CohnReznick
ADVISORY • ASSURANCE • TAX

Mergers and Acquisitions Escalate in 2018

Mergers and Acquisitions Escalate in 2018

Worldwide mergers and acquisitions happened at a quicker clip in 2018, dominated by large deals and high cross-border activity.

Global M&A hit $3.1 trillion in the first half of 2018, with completed and in-process deals up more than 26 percent from the first half of 2017, per Bloomberg data. "Transaction volume was the highest it's been since the first half of 2007," said Jeremy Swan, managing principal, financial sponsors industry for CohnReznick.

Bloomberg data showed North America alone hit $1.5 trillion. The strongest increases were in Europe (38 percent), North America (32 percent), and Latin America/Caribbean (31 percent).

The passage last year of the U.S. Tax Cuts and Jobs Act, which lowered the corporate tax rate to 21 percent from 35 percent and made other changes, contributed to the surge in activity, primarily because of the anticipated increase in corporate earnings. "It probably pushed already high valuations even higher," said Jeff Marks, managing director, corporate finance advisory, at J.P. Morgan.

"Multiples are up a bit, but price/earnings ratios are up quite materially," Marks said. "Nevertheless, the new U.S. law was still being codified, so analysts suggest the market has yet to factor in the impact of specific regulations."

Meanwhile, the boom is expected to continue, despite major uncertainties regarding tariffs and trade.

"Pending any unforeseen impacts, I'd expect the back half of this year to look a lot like the first half of this year," Swan said.

In terms of macro-economic factors, a booming economy and stock market, combined with low interest rates that may not stay low much longer, contributed to the surge in M&A activity.

"Economic growth is back, giving management and boards more confidence in what they are buying and what they are selling," Marks said. Deal volume historically correlates with the performance of the equity market. "Also, there is probably a bit of pent-up demand after the down years in M&A—by volume—in 2016 and 2017," he said.

"Pending any unforeseen impacts, expect the back half of this year to look a lot like the first half."

Big Deals and Bigger Deals

Very large deals have dominated M&A so far in 2018. Bloomberg data shows a jump of 82 percent in transactions valued over $5 billion, compared with the first half of 2017, with the total volume of these deals hitting $1.4 trillion, or 45 percent of the total.

Swan counted at least 35 transactions worth more than $10 billion. The largest deals were in health care, telecommunications, and media/entertainment. In health care, Cigna Corp. agreed to buy pharmacy-benefit manager Express Scripts Holding Co. for $54 billion, and Takeda acquired Shire for $62 billion.

Deals of $5 billion or more made up 45 percent of transaction volume.

In telecom, Sprint Corp. and T-Mobile US agreed to merge in a transaction worth roughly $27 billion. In media/entertainment, Walt Disney Co. bought entertainment assets from 21st Century Fox for $73 billion.

In all three industry segments, "Large companies are seeking to acquire more growth, more vertical integration, and more technology," Swan said. "They are expanding into new industries and new geographies. That, combined with the availability of capital, creates opportunities for these large transactions."

Technological disruption is a particularly strong driving force, as technology becomes embedded in all sectors of business and the economy. "Virtually no industry is immune to the competitive pressures emanating from digital and technology disruption," said Susie Huang, head of M&A for the Americas at Morgan Stanley.[1]

No industry is immune to the competitive pressures emanating from technology disruption.

Cross-border deals are on the rise as well. Swan estimated that of total transaction volume in the first half of the year, nearly 40 percent involved an acquirer and acquiree in different countries. "That is the highest volume of cross-border deals since the first half of 2007," he said. "And this is despite an estimated 40 percent decline in Chinese companies acquiring U.S. businesses, a likely result of political friction combined with real and threatened tariffs."

This continues an increase of cross-border deals in 2017, when these transactions accounted for more than one-third of transaction volume. "In a relatively low-growth environment, inorganic growth is driving strategic dialogue in the boardroom, and you are seeing companies branching into different continents to expand their revenue base," said Colm Donlon, head of M&A for Europe, the Middle East and Africa at Morgan Stanley.[2]

"The frenetic market has made deals difficult for private equity buyers," Swan said. "The volumes we've seen reflect the fact that M&A is being heavily driven by strategic buyers which can pay a premium. Strategic buyers enter the market and outbid private equity firms. That's a win for strategic buyers, but it also drives up valuations."

Nevertheless, there's been a steady increase in the percentage of deals closed by financial sponsors, a trend Swan expects to continue. "We have close to $1 trillion available globally that financial sponsors need to put to work."

New Tax Rules, Uncertainty on Trade

Two other factors are at play in the market: tax changes and trade.

The new tax law has helped boost the economy by putting more money in corporate coffers,[3] but the direct impacts have yet to be felt. "When the law first passed, some feared the limits on interest deduction might dampen leveraged deals," Swan said.

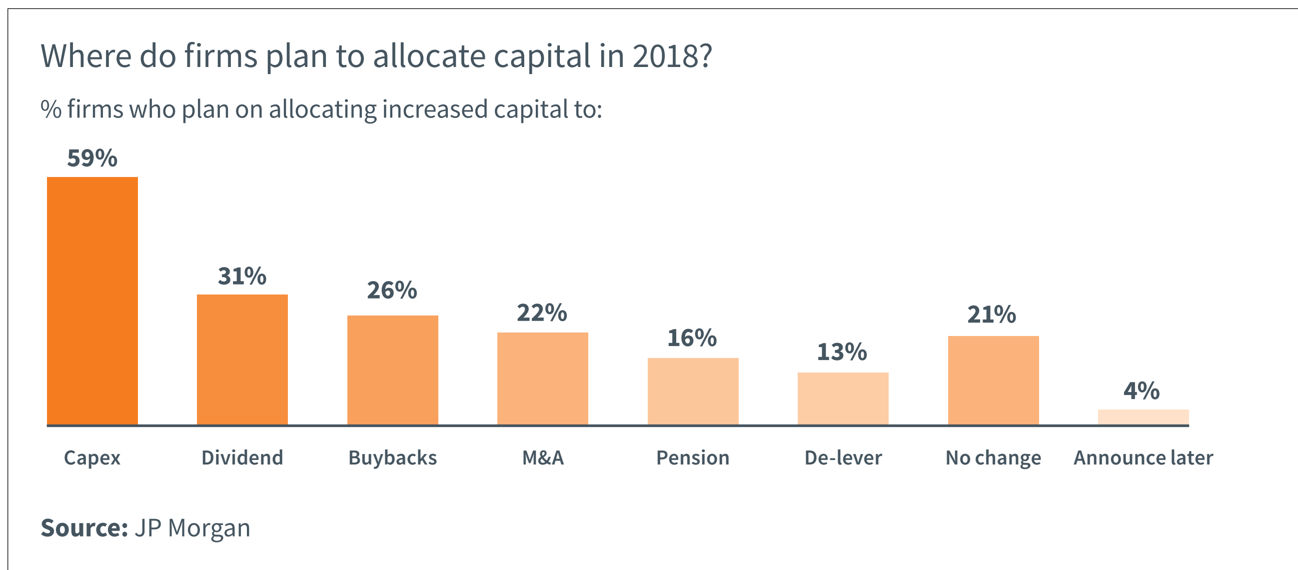
1 Morgan Stanley, "Five M&A Trends Investors Should Watch in 2018," Feb. 6, 2018, https://www.morganstanley.com/ideas/5-acquisition-trends-investors-should-watch-in-2018

2 Ibid

3 Xing Gao, "Tax Reform, Trade Barriers—How M&A Activities Will be Impacted," Bloomberg, June 22, 2018, https://www.bna.com/tax-reform-trade-b73014476798/

"We haven't seen a lot of that yet," Swan said, noting that the regulations to implement many of the provisions in the new tax law are still being written. "We've seen people moving forward with deals, some more aggressively, based on the current tax code."

Still, companies planned to spend the bounty across the board, according to a J.P. Morgan review of earnings announcements and other investor communications from 100 large-cap U.S. companies that mentioned capital allocation plans under the new tax law. Some 59 percent of the firms said they planned to spend the extra cash on capital expenditures, followed by dividends (31 percent) and buybacks (26 percent).



Source: JP Morgan

"By and large, companies are following through with their announced plans for increased spending," Marks said. The most eye-popping outlays, however, were share buybacks, which increased dramatically in the first half. Authorizations were up 52 percent in the first quarter of 2018 and 105 percent in the second quarter, compared to respective quarters in 2017, according to J.P. Morgan data. Apple was a big contributor to those numbers, announcing in May that it would buy back $100 billion in stock.

Stock buyback authorizations were up 105 percent in the second quarter.

In the first seven months of 2018, there were $754 billion in buyback authorizations, according to Goldman Sachs.

"The surge in buybacks is logical because it's the easiest and quickest way to spend money," Marks said. "Other options, such as buying equipment, building factories or hiring new employees, have longer lead times. And increasing dividends has long-term consequences. It's an amount that theoretically compounds forever."

The last time U.S. companies were allowed to repatriate foreign earnings at a lower tax rate, in 2004, they were criticized for spending most of it on buybacks, and similar criticism has surfaced this time. In fact, Apple said it would pay for its planned $100 billion stock buyback from the $252 billion it was repatriating because of tax changes.

However, Marks said that the 2004 American Jobs Creation Act allowed a limited time for repatriation at a lower tax rate and didn't address the underlying problem that led to such cash being "trapped" in the first place. The 2017 law has changed that by lowering taxes and moving the U.S. much closer to a territorial tax system used by much of the rest of the world.

"Repatriated cash is not having a big effect on 2018 M&A," Swan said. "It's not driving M&A activity any more than the cash that was already sitting on corporate balance sheets before the new tax law."

The most unpredictable factor impacting M&A remains the possibility of sustained tariff and trade wars. As tariffs are threatened, imposed, increased, decreased, or removed, it can change the valuation of M&A deals. For example, some companies may find a particular M&A deal makes less sense in light of the recently imposed steel and aluminum tariffs, prompting a decision to drop the transaction, or at least renegotiate it.[4]

So far, though, M&A activity has been relatively immune to the shifting winds of trade. "Such geopolitical issues have historically been enough to cause corrections in the market," Swan said. "Interestingly, in the last 18 to 24 months, these factors have caused only minor and quick corrections. The market corrections happen almost the same day as the latest news."

4 Gao, "Tax Reform, Trade Barriers—How M&A Activities Will be Impacted"

About CohnReznick

CohnReznick LLP is one of the top advisory, assurance, and tax firms in the United States, combining the resources and technical expertise of a national firm with the hands-on, entrepreneurial approach that today's dynamic business environment demands.

Headquartered in New York, NY, and with offices nationwide, CohnReznick serves a large number of diverse industries and offers specialized services for middle market and Fortune 1000 companies, private equity and financial services firms, government contractors, government agencies, and not-for-profit organizations. The Firm, with origins dating back to 1919, has more than 2,700 employees including nearly 300 partners and is a member of Nexia International, a global network of independent accountancy, tax, and business advisors.

For more information, visit [www.cohnreznick.com.](http://www.cohnreznick.com)

© 2018 CohnReznick 0218-JO25280