Corporate caution… to the wind

The US tax resolution is expected to increase corporate confidence and fuel M&A activity

Clarity on tax reform restores confidence
In the fourth quarter of 2017 it was clear that many companies were watching and waiting for passage of the Tax Cuts and Jobs Act before moving forward with long-term corporate planning. Ian Read, CEO of Pfizer, put it best in his company's second quarter earnings call last year, stating, "There are short term events in the marketplace, such as tax reform, that may change asset values. Any focus on business development is somewhat delayed by the resolution of that." Certainly, deal activity slowed somewhat in the back half of 2017. However, with the recent passage of the tax bill, this sentiment seems to be dissipating. Greater certainty is likely to embolden corporate leadership to act more decisively, and we believe that the result will be an increased level of mergers and acquisitions (M&A) activity.

60%

of US executives expect larger deals in 2018 versus 2017[1]

USD 225bn

in mergers announced within the first month of 2018—the strongest start to a year in nearly two decades.[2]

[1] Deloitte 2018 M&A Trend Report.
[2] Bloomberg: "Global M&A is having a Moment with Best Start to Year Since 2000." February 1, 2018.

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A repatriation spending spree

Since the tax holiday of 2004 expired, US companies have kept their ex-US cash balances offshore to avoid paying high US corporate tax rates—with the hope of reducing or avoiding taxation on their offshore profits in the event of a tax reform. Under the new tax bill, corporations now have an incentive to repatriate cash at significantly lower tax rates, which will lead to a return of domestic cash on balance sheets. The question remains: what will these companies do with their increased buying power?

Over the past 20 years, corporate share repurchases have been considered a surefire way to boost earnings. However, in recent years, companies actively repurchasing their shares have underperformed the broad equity market by roughly 20%—a signal to corporations to consider other uses for excess cash.[3] A recent M&A survey from Deloitte supports this notion, as M&A was identified as the top potential target for cash reserves—both domestic and repatriated.[4]

40%

of US executives identified M&A as their number one intention for cash reserves[4]

vs.

14%

of US executives identified share repurchasing as their number one intention for cash reserves[4]

Additional factors supporting a strong M&A environment in 2018

- ✓ Strong equity markets
- ✓ Accelerating GDP
- ✓ Flattening yield curve
- ✓ Strong activity in Europe expected to continue
- ✓ Widening Weighted Average Cost of Capital (WACC) spreads
- ✓ Supply / demand imbalance with the exit of proprietary trading desks
- ✓ Record dispersion between market winners and losers
- ✓ Increased pressure for technological advancements
- ✓ Shareholders are receptive to transformative transactions
- ✓ New administration is expected to be more relaxed with respect to anti-trust challenges

> "We believe tax reform in the US will be very supportive of corporate activity and represents an inflection point in the M&A market, as corporate confidence continues to build and offshore cash will be repatriated with new tax incentives. Combined with a supportive market backdrop—including resurgent global economic growth and a healthy deal environment in Europe—skilled managers have the opportunity to take advantage of what we believe is the most attractive merger environment in many years."

Blake Hiltabrand, Head of Merger Arbitrage Research and Senior Portfolio Manager at UBS O'Connor

[3] As of the end of January 2018, performance of the SPDR S&P 500 Buyback ETF since its inception (February 2015) was 20% lower than performance in the SPDR S&P 500 ETF Trust during the same time period.
[4] Deloitte 2018 M&A Trend Report.

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