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2019 U.S. and Global M&A Outlook: Despite Mounting Headwinds, Potential Remains for the New Year

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Mergers and acquisitions activity in the U.S. and globally was again robust in 2018. Despite concerns early in the year that activity could be dampened by emerging worries over trade, rising interest rates and global political uncertainties, deal activity remained resilient, facilitated by relatively stable equity markets and readily available financing that prevailed for a significant portion of the year. However, the pace of activity slowed over the second half, particularly in the fourth quarter as market volatility grew and financing markets tightened.

The value of announced transactions in 2018 increased substantially from 2017, with global transaction volume of over $3.5 trillion, and U.S. volume of approximately $1.5 trillion, up roughly 11.5 percent and 15.4 percent, respectively, from 2017, according to Mergermarket. While not record-setting, these volume levels are close to the high-water marks of 2015 and 2007. The number of "megadeals" — the majority of which were announced in the first six months of the year — was notable, with at least 36 deals having a transaction value in excess of $10 billion. The number of transactions with an announced value greater than $5 billion increased substantially both globally and in the U.S., and accounted for over a third of M&A value. Notably, while average deal values increased from the prior year, the number of transactions was down.

Activity was again driven primarily by strategic transactions, as corporations continued to be willing to make substantial investments to respond to the imperatives of growing earnings and enhancing competitive platforms by augmenting technological capabilities, product offerings and geographic reach. Private equity (PE) activity picked up early in the year as financial sponsors sought to deploy record levels of available capital into bigger transactions, although activity moderated in the second half.

Selected 2018 Trends

Seeking Scale. Many of the large transactions in 2018 involved expansion by companies in their existing industries, seeking to grow customer base through horizontal transactions and to broaden offerings to existing customers through vertical acquisitions. This strategy of pursuing revenue and

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margin growth through scale is a perennial driver of merger activity but was notable in 2018 because it drove a number of sizeable transactions, as even large companies sought significant deals capable of moving the needle in industries as diverse as health care, technology, media and industrials.

Impact of Disruption. Technology's potential to significantly alter business models and reshape entire industries, and its impact on the M&A market, was one of the most significant trends to emerge in this M&A cycle. Acquisitions of technology businesses by nontechnology companies, and acquisitions of new technology by technology businesses, contributed significantly to 2018 activity levels in the U.S. and globally.

Activism. Activist funds continue to have a meaningful impact on corporate strategic activity. Assets under management at activist funds remain high, the number of campaigns and amount of capital being deployed continue to mount, and the influence of large U.S. funds beyond North America continues to grow. 2018 saw numerous campaigns seeking to pressure corporations to pursue strategic changes, most frequently including board change and M&A initiatives such as sale of the company, or the sale or spin-off of businesses. Consistent with trends in recent years, a significant number of campaigns were pursued by first-time activists and "occasionalists." Traditional institutional investors took a vocal role, providing their views through engagement with both those in management and activists. Deal activism, in which activist funds seek to renegotiate price (known as "bumpitrage") or stop a transaction altogether, was pursued at both targets and acquirers. Continued market volatility provides both opportunities and challenges for activist funds. Given the prevalence of activism and the potential for unsolicited activity on the part of strategic acquirers, boards and management teams must be prepared, particularly in the context of considering transactions.

Decreased Acquirer Shareholder Support. Shareholders of target companies have been less supportive of transactions than they were earlier in the cycle, reflecting growing concerns over strategic fit, asset prices and leverage levels. Excess returns for acquirer shareholders upon transaction announcement have been in decline for several years, reversing the trend of positive returns on announcement of these transactions experienced earlier in this M&A cycle. Coupled with increasing activist challenges to transactions (and strategies seeking profit from transaction withdrawal), this has caused transaction parties to tread more cautiously.

Private Equity. In recent years, private equity firms have struggled to find attractive targets and compete with strategic acquirers. In 2018, however, private equity seemed to once again find greater success in sourcing deals. Sitting on more than $1 trillion of dry powder in 2018, these firms were willing to take on larger transactions, particularly in the first half of the year. Globally, leveraged buyouts activity for the year was up by over 25 percent in value. Private sources of capital in addition to traditional PE firms such as family offices and multifamily funds likewise were active players in the M&A arena. In 2019, private capital buyers may benefit from opportunities created by equity market volatility. However, if challenges in leveraged financing markets continue into the new year, that could affect the ability to take advantage of some of those opportunities.

Regulatory. There has been significant focus over the past year on regulatory challenges to merger transactions, primarily involving antitrust/competition and national security approvals. In the antitrust/competition arena, regulatory agencies have brought several high-profile merger challenges in the U.S., Europe and China; however, it is unclear at this point if these are attributable to changes in enforcement policy, a function of corporations pursuing more aggressive transactions or other factors. (See "US and EU Antitrust Enforcers Remain Active and Aggressive, With Some New Wrinkles.") New or revised regimes for national security review of transactions in a number of jurisdictions, coupled with heightened scrutiny of sensitive acquisitions, have created greater uncertainty and increased the challenges associated with completing cross-border transactions in certain industries. (See "Foreign Investment Control Reforms in Europe.")

Looking Ahead

Notwithstanding the robust level of M&A activity in 2018, cautionary signs have appeared in the market. Activity slowed meaningfully later in the year, with the value of transactions in the second half being more than 25 percent lower than the first-half value, and fourth-quarter value of approximately $700 billion being the lowest level since 2013. The decline in transaction volumes in the second half of the year, particularly in the fourth quarter, is a concerning sign, as is the decrease in number of transactions compared to 2017. As we move later into the market's current cycle, there is a mounting sense of nervousness that what were once viewed as potential concerns have become issues of more immediate importance. Some of these headwinds include apprehension over the duration of the economic cycle and the growing consensus that the rate of economic growth will slow in the coming year; trade and tariffs; increased equity market volatility; rising interest rates; and increased volatility in leveraged loan markets and tightening of borrowing conditions. (See "Enhanced US Export Controls and Aggressive Enforcement Likely to Impact China" and "US Capital Markets Face Uncertainty Entering 2019, With Volatility Likely to Continue.")

At the same time, several factors suggest significant M&A activity can continue in the coming year. Most importantly, the strategic imperatives to grow earnings and optimize business platforms driving corporate merger activity in the past few years have not diminished. Furthermore, activist funds are continuing to pursue platforms involving the sale of public companies or the disposition of their businesses (reinforcing companies' pursuit of corporate clarity through the sale or spin-off of noncore businesses). Corporate buying power remains high, with access to significant balance sheet cash and to the debt financing markets, although there have recently been challenges in leveraged loan/high-yield markets. Finally, private equity buyers remain anxious to deploy substantial capital. Absent meaningful deterioration in fundamental economic conditions or sustained disruption of access to deal financing, these drivers should continue to support significant transaction levels in the coming year.