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US M&A Outlook: Rebounding Market Fuels Optimism for Deal Activity in 2021

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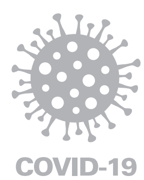
After nearly a decade of growth, global M&A activity in the first quarter of 2020 was down 39.1% by deal value year over year — comparable to levels seen in the first quarter of 2008, in the midst of the financial crisis. The chilling effects of the COVID-19 pandemic in the first half of the year translated to a significant backlog of M&A transactions. Approaching the end of 2020, however, dealmaking returned in full force, despite the ongoing human challenges imposed by the pandemic. Coupled with cautious optimism around the effects on dealmaking from the new administration, record special purpose acquisition company (SPAC) capital formation, favorable financing trends and the likely continued benign interest rate environment for the foreseeable future, we believe that evolving conditions support a strong 2021 for U.S. M&A.

The dramatic decline in M&A activity around the globe in the early part of the year was largely attributable to the staggering effects of the pandemic, including the restrictive public health measures many governments worldwide adopted in response to the crisis. The U.S. M&A market suffered one of the steepest declines in activity of any region in the first six months of the year, with U.S. deals declining by approximately 70% compared to the same period in 2019 and representing just one-third of global M&A by deal value (down from over 50% in 2019).[1] During the same period, global M&A activity declined 53% by aggregate deal value and 32% by deal volume, year over year.

In the second half of the year, U.S. deal activity jumped more than 400% by value between the second and third quarters (a 38% increase year over year), and U.S. M&A once again represented nearly half of global deal value for the full year, in part as a result of pent-up demand from the early stages of the COVID-19 pandemic. Large deals (those valued at $5 billion or more) had a resurgence in the second half of the year, with seven megadeals ($10 billion or more) announced in the third quarter. Eight of the 10 largest deals by transaction value announced in the U.S. in 2020 were in the technology and life sciences sectors, showing the resilience of these sectors in the face of the pandemic.

Selected 2020 Trends



Terminations and Withdrawals

COVID-19 resulted in a spike in deal withdrawals and terminations in late March 2020 globally, with many acquirers having buyer's remorse as business deteriorated for targets as a result of the pandemic. By the end of June 2020, more than $100 billion of U.S. M&A deals had been terminated. Interestingly, the value of terminated deals during the first half of 2020 was only slightly up from the same period in 2019 ($94.8 billion) and down from the same period in 2018 ($152.64 billion), indicating that the aggregate effect of COVID-19 on deal terminations may not have been as significant as initially suspected. Some delayed or disrupted transactions ultimately moved forward with adjustments to pricing terms.

1 Sources for the data in this article are: Mergermarket M&A Report, Bloomberg, Deal Point Data, S&P Global Market Intelligence, SPACInsider.com, Lazard, Activistmonitor and PitchBook.

Unsurprisingly, M&A practitioners adapted by introducing explicit contractual provisions to allocate deal risk resulting from COVID-19. While a limited number of transaction agreements signed in February 2020 (such as the agreement between E*Trade and Morgan Stanley) reflected a "pandemic exception" to the definition of material adverse effect (MAE), once the effects of the COVID-19 pandemic became apparent, MAE provisions routinely began to clearly and specifically exclude effects resulting from the outbreak or spread of COVID-19. Interim operating covenants now regularly provide some degree of flexibility for targets in responding to the pandemic, for example, including actions necessary to protect the health and safety of employees or others having business dealings with the company. However, the specific details and general scope of such flexibility are varied and the subject of significant negotiation between the parties, as alleged breaches of these covenants are often the basis acquirers assert when seeking to walk away from a signed deal. We expect practitioners to continue to allocate pandemic risk in 2021 and beyond.

Biden Administration

In the U.S., the new administration's impact on M&A is still an open question. Many dealmakers had been taking a "wait-and-see" approach; however, now that the results of the election are known and the Democratic Party will control both chambers of Congress, many are cautiously optimistic about the effects of the new administration on U.S. M&A, particularly if tight congressional majorities and macroeconomic trends restrain dramatic regulatory changes. Many M&A professionals expect that there may be regulatory developments, in areas such as antitrust and national security, that could have some impact on, but are unlikely to fundamentally change, the overall dealmaking environment under the new administration.

How aggressive the federal antitrust agencies are likely to be will largely depend on whether President Biden appoints moderate or progressive enforcers. Typically, change comes more slowly at the Federal Trade Commission (FTC) than the Department of Justice (DOJ) because the president has to wait for openings on the five-member commission before new ones can be appointed. However, due to the recent announcements that Republican Chairman Joseph J. Simons will be resigning on January 29, 2021, and Democratic Commissioner Rohit Chopra will be nominated to head up the Consumer Financial Protection Bureau, President Biden will have at least two slots to fill and can thereby flip control of the FTC to the Democrats. (See "Transition From Trump to Biden May Bring Less Change to Antitrust Enforcement Than Expected.")

In terms of industry-specific enforcement, federal agencies and the Biden campaign have indicated that the pharmaceutical and health care industries may face increasing scrutiny from antitrust enforcers under the new administration. In recent months, the technology sector, particularly where some of the industry's largest players are concerned (further highlighted by the antitrust lawsuits filed in recent months against Google and Facebook by the DOJ and FTC, respectively), has faced bipartisan scrutiny that is expected to continue under the new administration.

Similarly, the enhanced oversight of Chinese takeovers of U.S. companies by the Committee on Foreign Investment in the United States (CFIUS), which was a priority under the Trump administration in 2020, is expected to continue under the Biden administration (though the tone with respect to Chinese investors seems likely to soften under the new administration). (See "US-China Trade and Enforcement Issues: What's Next?")

Although President Biden proposed a number of fundamental changes to the tax code during his campaign — including, most notably, significant increases to tax rates — even with a Democratic-controlled Senate, drastic changes to corporate tax law may be unlikely until the economy recovers from the effects of the pandemic. (See "Growing Complexity in the Tax Aspects of Transactional Negotiations.")

Year of the SPAC

2020 was a banner year for SPACs, and 2021 shows no sign of slowing. SPAC IPOs in 2020 left over 200 post-IPO SPACs actively searching for targets, which most are required to find within the first two years after the initial public offering (IPO). The popularity of SPAC transactions had been gradually increasing in recent years, but the onset of the COVID-19 pandemic, coupled with perceived inefficiencies in the traditional IPO market, appears to have acted as a catalyst to the meteoric rise in the popularity of SPACs. (See "The Year of the SPAC.")

In 2020, SPACs raised over $75 billion, in the aggregate, across 247 completed IPOs (compared with $12.01 billion raised across 59 IPOs in 2019). The average SPAC IPO size increased from $230.5 million in 2019 to more than $334.8 million. In July 2020, Pershing Square Tontine Holdings, Ltd. became the largest SPAC following its IPO, raising $4 billion. The record-breaking number of SPAC IPOs led to several other 10-figure transactions in 2020, including Opendoor Labs, Advantage Solutions and QuantumScape Corporation.

This increasingly competitive market for business combination targets has changed the way that de-SPAC transactions are negotiated and structured, however, with potential targets running competitive sale processes that resemble those of more traditional M&A auctions. As a consequence, there has been a growing focus by potential SPAC transaction partners on the SPACs themselves, including the amount of cash the SPAC raised in its IPO and holds in trust, the reputation of the sponsor or sponsors, actions SPAC sponsors are willing to take to reduce or restructure their promote, and the ability of the SPAC or its sponsors to raise additional capital (e.g., pursuant to a concurrent private investment in public equity, or PIPE). Some sponsors have even agreed to pre-IPO forward purchase arrangements

— which represent firm commitments to make additional equity investments in the post-business-combination merged company before knowing the identity of the target. There is little doubt that SPACs are likely to be a meaningful driver of activity in 2021.

Shareholder Activism

The pandemic muted the pace of shareholder activism globally in 2020, with 24% fewer campaigns initiated during the first three quarters of the year, compared with the same period in 2019. This decrease in activity (during a time when shareholder activism was otherwise expected to increase) was undoubtedly due in large part to activist concerns regarding the optics of opportunistically undertaking campaigns amid pandemic-related market volatility, while boards and management teams were focused on trying to save their businesses and protect their employees' health and safety. Those who participated in activist campaigns largely shifted their attention in the first half of 2020 from M&A objectives to changes to boards and management as well as operational improvements — only 34% of global activism campaigns launched during the first half of the year featured M&A objectives (down from approximately 47% for the same period in 2019).

As U.S. deal activity began to increase in the third quarter, however, activists began to again focus on M&A objectives. While U.S. shareholder activism for the third quarter remained down overall (64% lower than in the third quarter of 2019), a rebound in activist campaigns occurred in the fourth quarter, as M&A activity levels continued to recover from their COVID-19-related collapse. Shareholder activism in the U.S. is expected to continue to pick up during the 2021 proxy season as the economy stabilizes and M&A activity rises toward pre-pandemic levels.

Private Equity

U.S. private equity deal activity experienced a sharp shock toward the end of the first quarter when the COVID-19 pandemic derailed sponsor exit processes. However, the last few months of 2020 showed a strong rebound, with the promise of continued acceleration of M&A involving financial sponsors well into the new year. Many of the transactions that were put on hold in the first and second quarters were reactivated by the end of the third quarter, and sponsor buyout activity by aggregate deal value rose year over year for that quarter. By the end of the year, U.S. private equity deal activity saw 5,309 transactions worth a combined $708.4 billion close — down 3.4% by deal count and 7.3% by aggregate deal volume compared to the same period in 2019. But the momentum gained during the second half of the year indicates dealmakers are bullish heading into 2021.

Through the end of last year, there were also fewer private equity exits compared with 2019, though several significant exits via IPOs helped to buoy the aggregate exit value for the year (which ended up from 2019) as capital markets begin to recover as well. Following the astonishing boom in fundraising by SPACs, together with their increasing popularity as M&A counterparties for private targets, some private equity firms are beginning to see SPACs as a way to employ dry powder, with some general partners becoming SPAC sponsors and others agreeing to exit portfolio company investments via de-SPAC transactions.

Technology M&A

Technology M&A continued to be strong in 2020, as the level of the pandemic's impact on the sector was less severe than on other industries. Deals in the technology sector were the largest segment of deal value both globally and in the U.S.: Technology deals made up approximately 19% of all global deals and 28% of all U.S. deals. While many other sectors were down in M&A activity in the U.S. in 2020, technology M&A was up 57% from 2019. The largest U.S. deal in 2020 in the technology sector was AMD's acquisition of Xilinx for $35 billion. The strength of technology M&A can largely be attributed to the continued demand for technology products. For example, the number of fintech M&A deals accelerated in 2020, no doubt buoyed in part by the shift in consumer behavior away from traditional in-person methods and toward digital financial technologies. The largest digital health technology deal ever, Teladoc's acquisition of Livongo, was completed in 2020, and there is likely to be further M&A activity in the digital health technology space as a result of the pandemic continuing to push provider appointments with patients onto digital platforms.

We expect a high level of technology transactions to continue into 2021, as the pandemic has not changed the factors that previously made the space attractive and innovations in technology abound. Additionally, the pandemic has accelerated remote working and consuming trends, which will lead to additional combinations between technology companies and companies in more traditional sectors. That being said, as noted above, the impact of antitrust enforcement that is expected to continue in this sector will remain a critical factor in assessing the feasibility of and negotiating technology M&A deals.

Associate Alexandria L. Robertson contributed to this article.