to acquire a trendier image among the "Twitterati". Smaller brands tend to strive for a "cool" factor, and nowadays are more likely to use social media to boost sales. Coty, while integrating the beauty lines that it had acquired from P&G, also took a majority stake in Younique, an online cosmetics firm that relies heavily on social media for its sales.[21]

LVMH Luxury Ventures, created early in 2017, takes a slightly different path. The LVMH Group usually acquires big, established brands that operate as standalone units. But that means it may miss out on fast-growing, early-stage opportunities. LVMH Luxury Ventures bridges the gap, aiming to take minority positions in businesses with annual sales up to €20m. As Julie Bercovy, head of the division, explains:

> "We look at both the future potential iconic brands and business models in luxury with new distribution channels that target the next generation or break the value chain"
>
> **JULIE BERCOVY, LVMH LUXURY VENTURES**

Changing habits may also be helping regional champions to expand their global presence. Brazilian cosmetics firm Natura is paying L'Oréal €1bn for The Body Shop—the move is part of a developing trend for Latin American and Asian firms to expand their market shares by buying established brands. Natura may look for synergies that private equity could not deliver, using The Body Shop's global branch network to sell other Natura products, thinks Ms Hooker.

18 http://uk.reuters.com/article/us-procter-gamble-divestiture-coty-idUKKCN0PJ1K320150709

19 http://uk.reuters.com/article/us-reckitt-food-mccormick-idUKKBN1A32GQ

20 https://www.geekwire.com/2017/look-out-amazon-walmarts-3-3b-jet-com-deal-starts-to-pay-off-with-big-growth-in-online-sales/

21 https://www.coty.com/news/coty-enter-partnership-younique-leading-online-peer-peer-social-selling-platform-beauty

Financial services: Thinking out of the box

Rising capital requirements and tighter regulation have led to a constant flow of consolidation in the lower ranks of US banks and among insurers and asset-management firms in Europe and Asia-Pacific. In the US, the First Financial-MainSource Bank tie-up is the latest in a long line of regional consolidations.[22] Yet both the US and Europe still have too many undersized banks, and markets remain fragmented. Further rationalisation makes sense, but can be politically fraught. Germany has criticised its neighbours for failing to tackle weak banks, but it too has profitability problems at the *Landesbanken*, owned by regional states.

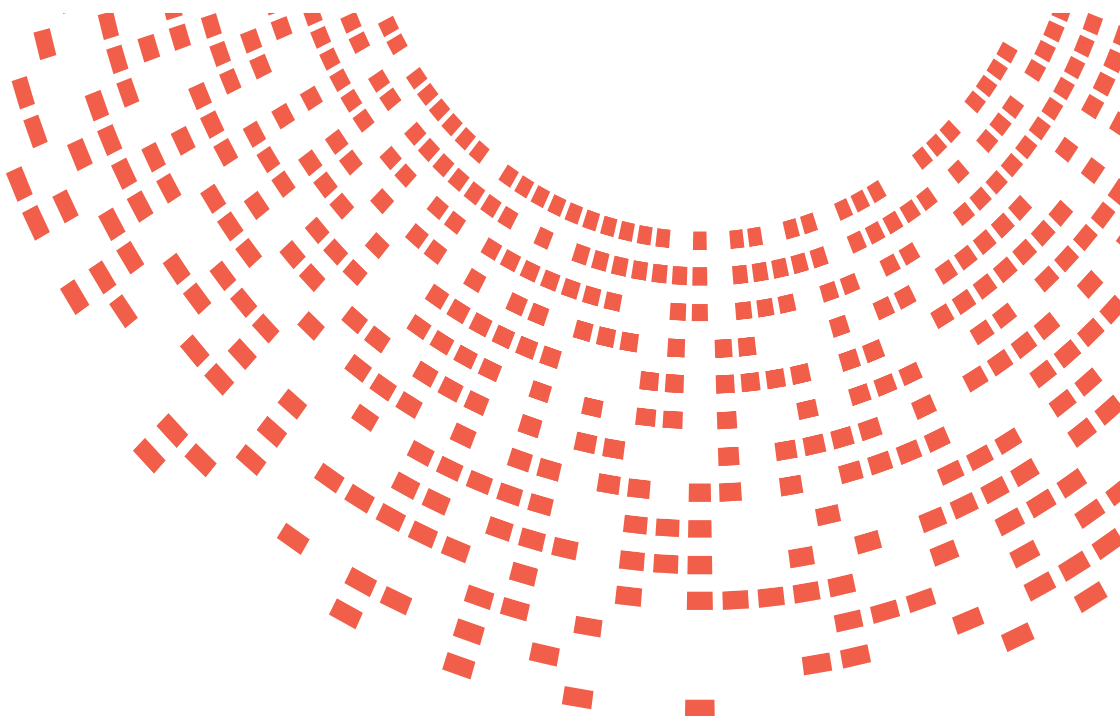
In asset management, the likes of Standard Life and Schroders have been snapping up smaller fund groups to bulk up their assets and reduce costs. As James Tye, head of financial services M&A at PwC, points out, asset-management consolidation should be a relatively easy task when compared with the complexity and compliance issues involved in pricing up a bank.

> "Asset managers have low capital requirements, and cashflows are transparent: you know what you are getting. There has been relatively low big-ticket volume, but lots of activity at the mid- and lower levels"
>
> **JAMES TYE, HEAD OF FINANCIAL SERVICES M&A, PWC**

More positively, for banks with the cash and foresight to tackle digitalisation and the switch to smartphones, there has been an uptick in M&A deals with fintech firms. BBVA and Santander of Spain, French banks including mutual bank BPCE, and Asian banks like DBS, hope to thwart the threat that Google and others may pose to their staid business models. Mr Tye characterises this emerging model as a "bank in a box", whereby "you get a single licence and you're fully online. You have limited services and customer interactions, but you're super-low-cost."

In asset management too, technological advances are driving a change in the business model and thus in the types of companies involved in deals. One example is Ant Financial, an affiliate company of China's Alibaba Group, which operates payment app Alipay and a money-market fund. Tapping into Alipay's 450m-strong customer base and the cash in their digital wallets, Ant Financial has become the largest asset manager in the world.[23] Fintech deals could accelerate and emerging fintech firms are in a position to charge a premium.

The insurance sector is also promising, particularly in Asia, where the rise of the middle class is fuelling consumer demand for all types of insurance as national social-security systems tend to remain weak. In fact, insurance companies may lead the next wave of tech adoption in financial services and may set their sights on tech targets for M&A. Mr Tye describes this trend: "Banking was about five years behind [in terms of technology adoption such as apps]. Insurance is about 10 years behind."



Media and telecoms: Vertical deals

Horizontal deals between competitors tend to attract more negative attention from competition authorities, as well as pushback from customers who fear price hikes in telecoms and corporate influence in media. In the US, Comcast, a cable giant, withdrew its offer for Time Warner Cable as the Department of Justice feared that the combined entity would have too much control over the nation's broadband internet. Likewise, both AT&T and Sprint gave up trying to buy T-Mobile when competition authorities got involved.

Roy Behren, co-manager of The Merger Fund at Westchester Capital, sees little appetite to allow a reduction from four to three national mobile carriers in the US. The European Commission is also wary of national four-to-three deals as it believes it may reduce competition and result in rising prices for customers.[24]

Recent deals in Denmark, France and the UK have failed on similar antitrust ground.

But regulators may look more favourably on cross-border deals, provided that merger partners commit to rolling out next-generation technology such as 5G.[25] 5G technology will be critical to the success of the Internet of Things, and in particular connected vehicles. However, few corporates seem interested so far, given uncertainty about the investment costs involved.

New merger models are emerging. "In the media space, we are seeing a lot of vertical deals where distribution and content are married together," says Mr Behren. Cable giant Comcast led with the purchase of a stake in NBC Universal, followed by an eventual takeover of the entire company. AT&T is now chasing Time Warner's content divisions as consumers switch from live, programmed television to on-demand content on mobile devices. But the risk of public pushback exists here too, as people become more familiar with issues like net neutrality.

22 iBanknet, 30th June 2017. http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=bankmanda

23 https://www.ft.com/content/28d4e10 0-2a6d-11e7-bc4b-5528796fe35c

24 http://www.politico.eu/article/veto-of-uk-mobile-merger-sends-chill-across-europe-commission-three-02/

25 https://www.cnbc.com/2017/02/28/reuters-america-update-2-eu-open-to-compromise-on-some-parts-of-mobile-industry-agenda.html

Conclusion: A positive outlook

The global M&A space has been far more active in recent years than in the period immediately after the financial crisis of 2007-08, buoyed by sustained economic growth in Asia-Pacific, and particularly in China. An economic recovery in Europe could further reinforce this trend. The view on North America is positive, but would be far stronger if there were more clarity on policies such as tax reform and the inversion rules. Encouraging US companies to repatriate their offshore billions would boost domestic M&A, experts say.

On the other hand, increased scrutiny of deals across the board—from European and US regulators of foreign purchases (particularly from China) to tighter regulatory oversight at home—has dampened megadeal activity. This trend appears to stem from the fear of losing headquarters, manufacturing facilities and associated jobs. It is also driven by uncertainty over the ability to retain key intellectual property rights. Some experts believe that Chinese buyer interest may now turn domestic, due to the Chinese government's restrictions on outbound capital flows. But experts believe that there is still room for average-sized deals that are aligned with China's economic development plans.

The focus on deals that serve a strategic purpose for the acquirer is also evident in the consumer-goods and services space. Shareholders are more receptive to such deals, watching closely to ensure that deals provide opportunities for growth and cost efficiencies through synergies. In addition, many established companies are engaging in M&A with new technology firms to take advantage of the fresh market opportunities that they represent. Technology is a thread running through all sectors, and this will continue to be the case in the coming years.

Appendix

The report is based on extensive desk research and in-depth interviews with senior executives at financial institutions and companies, including M&A consultants, investment bankers and credit-rating agencies. The interviews were conducted in July-August 2017. Our sincerest thanks go to the following participants (listed alphabetically) for their time and insights.

Roy Behren
Co-Manager, The Merger Fund
Westchester Capital Management

Julie Bercovy
Head of LVMH Luxury Ventures
LVMH

Marc Deschamps
Co-chief executive officer
Drake Star Partners

Matthew Gooch
Head of European banking
William Blair

Lisa Hooker
Partner, transaction services, retail and consumer
PwC

Ellen Itskovitz
Senior director, US corporates
Fitch Ratings

Dominic Lee
Partner
Gleacher Shacklock

Greg Peirce
Co-head, M&A advisory
UBS Investment Bank APAC

James Tam
Asia Pacific head of M&A
Morgan Stanley

James Tye
Partner, transaction services
PwC

For the purposes of this report, we have defined M&A deals as having the following characteristics:

Deal value: US$100m or more

Deal status: For the years up to and including 2016, M&A deals are limited to those completed or assumed completed. For 2017, M&A deals include those completed, assumed completed, and pending (awaiting shareholder approval or regulatory approval)

Deal type: Includes mergers, acquisitions, management buy-outs and management buy-ins

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