RPC

Deal Trends in UK M&A

Brexit, Trump and the plummeting Pound. It's been a turbulent first half to FY17, but what does it all mean for dealmaking in the UK?

In a turbulent year of much geo-political change and uncertainty in the UK it is not surprising that dealmaking activity in the first half of 2016 slowed. Investors have generally responded to the UK's referendum on leaving the European Union with a more cautious approach to growth. The shockwaves that reverberated throughout global financial markets were then exacerbated by Donald Trump winning the US presidential election.

The indications are that Q3 has remained strong and there is a continued appetite to close deals. We will have to wait and see if that trend continues for the rest of the year. Q4 is usually very strong for M&A in the UK.

Looking at the data, there was a 54% increase in the number of deals with a disclosed value of more than £25m which completed in July and August 2016, compared to the same two months in 2015 (51 deals vs 35 deals) (source: PWC).

While the overall value of deals decreased from £11.6bn in 2015 to £7.4bn in 2016, this is down to the completion of three £1bn plus mega deals in the technology, media and telecoms (TMT) sector last year. Although the value of TMT deals was down this summer, the combined deal value across all other sectors increased by £2.5bn year-on-year (source: PWC).

The pound, in its weakened state, has instigated a flurry of dealmaking activity by overseas acquirers. A number of UK assets will remain vulnerable to international takeovers due to the circa 20% discount in the pound. Some recovery in the pound has been seen since the US presidential election and the UK's Autumn statement, but longer term analysis predicts a slow recovery.

When we examine who has been acquiring UK assets, this is being led always by demand from the US, but increasingly so from Asia, namely Chinese and Japanese (see further below). The UK remains a very attractive and open country to acquire growth, established brands and talent.

Deal Values - down on a 2015 high, although there is a larger spread of smaller deals. However, there have a been a number of significant deals in the market, with the likes of Softbank's sudden and surprising acquisition of ARM; merger of Hewlett-Packard Enterprise and Micro Focus International to create one of the world's largest infrastructure software companies; and Ctrip's agreement to acquire Skyscanner.

Sectors – private equity activity levels and pipelines are looking strong despite deal volumes having declined. Private equity funds have amassed considerable amounts to invest over recent times, and we should see increased dealmaking activity from them in the market. Life sciences and TMT remain active, although deal values are lower than previously. TMT is looking to keep running off the announcements by Google and Facebook to increase staffing levels and investment in the UK. The infrastructure market has remained steady. Brexit is, however, continuing to have a strong negative impact on deals in the financial services sector. Oil and gas and natural resources also remain in a slump.

Asian acquirers - Asian outbound M&A is expected to continue strongly going forwards as businesses look for sources of growth and products and services to add value to the fast-growing middle class. This is being led by China and Japan, both of whom have differing needs for outbound investment.

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China - is on a journey of transformation and there is a continued flow of cash outbound across the world. The UK continues to welcome Chinese investment as has been demonstrated when the UK Government gave the go-ahead for a new power station at Hinckley Point. Generally, China is now seen as a more sophisticated acquirer and more capable of closing transactions. However, its government is very concerned with capital outflows and at the time of writing has announced restrictions in an attempt to relieve downward pressure on the renminbi and draining foreign reserves. The State Council is most concerned about outbound M&A worth more than $10bn. Deals of $1bn+ will also be scrutinised to check that they are not outside the investor's core business. Finally, State owned enterprises will not be allowed to invest more than $1bn on a single overseas real estate transaction (source: FT). We will have to see how long these restrictions last and how effective they actually will be as some commentators think the money will find its way to where it needs to be for any acquisitions. A slowdown in the outflow of Chinese investment would have an impact on M&A in the UK and across other geographies.

Japan – a country where domestic markets are mature and saturated with very little or no real growth opportunities. There is a continued push to secure growth through outbound M&A. Europe remains a popular destination for Japanese money, and within Europe the UK remains one of the preferred locations. Now that a number of acquisitions of UK businesses by Japanese companies have completed following the Brexit announcement, other Japanese companies will undoubtedly follow suit. Japanese acquirers are generally welcomed as they have a long history of reinvesting profits rather than repatriating them, and growing industries outside of Japan like the automotive sector in the UK.

Launchpad – the UK, with its laissez faire attitude, professional services, time zones, English language, talent pool and an abundance of top Universities has been the launchpad into Europe for many global companies. It has been an enviable beneficiary of foreign direct investment. Whether the UK can continue to be a launchpad remains to be seen. Interestingly, as has been demonstrated by Softbank's acquisition of ARM, where the plan of any acquiring corporate is globalisation, Brexit is less of concern.

To add a note of caution, Bankers talk of a host of concerns that could dampen the current buoyancy in the market: impact of Donald Trump taking office, French and German elections next year, terrorism and euro zone growth.

POTENTIAL IMPACT OF BREXIT ON M&A DEALS

Until the Brexit negotiations are concluded, which some observers feel could take many years, the legal framework in which UK M&A deals are implemented will remain the same. There is a school of thought that some overseas buyers may look to negotiate material adverse change protection in the sale and purchase agreement. This would be in circumstances where there is going to be a long delay between signing and completion, and there is a fear on the side of the buyer that major economic changes like currency fluctuations may have an adverse impact on the economics of the deal by the time it reaches closing.

Cross border mergers between EEA States – the current EU level framework that regulates cross border mergers between UK companies and EEA State companies would not be available post Brexit. The anticipation is that these regulations would form part of the Brexit negotiations.

Takeovers – it is expected that the regime in place to deal with public takeovers will remain largely the same. This is on the basis that the UK Takeover Code that gives effect to the EU Takeovers Directive was mostly in place prior to that Directive. There will not be any need for substantial changes. Shared jurisdiction rules, however, will need to be reviewed to the extent that the UK leaves the EEA.

Private M&A – the expectation is that the legal framework for domestic and many international transactions will remain the same and subject to English contract law. It remains to be seen whether the popularity of English law for international transactions is effectively challenged by other European states. There are a number of specific areas on M&A transactions that may see some minor changes; one being dispute resolution with possible changes to the enforceability of English judgments in EU member states and vice versa. English judgments would require separate recognition prior to enforcement. Some observers are indicating a greater use of arbitration.

INDICATIONS OF PROTECTIONISM AND THE ISSUE OF RECIPROCITY

Recently, there have been a number of acquisitions around the world that have been prevented by protectionist minded governments. Theresa May, as the UK's new Prime Minister, however, has already demonstrated with the approval of Hinckley Point, that the UK will remain an open market. It is expected that the openness of the UK to direct foreign investment will continue to differentiate it from its European neighbours when international acquirers are considering investing in Europe.

A number of Chinese acquisitions in particular have been the subject of tension partly stemming from the lack of reciprocity and concern over ownership of key assets. Very interestingly in the M&A world, assets key to a country's future business are now coming into scope of protectionism.

As reported in the FT on 9 August 2016, Germany is a top target in China's search for innovative engineering groups. Midea, a Chinese appliance maker has made an offer to acquire Kuka, an innovative German engineering company, for €4.5 billion. This offer has caused some concern in Germany as Kuka is a successful company in a strategic sector for Germany's digital future. Gunther Oettinger, the EU's digital commissioner, called on other European companies to make a counter offer, but none came forward. Midea now holds around 94% of Kuka's shares. The German government cannot block this acquisition as Ministers can only intervene to prevent a takeover by a non-EU investor when it involves strategic infrastructure such as energy networks, or defence companies. Kuka does not qualify.

In the USA, a few Chinese deals have fallen foul of the Committee on Foreign Investment. Philip's failed to sell its lighting business to a Chinese-led consortium and Tsinghua Unigroup withdrew from a $3.8 billion investment in Western Digital.

Overall, there are certainly challenging times ahead, but for the UK the dealflow continues apace and we remain a very open and welcoming country for investment. ■

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Head of RPC's Japan Desk, Nigel Collins is a senior corporate lawyer with extensive experience and a deep cultural knowledge of Japan and Japanese business.

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