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Global M&A
: recent trends and future outlook

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Executive Summary

In 2014, global M&A transaction volume grew to a post-2007 high in value terms, driven by large deals. The US, the world's biggest M&A market, will likely remain the chief driver of global M&A activity, but the impact of recently revised US tax rules and changes in the funding environment bear close watching going forward.

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NOTE

1) All M&A data cited herein are sourced from Thomson Reuters. Transaction volume data include both completed and pending deals.

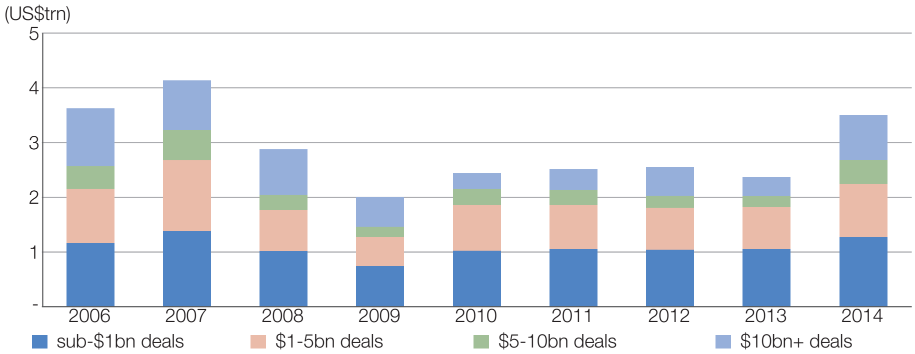
Global M&A transaction volume[1] is resurgent following a steep downturn in the aftermath of the 2008 financial crisis. After most recently peaking at over $4 trillion in 2007, it fell to a post-crisis low of $2 trillion in 2009 and continued to languish for the next several years. In 2014, however, M&A transaction volume increased roughly 50% year on year to a post-2007 high of around $3.5 trillion (see Exhibit below).

Factors behind recent growth in M&A activity

M&A deals valued at $5 billion or more increased markedly in 2014 as shown in the graph below, which breaks down global M&A transaction volume into deal-size buckets. In 2007, M&A activity's most recent peak year, private equity (PE) funds collaborated on a number of large acquisitions. In 2014, by contrast, growth in M&A deal volume was driven largely by major acquisitions by corporations, not PE funds.

Why did major corporate acquisitions pick up in 2014? One reason is that industry consolidation through M&A is gaining momentum in several sectors that are

Exhibit: Global M&A transaction volume broken down by deal size



Source: Thomson Reuters

approaching inflection points. Such sectors most notably include TMT (technology, media and telecom) and healthcare. M&A transaction volume in these sectors has in fact increased substantially, mainly in the form of large deals. Consolidation within the TMT sector is driven largely by fusion of telecommunications and broadcasting amid the ongoing Internet infrastructure buildout and technological progress in the digital realm. M&A has also been playing a role in this consolidation process[2]. In the healthcare sector, pharmaceutical makers are utilizing M&A as they refocus on their highest-priority businesses in response to growth in new drug R&D costs and impending expiration of patents on existing blockbuster drugs[3].

2) For example, AT&T announced plans to acquire Direct TV in May 2014.

3) For example, GlaxoSmithKline (GSK) and Novartis announced reciprocal divestments/acquisitions in April 2014, including GSK's acquisition of Novartis's vaccine business and Novartis's acquisition of GSK's oncology product portfolio.

A second factor behind the recent pickup in M&A activity is availability of relatively low-cost funding from various sources to make acquisitions in the aim of industry consolidation as discussed above. Since the financial crisis, companies, particularly major corporations, have been accumulating cash. Additionally, credit spreads and government bond yields in developed countries have generally been suppressed at low levels, resulting in an environment in which many companies can access relatively low-cost debt financing to fund acquisitions. Meanwhile, with equity prices rising, stock-for-stock acquisitions also are increasing in prevalence.

A third factor is that shareholders have become more receptive to M&A. Even if a prospective acquisition makes sense strategically and can be readily financed at advantageous terms, the deal will not go forward unless the acquirer and acquiree can agree on an acquisition price. In this respect, recent appreciation in equity valuations has increased acquiree-company shareholders' financial incentive to sell their shareholdings. Moreover, in 2014 even acquirers often experienced share price gains after announcing major acquisitions[4]. In response, acquirers' shareholders also have become more amenable to M&A deals. Such sentiment is another tailwind for M&A activity.

4) According to Thomson Reuters, 136 M&A deals that were valued at $1 billion or more and involved a US acquirer were announced in 2014 through December 2. The acquirer's share price rose after the deal was announced in more than two thirds of these cases. By comparison, this ratio's seven-year average is 50%.

Outlook and future focal points

Near term, the outlook for M&A activity hinges largely on trends in the US, the largest M&A market. Outside the US, the European telecom sector is undergoing consolidation and Chinese companies are increasingly acquiring foreign companies. Nonetheless, the US's share of global M&A transaction volume has been growing in recent years[5].

5) M&A deals involving US companies accounted for 44% of 2014 global M&A transaction volume (in value terms), up from 32% in 2010.

The US stands out as a relatively robust economy amid the current global economic slowdown. With US equity prices at all-time highs, US-related M&A activity is likely to remain brisk. It remains to be seen, however, whether the number of M&A deals valued at $5 billion or more, which were the chief driver of last year's growth in M&A transaction volume, stays in the vicinity of its 2014 level. M&A activity, being an aggregation of corporate behavior at the micro level, is inherently difficult to forecast, but a couple of potential impediments to large M&A deals have recently emerged.

One such impediment is related to the US tax system. In the healthcare sector, several large M&A deals announced in 2014 involve so-called tax inversions. In a tax inversion, a US company acquires foreign company domiciled in a country, such as Ireland, where corporate tax rates are lower than in the US. After the acquisition, the US company relocates its legal domicile to the acquiree's home country in the aim of benefiting from that country's lower tax rates. While tax considerations are of course not the sole reason that US companies engage in such acquisitions, some tax inversions have been criticized as being primarily tax avoidance schemes. In response, cracking down on tax inversions has become a hot topic within the US government. In September 2014, the US Department of the Treasury issued revised rules to reduce tax inversions' tax benefits[6]. Few expect the rule changes to completely eliminate tax inversions, but it should curb them to some extent by restricting the use of foreign subsidiaries' retained earnings.

6) The rule changes include a number of reforms, including restrictions on several methods that enable US companies relocating to a new tax domicile to utilize foreign subsidiaries' retained earnings while deferring payment of US taxes. One of the aims of tax inversions is to effectively utilize foreign subsidiaries' accumulated earnings without paying US taxes on those earnings. The revised rules are partly intended to reduce companies' incentive to do tax inversions by restricting their use of foreign subsidiaries' retained earnings, thereby reducing tax inversions' economic benefit.

Another concern is emergent signs of increased debt financing costs, most notably in the form of widening of credit spreads in the US high-yield bond market. Although the adverse impact of wider credit spreads has recently been partially offset by a further decline in long-term US Treasury yields, continued spread decompression could dampen M&A activity by increasing acquisition funding costs. A related concern is a severe selloff in high-yield bonds in the energy sector in response to crude oil prices' recent decline. Energy-related bond issuance has been in an upswing in recent years, resulting in growth in the energy sector's share of total outstanding high-yield bond issuance. Instability in the energy sector consequently could reverberate throughout the high-yield corporate bond market, even well beyond the energy sector. While ripple effects on other sectors appear to be limited at present, the situation bears close monitoring going forward.

In sum, the global M&A outlook hinges largely on US market trends, an increasingly important determinant of global M&A activity in recent years, but taxation developments and changes in the funding environment need to be closely monitored in addition to factors such as economic fundamentals and equity market performance.

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