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Mergers & Acquisitions

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USA

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Overview

Last year saw record U.S. deal activity, easily topping even pre-financial crisis levels. Total volume of announced M&A transactions involving U.S. targets rose to approximately $2.3 trillion, an increase of 64% from 2014, and of 49% from the previous high set in 2007. As in 2014, activity was fuelled by boardroom confidence and a relative dearth of organic growth opportunities. Additional factors contributing to M&A growth were ample liquidity levels, the availability of debt financing at favourable rates, and strong equity markets, permitting strategic buyers to use their stock as acquisition currency. But contrary to the relatively stable economic environment experienced in 2014, the second half of 2015 exhibited increasing market volatility, political and economic disruptions in many parts of the world, and the prospect of rising interest rates in the U.S. Nonetheless, the year ended on a strong note with the announcement of several mega-deals, including the merger of equals between DuPont Co. and Dow Chemical Co., and Pfizer Inc.'s acquisition of Allergan plc.

Transactions with a U.S. target represented approximately one half of globally announced deals. Of the ten largest transactions announced worldwide, six involved a U.S. target and seven a U.S. acquirer. Inbound acquisitions grew by 68% to $464bn, the strength of the dollar notwithstanding. This trend reflects the perceived safety of investments in the U.S. and demonstrates the limited impact of currency fluctuations on deal activity. In addition to continued interest from European buyers, Chinese and, to a smaller extent, Indian companies emerged as active buyers of U.S. assets.

It was also another year of mega-deals, with 78 announced acquisitions of U.S. public company targets in excess of $5bn (*vs*. 56 in 2014). Both on a global and on a U.S. level, deal size was the driver of M&A growth, while the number of transactions was relatively flat (approximately 10,000 in the U.S. and 42,000 worldwide in both 2014 and 2015).

Despite the number of large transformative transactions, U.S. companies continued to focus on their core business and used the fertile M&A environment to dispose of non-core activities. Given the availability of eager strategic buyers, these disposals often took the form of sales. Interestingly, the number of announced spin-offs dropped by 42% to 46. At least in part, the decline in spin-offs may be attributed to the prevailing uncertainty over their taxability, exacerbated by the Internal Revenue Service's reluctance to issue private letter rulings.

The role of shareholder activists evolved further in 2015. Not only were several of the aforementioned spin-offs the result of activist pressure, but increasingly activists pushed companies to engage in takeovers or mergers. In a number of cases, company leadership found a way to work with activists, including in the DuPont / Dow Chemical merger, where activist investor Trian Fund Management LP, after losing a proxy fight with DuPont, remained an active and engaged shareholder, even consulting with DuPont (under a confidentiality agreement) in connection with the announced transaction in which DuPont and Dow Chemical – a large chemical company in which shareholder activist Third Point has a significant stake – would merge with the intention to eventually split the combined company into three independent, publicly traded companies.

Hostile and unsolicited activity remained roughly the same in 2015 as it was in 2014 at approximately $300bn, with the number of bids increasing from 30 in 2014 to 36 in 2015. Many of these were comparatively small bids, with only four exceeding the $20bn mark, and only nine exceeding the $1bn mark. Completing hostile or unsolicited offers continued to be challenging. Of the nine offers above the $1bn mark, only three have been successful (turned friendly), while five have been withdrawn, and one remains pending.

Private equity sponsors were once again cautious on the acquisition front, as higher deal multiples and competition from strategics resulted in fewer attractive investment opportunities. Buyout volume decreased by 4.8% to approximately $600bn, with the number of completed deals declining by 8.2% to approximately 3,600. Indeed, most acquisitions by private equity sponsors fell into the category of add-on acquisitions of less than $25m, enhancing the positioning of existing portfolio companies for an eventual exit. Exit activity, meanwhile, continued to be brisk, with deal volume increasing by 10% to approximately $320bn, representing approximately 1,130 transactions (a decline in the number of transactions of 2.4%). Although exits included initial public offerings and secondaries (*i.e.* sales from one to another private equity sponsor), for the most part they took the form of sales to strategic buyers.

Significant deals and highlights

<u>Strategic transactions</u>

In a year of record-breaking deal making, a few deals stood out for their size and complexity. These include:

- In May 2015, Charter Communications Inc. announced its $78.7bn acquisition of the much larger Time Warner Cable Inc. The transaction came about after a series of failed approaches by Charter over a two-year period, and the termination of Time Warner Cable's agreement with Comcast Corp., which had faced significant delay at the Federal Communications Commission. As transaction consideration, Charter offered Time Warner Cable's stockholders the choice between two different stock and cash combinations. The transaction was coupled with a sale of additional stock to Liberty Broadband Corporation (a stockholder of both merger parties) and with a separate acquisition, valued at $10.4bn, of the cable provider Bright House Networks.
- In November 2015, Pfizer Inc. and Allergan plc announced their combination in a transaction valued at $160bn, the largest announced so-called "inversion" to date, the largest pharmaceutical deal in history, and the third-largest deal in history. The acquisition will be effectuated by merging a wholly owned Allergan subsidiary with and into Pfizer and renaming the Allergan parent company "Pfizer plc". Allergan shareholders will retain equity in Allergan, whose stock will be split 11.3-for-one immediately prior to the merger. Pfizer shareholders will be able to elect between shares and cash; in the event that the aggregate cash consideration otherwise payable would be less than $6bn or greater than $12bn, share and cash elections will be subject to proration. Following the transaction, and assuming an aggregate cash consideration

of $12bn, former Pfizer shareholders will own approximately 56% of the combined entity with former Allergan shareholders owning the remainder.

- In December 2015, DuPont Co. and Dow Chemical Co. announced a merger of equals valued at $68.4bn, the year's largest merger in the chemicals industry, and the fifth largest overall. Following the consummation of the merger, the companies plan to undertake a restructuring, targeting $3bn of annual cost savings, and a subsequent split into three independent public companies. Prominent activists (Trian Fund Management LP and Third Point LLC) supported the transaction, and, as noted above, prior to announcement of the merger, DuPont Co. had defeated Trian in a proxy fight. The deal was also motivated by the need to create efficiencies in an environment of falling commodity prices.

Private equity

As noted, private equity-backed acquisitions were muted. Noteworthy are two outsized add-ons:

- In March 2015, H.J. Heinz Company, owned by the Brazilian private equity sponsor 3G Capital and Berkshire Hathaway Inc., announced its acquisition of Kraft Foods Group, valued at $54.7bn. In connection with the deal, the owners of Heinz invested another $10bn to fund a special dividend to Kraft shareholders. The deal closed in July 2015. The combined company continues to be listed, with Heinz's former shareholders owning 51% of its stock.
- In October 2015, Dell Inc., which was taken private by Silver Lake Partners and founder Michael Dell in 2013, announced its $65.8bn acquisition of EMC Corp. Consideration consisted of a combination of cash and, somewhat rare, tracking stock intended to track the performance of Dell's post-closing economic interest in the business of VMware, EMC's publicly traded subsidiary.

Notable private equity exits include:

- TPG Capital's sale of generics drug maker Par Pharmaceutical Holdings Inc. to Irish Endo International PLC in exchange for a combination of cash and stock, valued at $8bn, announced in May and closed in September 2015. Par had also considered going public, having filed for an IPO in March 2015. Endo had become an Irish company in 2014 in connection with its merger with Paladin Labs Inc.
- KKR & Co.'s initial public offering of the provider of payment technology solutions First Data Corporation in October 2015. Raising $2.6bn sufficed to make it 2015's biggest initial public offering.

Unsolicited transactions

Given the aforementioned difficulties in executing a hostile offer, the three successful offers in excess of $1bn deserve mention:

- In July 2015, health insurance provider Cigna Corp. agreed to be acquired by Anthem Inc. for $54.2bn in cash and stock, after rejecting Anthem's $47bn bid in the preceding month. The initial offer represented a 29% premium, the final offer a 38% premium over the unaffected stock price.
- After a five-month standoff following an uninvited offer, rare disease drug maker Shire PLC of Ireland and U.S. target Baxalta Inc. agreed in January 2016 on an acquisition for cash and stock valued at $32.5bn. Initially, Shire PLC had made an all-stock offer worth $30bn, a 36% premium over the unaffected stock price, vs. a 43% premium implied in the negotiated offer.
- Also in January 2016, following a six-month pursuit, Media General Inc. agreed to be acquired by Nexstar Broadcasting Group Inc. for a combination of cash and stock

valued at $2.3bn. The deal is sweetened by a contingent value right which could generate another $549m for Media General's stockholders. Nexstar had made three prior offers with implied premiums of 30–41% over the pre-announcement stock price. The negotiated offer represents a premium of 58%.

A pending situation of interest is Canadian Pacific Railway Ltd.'s unsolicited offer to acquire Norfolk Southern Corp. Following rejection of an offer made in November 2015, Canadian Pacific has twice revised its offer, now consisting of cash, stock and a contingent value right. This offer is another example of the growing clout of activist investors: In 2012, William Ackman's Pershing Squire Capital LLP ousted the majority of Canadian Pacific's board, and, as Canadian Pacific's largest shareholder and a director, is now advocating for the acquisition of Norfolk Southern. The offer faces intense regulatory scrutiny and opposition from both lawmakers and unions.

Key developments

<u>Case law developments</u>

Two Delaware Supreme Court decisions in 2015 reinforced that Delaware law is deferential to the decisions of disinterested, well-informed boards acting in good faith:

- *In re Cornerstone Therapeutics Inc. Stockholder Litigation* deals with the applicability of exculpatory charter provisions to transactions that are subject to entire fairness review (a heightened standard typically requiring defendants to prove fairness of a deal's price and process). Plaintiffs had argued that such charter provisions should not shield directors against breach of fiduciary duty claims where the standard of review is entire fairness. The Delaware Supreme Court held that directors should in fact be shielded by such provisions, regardless of the applicable standard of review, unless the plaintiff pleaded facts supporting a rational inference that the director breached the duty of loyalty or engaged in other non-exculpated conduct.
- In *Corwin v KKR Financial Holdings, LLC* the Delaware Supreme Court confirmed that an uncoerced, fully informed vote of disinterested stockholders in favour of a challenged transaction provides an independent basis to invoke the business judgment rule, insulating the transaction from all attacks other than on the grounds of waste, irrespective of whether the stockholder vote was voluntary or statutorily required. This decision eliminated the uncertainty, created by an earlier case (*Gantler v. Stephens*), as to whether the business judgment rule is only invoked by voluntary stockholder votes or also by statutorily required votes, such as, in particular, merger votes.

Another Delaware Supreme Court decision that received widespread attention in 2015 was *RBC Capital Markets, LLC v. Jervis (Rural Metro)*. Here, the Delaware Supreme Court held that third parties, such as financial advisers, may be liable for aiding and abetting a breach of the duty of care by misleading the board or creating an informational vacuum. In this case, the financial adviser, by failing to disclose its conflicts of interest, had been found to have perpetrated a fraud on the board, intentionally duping and purposely misleading the directors into breaching their duty of care. The Court emphasised that the abetting party must act with scienter, and that the court's holding is a narrow one, not to be read expansively.

Throughout 2015, and continuing in early 2016 with the decision *In re Trulia, Inc. Stockholder Litigation*, the Delaware Court of Chancery demonstrated increasing reluctance in approving settlements of stockholder lawsuits that exchange supplemental disclosures against a broad release of claims against defendants. In the *Trulia* decision, the Chancery Court noted it would disfavour disclosure-based settlements, unless: (i) the supplemental disclosures addressed a plainly material misrepresentation or omission; and (ii) the release was narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process.

Shareholder activism and corporate governance

As noted above, shareholder activists continued shaping M&A activity. Often, companies attempted to preempt shareholder activist demands by engaging in strategic reviews and resulting M&A transactions, before coming under activist attack. In addition, companies were quicker to settle with activists, sometimes agreeing to appoint activists or their nominees as directors in as little as days or weeks following public disclosure of the activist's position in the company's stock. Well-established activists were even able to secure board seats without running a proxy contest.

A hot topic on the governance front was proxy access, with at least 116 companies having received shareholder proposals seeking a proxy access bylaw. These proposals typically entitle shareholders owning a minimum of 3% (or sometimes 5%) of a company's shares for three years to gain access to the company's proxy statement for nominees for up to 25% of the number of directors. By the end of 2015, approximately 125 companies had implemented such type of bylaw, with more expected to follow.

Antitrust enforcement

Antitrust regulators, the Federal Trade Commission and the Department of Justice, continued on their path of aggressive enforcement, initiating court challenges to block seven transactions and requiring remedies in 23 others. Four deals were abandoned due to antitrust challenges, notably among them General Electric Co.'s contemplated $3.3bn sale of its appliance business to Sweden's AB Electrolux. In July 2015, the Department of Justice had sued the parties to block the sale. After five months of litigation and four weeks of trial, less than a week from the trial's scheduled conclusion, General Electric elected to terminate the agreement in December 2015, triggering Electrolux's obligation to pay a $175m reverse termination fee. The tougher regulatory environment of recent years certainly warrants particular attention in determining outside dates and structuring termination fees.

Industry sector focus

Activity abounded across sectors, with healthcare, technology, and energy and power among the most active.

Healthcare

The healthcare sector saw a plethora of pharmaceutical deals, often driven by a need for new drugs and drug pipelines, given patent expirations on blockbuster drugs and the duration and costs related to research and development, and drug approval processes. Two landmark transactions were described above (Pfizer / Allergan and Shire / Baxalta). As a sign of the level and pace of activity in the pharmaceutical space, several of the participants of these transactions engaged in multiple other deals throughout the year. For example, in February 2015, Pfizer Inc. announced the acquisition of Hospira, Inc., a leader in injection and infusion technologies and biosimilars, in a deal valued at $17bn; the transaction closed in September 2015. In July, Allergan announced the sale of its generics business to Israel's Teva Pharmaceutical Industries for $40.5bn. Shire made no fewer than four other significant acquisitions in 2015, ranging in value from $70m to $6bn.

The implementation of the Affordable Health Care Act created consolidation pressures in the health insurance industry. Notable deals include the Anthem / Cigna transaction mentioned above. In July 2015, shortly before Anthem's and Cigna's announcement of a negotiated agreement, health insurance provider Aetna Inc. agreed to acquire Humana Inc. in a cash and stock deal valued at $34.6bn.

Last but not least, 2015 saw significant activity involving drug store operators. In May 2015, CVS Health Corp., the second-largest pharmacy chain in the U.S., agreed to acquire Omnicare Inc., a leading provider of pharmacy services, in a transaction valued at $12.7bn, a vertical combination expanding CVS's distribution channels. The transaction closed in August 2015. And in October 2015, Walgreens Boots Alliance Inc. agreed to acquire Rite Aid Corp. in a transaction valued at $17.2bn, a combination between two operators of drug stores. Both transactions were all-cash deals.

Technology

Deals in the technology sector were driven by the prospect of gaining scale, and pressure to consolidate in areas experiencing lower growth and profitability. In addition, a number of smaller transactions were motivated by the desire to acquire new technologies. A notable example of a combination targeting scale is NXP Semiconductors NV's $11.8bn cash and stock acquisition of Freescale Semiconductor Ltd., announced in March and closed in December 2015. The transaction created the biggest semiconductor supplier in the automotive industry. It also constitutes one of the largest private equity exits in 2015, Freescale having previously been owned by a consortium of private equity sponsors. Generally, the semiconductor space saw a flurry of merger activity in the past year.

Energy and power

In an environment of depressed oil prices, the midstream and oil field services sectors saw the biggest activity in the U.S. energy space. The year's biggest midstream deal was Energy Transfer Equity LP's acquisition of The Williams Cos. Inc. valued at $37.7bn, announced in September 2015. Shareholders of The Williams Cos. can choose between a combination of stock and cash and an all-cash offer (with the cash component being subject to a certain cap, and cash elections to be prorated to the extent the cap is exceeded). Only three months earlier, The Williams Cos Inc. had rejected a $48bn offer from Energy Transfer – evidence of how the commodities bear market affects deal-making. Notable among oil field services transactions is Schlumberger Ltd's $14.8bn acquisition of oilfield equipment maker Cameron International Corp., announced in August 2015, for a combination of cash and stock.

The year ahead

As we move into 2016, the key ingredients for healthy M&A activity stay in place, including a desire for non-organic growth, as well as ample liquidity. Similarly, some of the consolidation pressures contributing to 2015's record activity have not abated, among these the continuing slump in commodity prices. Furthermore, as the M&A cycle matures, a reduction in available acquisition targets may pressure strategics to move faster or increase their appetite for unsolicited activity.

At the same time, there clearly are headwinds based on economic and geopolitical factors, as evidenced by China's economic woes and the resulting global market disruption. These headwinds may put a lid on deal activity, but may also work out to create attractive acquisition opportunities – in particular for players, such as private equity sponsors, that were reluctant to invest at the comparatively high valuation levels prevailing through much of 2015.

On balance, market and industry conditions augur well for another notable year of M&A activity.

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