Client Alert

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State of the M&A Market in 2018

At the beginning of 2017, dealmakers seemed to be holding their breaths. US M&A volume, for example, dropped by more than half from the fourth quarter of 2016 to the first quarter of 2017. Although M&A transaction volume picked up as the year progressed, and the overall number of US transactions increased by about 14%, aggregate US transaction volume ultimately decreased approximately 16% from 2016. Many of the headwinds that affected 2017 appear to have been resolved, which, according to FactSet, resulted in 2,786 US transactions announced at a total value of $503.5 billion in the first quarter of 2018. We believe this could indicate a resurgence in the M&A market for the remainder of 2018.

Looking Back on 2017

One key reason for the slow start in 2017 was political uncertainty, particularly in the aftermath of the close US presidential election in November 2016. Markets and dealmakers were unsure how to evaluate the implications of President Trump's election, and the possibility of wide-ranging policy changes seemed high. In particular, market participants' hope for business-friendly proposals like deregulation and lower corporate tax rates clashed with their concern over border taxes, tariffs, and other restrictions on free trade.

In hindsight, President Trump's policy decisions had limited effects on the M&A market in 2017. The Trump administration succeeded in lowering the corporate tax rate and generally refrained from adopting new border taxes, tariffs, and other restrictions on trade. Furthermore, although the administration oversaw numerous deregulatory actions, there was no sweeping deregulation of industries that might have driven an increase in M&A.

In contrast to 2017, however, President Trump has announced recently a variety of new tariffs aimed primarily at Chinese imports. China responded with proposed tariffs of its own, although Chinese President Xi Jinping subsequently made conciliatory remarks in a recent speech on trade. It remains to be seen whether these tariffs will have significant effects on the global economy, and whether the United States and China will reach an amicable resolution or engage in an escalating trade war.

In addition to the uncertainty created by the recent tariffs, the Trump administration's stance on multilateral trade deals remains in flux. One of President Trump's first major executive actions was to abandon the Trans-Pacific Partnership, which had the potential to expand free trade in many industries between the United States and many Asian countries. President Trump has suggested recently, however, that the United States might join the trade deal after all. Closer to home, the Trump administration continues to threaten to withdraw from NAFTA if the treaty is not renegotiated in favor of the United States. The United States, Mexico, and Canada trade goods worth more than $1 trillion annually, and whether NAFTA is terminated, modified, or left unchanged could have a dramatic effect on the US and North American economies.

Based in part on the steady, generally business-friendly policies advanced by the Trump administration in 2017, US equity markets enjoyed what can only be described as a stellar year. The S&P 500 advanced over 19%, finishing the year within 1% of its all-time high set earlier in December, and, in a historical first, the S&P 500 did not record a single down calendar month during the year. This was in stark contrast to

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Wall Street's consensus forecast of a 5.5% return, which was the lowest estimated return since at least 2005.

The S&P 500 was down modestly in the first quarter of 2018, which was the index's first losing quarter since the third quarter of 2015. Financial markets have also experienced significantly more volatility in 2018 than in 2017, likely due to the rapidly evolving outlook on the potential for, and uncertain impact of, the ongoing trade dispute between the United States and China.

Economic Environment in 2018

Looking forward, the economic environment appears to be generally supportive of a continuing rebound in the M&A market. The Federal Reserve, after raising its federal funds rate target a quarter point in December (to 1.25%–1.5%) and again in March (to 1.5%–1.75%) has maintained its forecast of a total of three quarter-point rate increases in 2018. The Federal Reserve forecasts an additional three quarter-point rate increases in 2019, and two more quarter-point increases in 2020. The Federal Reserve also raised its US economic growth forecast to 2.7% (up from 2.5% in December and 2.1% in September) and predicted inflation would not reach its 2% target until 2019. Steady but not overwhelming economic growth, low inflation, and relatively low—but forecast to increase—interest rates should help create a favorable economic environment for M&A activity. The economic outlook may change, of course, but for now it seems more likely that any hesitation by dealmakers to engage in M&A transactions will be attributable to individual idiosyncrasies rather than market-wide anxiety.

Available Cash and Changing Demographics

At the end of 2017, S&P 500 companies had approximately $1.8 trillion in cash and cash equivalents on hand. Private equity funds had a similarly large amount of investable assets, which were estimated to exceed $1 trillion at year-end. Sooner or later, these assets must be deployed. And although companies may invest their cash in something other than M&A, such as stock buybacks or internal investments in their businesses, private equity funds are, in most cases, forced buyers. This dynamic may result in rising acquisition valuations, particularly for high-quality companies that use an effective sale process to generate demand from multiple potential buyers.

Complementing these piles of available cash is the country's changing demographic mix. The Baby Boomers, generally considered those born between 1946 and 1964, are now between 53 and 72 years old. Among these approximately 76 million people are a large number of business owners and, at some point, the desire to retire will cause these aging business owners to put their companies up for sale. This may help explain the rise in the number of transactions in 2017 even as aggregate transaction volume decreased.

We note also that the number of private equity-backed US companies continues to increase. This could be a cause or result of an IPO market that generally remains soft, but it seems likely that many businesses will continue to be sold privately rather than offered to the public. We expect private equity funds to be particularly sensitive to how the changes to the tax code may affect their after-tax returns, but it remains unclear whether the new tax regime will drive a wave of selling, buying, or restructuring, or if mixed incentives will not result in a one-way shift in private equity fund behavior.

Tax Cuts and Jobs Act

On December 22, 2017, President Trump signed into law the largest change to the tax code since its overhaul under President Reagan in 1986. The implications of the Tax Cuts and Jobs Act (the "Act") are numerous and still uncertain, but a few key points merit mentioning here:

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- Lower Corporate Tax Rate: The corporate federal income tax rate was lowered to a flat rate of 21% from a maximum rate of 35%. Greater after-tax profits will increase companies' cash balances, which may result in more M&A transactions.

- Elimination of Future Repatriation Taxes: The Act abandons the current worldwide international tax system for a new territorial tax system. Companies will pay a one-time tax (at a reduced rate) on historic earnings of foreign subsidiaries, but generally will not owe any tax on future dividends received from foreign subsidiaries. US companies will no longer have an incentive to avoid repatriating cash, and some companies, most notably Apple, ExxonMobil, and Honeywell, have already announced plans to repatriate cash currently held overseas. This influx of cash may increase spending on domestic M&A transactions by large, multinational companies.

- Asset Acquisitions Become More Valuable to Buyers: For the next five years, companies will be allowed to deduct immediately 100% of the cost of certain depreciable tangible assets, now including assets acquired from a third party. Asset acquisitions, including deemed asset acquisitions (e.g., through appropriate elections or by purchasing a disregarded entity), therefore will become more valuable to buyers.

- Cap on Deductibility of Interest Expense: Deductions for net business interest expense are now capped at 30% of an amount roughly equivalent to EBITDA. Beginning in 2022, such deductions will be capped at 30% of an amount that approximates EBIT. This change generally will not affect strategic acquirers, but we may see fewer debt-financed acquisitions. This change also may result in lower after-tax returns for highly leveraged acquisitions by private equity companies.

- Limitations on NOLs: The Act eliminates the two-year net operating loss ("NOL") carryback and limits the NOL carryforward to 80% of taxable income for losses arising in taxable years beginning after December 31, 2017. Due to these limitations, buyers may view a target company's NOLs as less important going forward.

- Increased Use of C Corporations: Because the corporate federal income tax rate was lowered to a flat 21% rate, there is a reduced tax rate differential between C corporations and flow-through entities. Although the Act provides a deduction of up to 20% for non-corporate taxpayers for "qualified business income" earned through certain flow-through entities, this deduction is phased out (and, in circumstances, does not apply) for taxpayers above certain income thresholds. We may see fewer conversions to flow-through treatment, particularly when the qualified business income deduction would be limited or inapplicable.

Technology Company M&A

In recent years, the number of M&A transactions involving technology companies has increased significantly. Some of these transactions involve technology companies' expanding their product portfolio or entering into new sectors of the economy. Many other transactions, however, have resulted from companies in traditionally less technology-focused sectors trying to incorporate new technologies into their existing business models. This has been particularly pronounced in the retail and fintech industries, where there has been a significant race to identify and implement disruptive technologies. In 2017, for example, Amazon acquired Whole Foods to add a physical footprint to its strong online presence. This followed Walmart's 2016 acquisition of Jet.com, which seemed to be an attempt to compete more directly with Amazon online. It will become increasingly difficult to draw meaningful distinctions between "tech" and "non-tech" companies, and we expect the trend of overlap between sectors—including through cross-sector M&A—to continue in 2018.

In addition to headline-grabbing acquisitions, however, many companies are using M&A to address gaps in their existing business models. Some companies may choose to address such gaps by hiring new talent to develop the missing technology internally. But in many cases, acquiring an existing company

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with a viable, proof-of-concept technology may be a cheaper and more efficient solution than developing the technology from scratch. Along similar lines, an increasing number of companies are turning to “corporate venture capital” to fund startups relevant to their business models. Examples of technologies that have and will continue to be adopted by “traditional” businesses include, among others:

- Blockchain: Although cryptocurrencies like bitcoin dominate the news today, the underlying blockchain technology can be adapted to record and process transactions, verify documents, manage supply chains, and track inventory, among a myriad of other uses.
- Artificial Intelligence: Through the continued advancement of various types of artificial intelligence, computers are now being used in fields ranging from medical diagnostics to self-driving cars to virtual assistants.
- Big Data: The capture, organization, storage, and analysis of the vast amount of information now generated by customer-business interactions can increase efficiency and generate new opportunities for many types of businesses.
- “Internet of Things”: The growing network of physical devices embedded with sensors, software, and network connectivity will continue to expand into new types of consumer devices.

Chinese Outbound Acquisitions and CFIUS Reform

Another persistent trend over the last several years has been outbound Chinese acquisitions. In 2005, Chinese companies spent less than $10 billion on foreign companies. That amount tripled by 2009 and rose to over $140 billion in 2017, placing China second behind the United States in total outbound acquisition volume.

The continuation of this trend may be at risk, however, as in August the Chinese government imposed new capital controls that caused outbound acquisitions to drop significantly. These capital controls, aimed at reducing “irrational” investments in certain industries and assets, separate potential investments into three classes:

- Banned: military, gaming, and certain other unsavory industries;
- Restricted: real estate and hotels, film and entertainment, sports, and investments that do not meet environmental standards; and
- Encouraged: investments that improve China’s technology, advance the Belt and Road initiative to strengthen connections between China and the rest of Asia, and expand research and development capabilities and investments in the oil, mining, agriculture, and fishing industries.

In addition to the above China-imposed restrictions, Chinese acquisitions of US companies appear likely to draw greater scrutiny from the Committee on Foreign Investment in the United States (“CFIUS”) going forward. CFIUS reviews certain covered transactions involving Chinese and other foreign buyers of US companies and assets, but China has ranked first in the number of transactions reviewed each year since 2011. In November, a bipartisan group of senators and US representatives introduced the Foreign Investment Risk Review Modernization Act (“FIRRMA”).

FIRRMA would result in, among other things, closer scrutiny of transactions involving buyers from certain countries of “special concern,” which would no doubt include China. The bill would also expand the types of transactions subject to CFIUS review, as well as increase the number of factors CFIUS would consider when evaluating whether a transaction presents a national security risk. Generally speaking, the changes

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would result in a broader focus on information, and potential informational and cybersecurity vulnerabilities, rather than physical assets alone.

Even setting the possible enactment of FIRRMA aside, however, the CFIUS review process has resulted in the termination of three proposed acquisitions involving Chinese buyers since December 2016. Note that this does not include potential transactions for which a CFIUS filing was withdrawn and not refiled. Withdrawal typically occurs when CFIUS indicates to the parties that it will not approve a transaction, but in that event the failed transaction generally does not become public knowledge.

Whether these changes have a significant impact on the overall US M&A market remains to be seen, but sellers considering transactions with Chinese buyers must stay abreast of these developments.

Conclusion

After a slow start and a mixed year overall in 2017, we believe that reduced political uncertainty and the continuation of current economic trends, combined with the other factors discussed above, will continue to provide a more favorable environment for M&A in 2018. Based on a solid first quarter, we expect that dealmakers, who maintained a generally wary mindset through much of 2017, may turn a more optimistic outlook into a resurgent year in the M&A market.

Authors

Steven M. Haas
shaas@HuntonAK.com

Brian L. Hager
bhager@HuntonAK.com

Scott H. Kimpel
skimpel@HuntonAK.com

Charles L. Brewer
cbrewer@HuntonAK.com

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