

Investment Insights

UBS Asset Management

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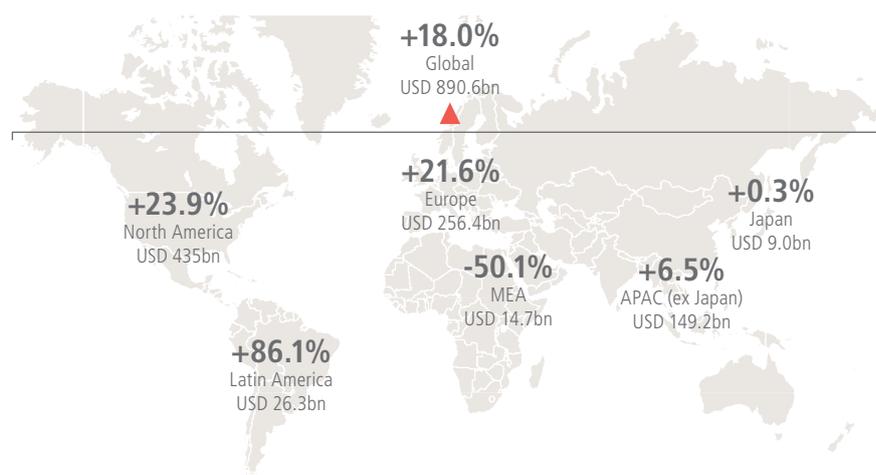
Global M&A activity in the first three months of 2018 was the strongest on record.¹ *Investment Insights* looks at the macroeconomic drivers to this boom in deals, whether they are likely to continue and what this says about the economic cycle.

Booming M&A: what's the big deal?

Erin Browne, Dan Heron

- Global Merger & Acquisition (M&A) accelerating to record levels as cash-rich corporate balance sheets, strong corporate confidence, low borrowing costs combine with robust global growth backdrop to drive deal flow.
- Disruptive technologies, structural industry change are major factors in increasing corporate activity across telecoms, media, IT, healthcare, pharmaceutical and retail.
- Shareholder activism, private equity cash pile increasingly powerful long-term supports to M&A.
- Cross-border deal flow remains strong despite geopolitical risks as digital due diligence tools de-risk M&A and aid integration.
- 2007 revisited? We see structural and strategic motivations rather than synergy-led growth for growth's sake as the major drivers to M&A. Scant evidence of late cycle excess to-date.
- Rising M&A likely to act as ongoing support to global equities.

Exhibit 1: Global M&A Q1 2018 values, % change v Q1 2017.



¹ Mergermarket's Global and Regional M&A Report Q1 2018.

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Source: Mergermarket's Global and Regional M&A Report Q1 2018.

After an 18 month delay due to anti-trust objections raised by the US Department of Justice, the completion of the USD 85bn takeover of media group Time Warner by telecoms giant AT&T in June to create a 'media vertical' is seen by many as opening the flood-gates to further major deals in the telecoms and media sectors. But if the blurring of the lines between traditional media and technology is likely to drive a swathe of other major content and distribution tie-ups, the two sectors are hardly alone in seeing an increase in corporate activity.

According to Mergermarket's Global and Regional M&A Report Q1 2018, the value of M&A globally in the first three months of the year was USD 890.6bn, up 18% yoy and the strongest start to the year since Mergermarket's records began in 2001. With 14 'megadeals' above USD 10bn across business services, energy, construction, real estate and consumer sectors, the figures are notable for their breadth by sector and geography, as well as for their scale. More recent newsflow, including the AT&T/Time Warner decision, suggests no let-up in the pace of activity since the end of Q1.

The key question for investors is whether this M&A boom is a short-term anomaly or something more substantial and sustainable that will influence markets over a meaningful horizon. We believe it is the latter. In truth, the case for increasing M&A globally over the next one to two years was already compelling even before the US government's objections to the AT&T/Time Warner deal were so comprehensively dismissed. Backed by a perfect storm of strong global growth, cash rich corporate balance sheets, low borrowing costs, high levels of corporate confidence and technology-led structural change across industries, 2018 was already shaping up to be a record year of corporate activity.

Return of animal spirits

With global growth rates comfortably above-trend and US economic momentum particularly robust, the demand backdrop certainly appears conducive to deal making and, in our view, is likely to remain so. Corporate confidence in this environment remains high. According to NFIB's Small Business Optimism Index in the US, confidence is at a 34-yr high—helped by all-time highs in some index components including expectations

for business expansion and positive earnings trends.

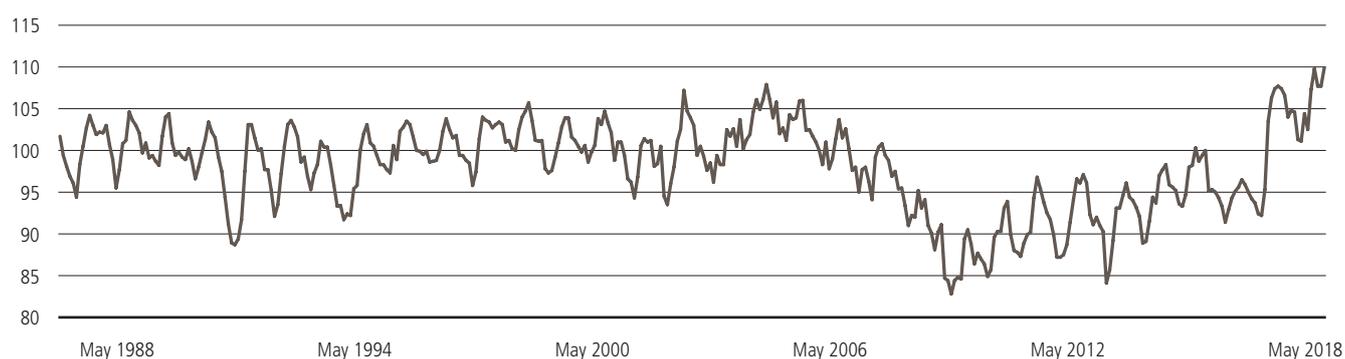
In a recent survey by global consultancy EY, (Global Capital Confidence Barometer, April 2018), some 86% of the corporate and private equity respondents said they expected the overall M&A market to improve over the next 12 months. Strong corporate earnings, particularly in the US, and a belief that credit availability will remain strong are the key ingredients here alongside the return of animal spirits in corporate America. Doing deals clearly involves risk. We therefore see current high levels of corporate optimism as an important support to M&A.

Tax cuts supporting US deal flow

A key driver of US corporate confidence comes from recent tax reform. Indeed, the Tax Cuts and Jobs Act has changed the tax landscape in a sufficiently material way to be a driver of increased M&A activity in itself. In simple terms, the reduction in the federal corporate income tax rate from 35% to 21%, the introduction of a territorial tax system (tax free dividends from overseas subsidiaries), and the provisions for the repatriation of cash held in overseas subsidiaries by US corporates are in aggregate likely to increase cash on balance sheets immediately, in some cases considerably. The tax reform therefore provides additional firepower for M&A deals as well as making domestic US targets more attractive.

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Exhibit 2: NFIB US Small Business Optimism Index at 30yr high



Source: DataStream, UBS Asset Management, June 2018.

Of course, stronger cash balances are also driving higher capital investment in the US. But the tightness of labor markets and common complaints about skills shortages are likely to be playing a major role in altering perceptions about the relative merits of organic versus acquisition-led growth.

Technology disruption: evolve or die

In a recent report by Deloitte, technology acquisition ranked as the number one strategic driver to M&A deals—above expansion of products or services and above expansion into new markets. It is not hard to see why. Just as AT&T's deal with Time Warner was about competing with the fundamental changes to the industry brought about by the progress of Facebook, Google, Amazon and Netflix, digital disruption and structural changes in industries are increasingly major drivers of corporate M&A. It seems highly unlikely that the AT&T/Time Warner tie-up will be the last deal to respond to such structural changes.

In the pharmaceutical industry, the failure of big pharma R&D to deliver an acceptable return on investment has seen the industry cut back on in-house research and turn to acquiring more successful biotech companies to plug patent cliffs and to bolster new drug pipelines. With an aging population, drug and device innovation and a fragmented delivery system, the broader healthcare sector has also seen a sharp increase in deal flow, with private equity particularly active. Amazon's entry into the healthcare and pharmaceutical sectors has hardly gone unnoticed as it seeks to disrupt decades old practices. The prospect of further deals across the sector appears strong.

Technology is also supporting deal flow in less obvious ways. New diagnostic tools assist with M&A integration and reporting. Tools that incorporate Artificial Intelligence (AI) into the due diligence process and that digitize acquisition target screening are helping to reduce potential conflicts, overall deal costs and the time it takes to identify and review potential targets. On the legal side, law firms are already employing AI with the goal of delivering faster and more comprehensive contract review on M&A deals. In reducing the risks involved in M&A, we see these as incrementally positive to potential deal flow over the long-term.

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Private equity dry powder

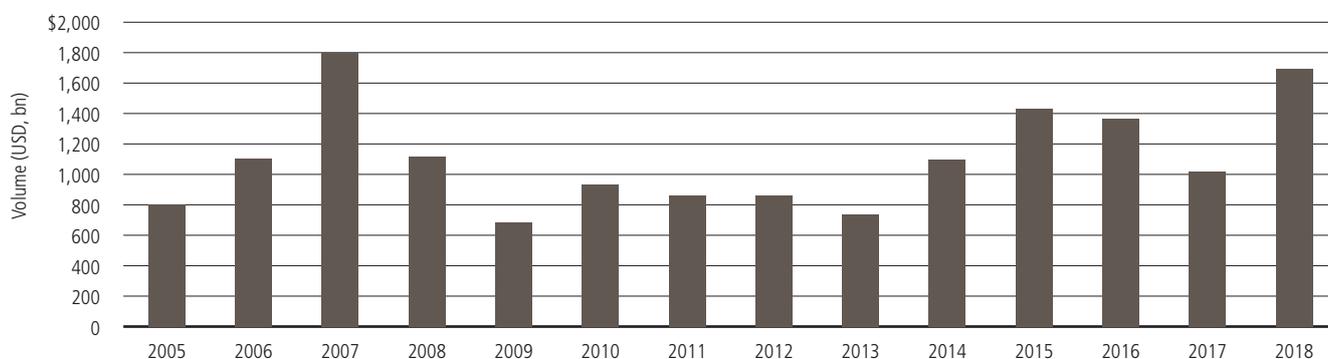
Another major driver to continued strength in M&A markets is the significant firepower of private equity. Having aggressively raised capital over a number of years, the industry is sitting on record cash piles estimated at over USD 1trn (Source: Preqin, as at end Q1 2018). Given the scale of the capital to be deployed, we believe that private equity-driven M&A will continue to be a major support to corporate activity levels in the coming years.

New markets

While ranking behind the acquisition of new technology as a strategic driver to M&A, entry into new markets remains a significant motivating factor in corporate activity. Google's recent acquisition of a 1% stake in Chinese ecommerce group JD.com for USD 550m despite Google's search engine being blocked in China is a case in point. Despite concerns regarding trade tensions restricting capital investment flows, to date the theme of globalization remains strong.

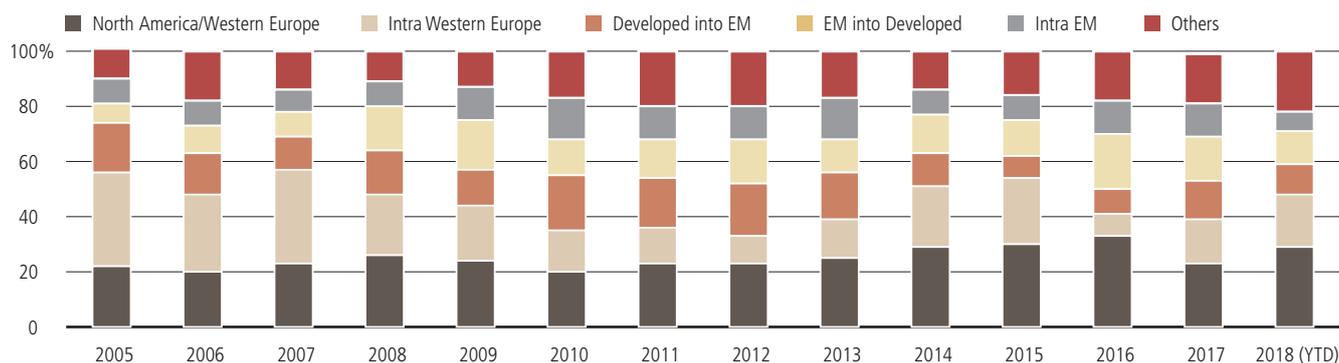
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Exhibit 3: Cross-Border M&A Activity, Volume (USD, bn)



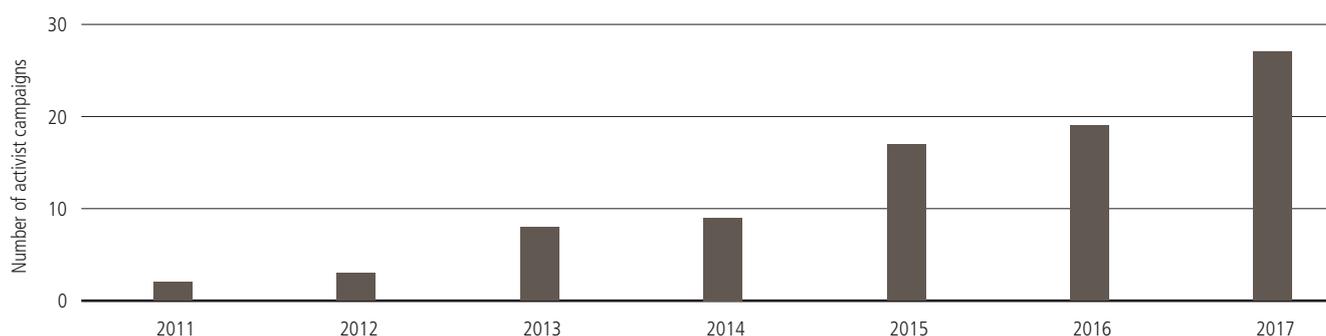
Source: Citigroup, May 2018; 2018 figure is annualised YTD.

Exhibit 4: Cross-border M&A Flows (% of Volume)



Source: Citigroup, May 2018.

Exhibit 5: Number of shareholder activism campaigns in Japan 2011–2017



Source: SharkRepellent, Activist Insight as of December 31, 2017. Note: Represents the following campaign types: Board control and representation, enhanced corporate governance, maximize shareholder value, remove director(s) and vote/activism against a merger.

In the EY Global Capital Confidence Barometer of 2016, just 38% of respondents said they were looking outside of their domestic markets or region to do deals. In the most recent edition of the survey in April 2018, that figure had increased to 63%—reflecting the confidence that corporate executives now clearly feel in cross-border activity to achieve strategic goals. Further data from Citigroup reinforces the point, with

cross-border M&A at a post-financial crisis high despite heightened geopolitical risk and concerns about protectionism (see Exhibit 3).

Rising shareholder activism

Another structural driver to increased M&A is more strident corporate governance and rising shareholder activism. Activists continue to put pressure on companies to either sell

themselves or to divest non-core or underperforming business assets in order to increase value to shareholders. This is not a theme that looks likely to abate any time soon. If anything, we see the trend increasing as the universe for shareholder activism broadens from its prior focus on developed western markets. A key driver to the Japanese equity story has been the scope for improved corporate governance and a greater focus on shareholder value—a trend neatly highlighted in the growth of shareholder activism campaigns this decade.

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Cheap credit—but for how long?

The availability of cheap credit clearly provides its own support to deals in which debt plays a part. While spreads have edged higher in recent months, overall borrowing rates for corporates remain low in an historical context.

Currently we see the biggest risk to M&A in rising geopolitical risks and protectionism.

Nonetheless, rising bond yields in the US and to a lesser extent in other major economies may also serve as a prompt to CFOs that the era of cheap money may not last in perpetuity. In that sense there may be an element of “now or never” for those wishing to take advantage of cheap financing. Our own view is that nominal yields in the developed world will tick higher only very gradually over an extended period given structural deflationary forces. While central banks have started along the long run to policy normalisation, cheap money appears likely to remain supportive to deal flow in the medium-term.

Potential headwinds

We should not dismiss the fact that there are also headwinds to increased M&A. Economic uncertainty and capital market volatility are currently low but can change quickly. M&A valuations do not appear overly stretched in an historical context but should they rise, will clearly present a meaningful hurdle to value creation. Meanwhile, increased regulation remains both risk and catalyst to increasing M&A.

Currently we see the biggest risk to M&A in rising geopolitical risks and protectionism. At the very least, the current stand-off on trade between the US and China is likely to curtail outbound M&A between the two countries in the face of regulatory uncertainty and fears about the prospects for future Sino-US relations. A broadening of trade wars would further increase corporate uncertainty to a degree that could impair M&A flow. Investors need only look to the Chinese regulator’s year long delay in signing off US-listed Qualcomm’s attempt to acquire Dutch semi-conductor manufacturer NXP to see how politics can impact potential M&A.

Late cycle excess?

Of course, many commentators quite rightly point out that a surge in M&A activity has been an indicator of a maturing cycle in the past, signalling a lack of organic growth opportunities that have driven corporates to seek to grow earnings by cost cutting and synergies. The largely debt-funded M&A boom of 2006/7 that preceded the financial crisis is the most recent example of corporate excess at the top of the cycle.

We believe there is some merit in this argument, but point to the breadth of other drivers aside from cost-cutting in the current M&A boom. We would also point out that while the US growth cycle is certainly already long in an historical context, the tax changes may prolong the cycle. In Europe and in the emerging markets however, we would argue strongly that the economic cycle is far from mature.

Overall, we see the case for increasing global M&A over the next year or more as compelling. On balance we see the prospect of rising M&A as a minor negative for investment grade credit, even accepting that this is partially offset by the boost to US credit fundamentals from the repatriation of cash held overseas. Spreads here are already tight. But in aggregate we see the theme as one that is likely to provide a sustained opportunity-set for specialist mandates—as well as representing a meaningful support to wider global equity markets.

Further reading

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