Client Alert

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2017 M&A Forecast

There is an old Wall Street adage that “the market abhors uncertainty.” This certainly seemed to be the case in the M&A market for much of last year, which saw global M&A volume drop from a record $4.4 trillion in 2015 to $3.6 trillion in 2016, according to Thomson Reuters. And yet, the fourth quarter of 2016 yielded $1.27 trillion of transactions—roughly a third of the year’s total—and October 2016 was the busiest month ever for the US M&A market. In our view, the question of whether 2017 M&A activity continues the rebound we saw from October to December or returns to the downward year-over-year trend from 2015 to 2016 will largely depend on whether we experience the same level of uncertainty in 2017 as we did in 2016.

Sources of Uncertainty

The uncertainty of 2016 and the beginning of 2017 has come largely from political events. First, Brexit, the vote by British citizens in June to exit the European Union, stunned the world and will have wide-ranging implications for international businesses and cross-border M&A activity. Most notably for US companies, Theresa May, the prime minister tasked with steering Britain through the exit process, has called for a clean break with the European Union. That means Britain would not remain a part of the EU common market. As a result, an easy gateway to Europe could soon disappear for US companies.

Britain’s separation from the EU common market cannot occur immediately, but look for companies to begin evaluating how to address the soon-to-be dual markets in Britain and Europe. In particular, after Britain fully exits the EU common market, US companies that have established outposts in Britain—which was the only major English-speaking economy in the European Union and is located relatively closer to the United States than the rest of Europe—may need to consider other ways to access the continent. Different regulations and restrictions on the flow of goods may cause companies to enter or leave one market or the other, which may drive acquisitions, divestitures and general corporate restructuring and M&A activity.

Although not as dramatic as the Brexit vote, global markets will closely watch the two-round French presidential election scheduled for April and May 2017. Marine Le Pen, the leader of France’s far-right National Front party, recently released plans to abandon the euro and possibly follow Britain out of the EU common market. If Ms. Le Pen succeeds in reinstating the franc, the continued vitality of the euro, and possibly even the European Union itself, will be in serious doubt. Ms. Le Pen is not expected to win the election—she leads the polls for France’s first vote, but trails either likely opponent in the mandatory runoff—but, as the US presidential election so recently demonstrated, election results do not always follow expectations.

Notwithstanding the political upheaval in Europe, we expect that the election of President Trump will have the greatest impact on US and global M&A markets in 2017. As we discuss in greater detail below, President Trump’s unexpected victory has the potential to spur M&A volume to new heights if he follows through on his business-friendly proposals. In particular, deregulation of financial institutions and increased spending in the defense sector could spark additional M&A transactions. If President Trump fails to implement many of his proposals, however, or if he adopts protectionist policies that reduce global trade, we may see the M&A market slow as a consequence of dealmakers’ uncertainty.

Taxes and Trade

From an M&A perspective, the most fundamental policy difference between the Obama administration and the Trump administration is with regard to taxes and the effects they may have on investment and trade. What the exact differences will be, however, remains uncertain. M&A activity may be greatly helped or hindered depending on which of several possible changes in tax policy ultimately occur.

Corporate Tax Rate

A very positive change for M&A activity—and one that seems likely to occur—is a lower US corporate tax rate. Lower corporate taxes would increase cash flow for US companies, which would result in more buying power in the M&A market. Lower taxes also could make US targets more attractive to foreign buyers, while simultaneously making US buyers more competitive when bidding against foreign companies. Setting aside all the other tax and policy possibilities discussed below, expect lower corporate tax rates to be a key consideration in companies' evaluation of whether to engage in M&A activity.

Repatriation Tax Holiday

Another potential change that seems likely to increase M&A activity is a so-called "tax holiday" on the repatriation of foreign assets held by US companies. Most estimates place the overseas assets of US companies at more than $2 trillion. Those assets are not subject to US taxes until companies return them to the United States from abroad. When companies repatriate their foreign assets, however, they must pay the full amount of US corporate income tax on those assets—currently 35% for most companies. President Trump has suggested lowering the repatriation tax to 10%, which would almost certainly result in a flood of cash back into the United States. Companies would no doubt use some of that cash to fund increased M&A activity.

Border Tax

One possible deterrent of M&A activity would be the implementation of a "border tax." A border tax would impose taxes on imports but not on exports, with the goal of increasing domestic manufacturing and the volume of exports. The effects of such a tax are difficult—if not impossible—to predict, which, from an M&A perspective, is the problem. There would be winners (e.g., domestic manufacturers) and losers (e.g., retailers that sell large quantities of imported goods) under a border tax regime, but until the details of any potential tax become clear, the effects on a particular business will be difficult to calculate. As a result, buyers might delay acquisitions until the uncertainty is resolved.

Tariffs

Although not necessarily M&A-specific, the potential imposition of tariffs could result in less M&A activity, particularly for larger targets with significant exposure to international trade. President Trump has promised to "get tough" on China, Mexico and other US trading partners, which seems to mean tariffs on imports from those countries. Most economists agree that tariffs or other protectionist trade policies are likely to result in reduced trade and lower economic growth. Unless and until President Trump eliminates that possibility from consideration, we may see buyers hesitant to acquire companies that depend on foreign inputs for their products or are affected generally by the global economy.

Deregulation

Other than taxes, we expect deregulation to have the greatest effect on M&A activity. Early signs—like President Trump's executive order requiring the rescission of two existing federal regulations before federal agencies enact each new regulation—point to the Trump administration's easing regulation in many areas. From an M&A perspective, however, loosening certain securities laws, rollback of the Dodd-

Frank Act, the possible repeal of the Affordable Care Act and a general shift from the promotion of renewable energy to the continued exploitation of low-cost fossil fuels should have the greatest impact.

Securities Laws

Jay Clayton, a securities and M&A lawyer and President Trump's nomination to chair the Securities and Exchange Commission, is widely believed to indicate that the Trump administration will emphasize ease of capital raising over continuing to increase regulation. Mr. Clayton's experience in business transactions departs from that of many previous SEC chairs, whose background was in enforcement. Furthermore, although the Senate has not yet confirmed Mr. Clayton, the SEC has already taken steps to eliminate certain controversial regulations. The SEC first announced that it will reconsider its requirements of annual reporting concerning the use of conflict minerals, which the SEC's acting chairman, Michael Piwowar, recently characterized as "misguided." Mr. Piwowar then announced that he is seeking public comment on difficulties companies may have faced in implementing a rule that requires disclosure of the difference in pay between the CEO and an average worker. The SEC will reconsider implementing the rule in light of comments it receives. And for the first time in 16 years, Congress and the president used the Congressional Review Act to overturn an SEC rule requiring companies to disclose payments made to foreign governments in connection with the commercial development of oil, natural gas or minerals. It seems likely that enforcement of securities laws and regulations will continue to become less strict. This trend should have a generally positive effect on M&A activity, as companies will have an easier time accessing capital markets and consummating transactions.

Dodd-Frank

President Trump has called the Dodd-Frank Act a "disaster," and Steve Mnuchin, the new Secretary of the Treasury, has promised to "kill" parts of the law. President Trump took the first step towards paring back Dodd-Frank in early February when he signed an executive order directing Secretary Mnuchin and other financial regulators to prepare a report on existing financial laws and regulations. That report is virtually certain to conclude that financial regulations are unnecessarily stringent and should be trimmed back. In the short term, at least, loosening the regulations on banks and other financial companies will likely reduce their compliance costs and costs of capital and improve their financial performance. A reduction in regulations might also boost lending, which would allow both strategic buyers and financial sponsors to finance acquisitions more easily.

Affordable Care Act

The Affordable Care Act (commonly referred to as Obamacare) may or may not be repealed fully, but it appears certain to undergo significant changes. Because of the complexity of the health care industry, however, it seems unlikely that buyers will aggressively target health care companies until the industry's future regulatory structure becomes more clear. Potential buyers surely also noted President Trump's comments about "astronomical" drug prices and criticism of overseas manufacturing, which rattled pharmaceutical stocks and may result in fewer acquisitions by the large drug companies. Furthermore, the recent, widely publicized breakups of the Aetna/Humana and Anthem/Cigna mergers on antitrust grounds may curb the appetite of industry participants to participate in large-scale M&A. At least for now, the health care industry seems likely to see less M&A activity as a result of political and regulatory uncertainty.

Energy

President Trump has not been as vocal about the specific changes he intends to make in energy policy, but deregulation appears likely. Most importantly, the Clean Power Plan is out, which will be seen as a positive change for power and utility companies. Next, the subsidies received by renewable energy will be eliminated, which, combined with the elimination of the Clean Power Plan, will help make coal competitive again. Finally, domestic fossil fuel production and transportation will have greater support from the new administration. Against this backdrop of deregulation, however, remains the fact that renewable energy technology continues to improve and will place increasing competitive pressure on the traditional fossil fuel industry. As a result, large energy companies may focus on developing alternative energy sources—including through M&A activity—even without regulations or subsidies that incentivize them to do so.

Conclusion

Notwithstanding the political uncertainty described above, we believe the global economic environment is generally favorable for M&A. Growth continues to be low and stable, monetary policy remains loose and inflation does not appear to be an imminent issue. This economic environment will encourage companies to seek expansion through acquisitions rather than just through organic growth, and they should have little difficulty financing those acquisitions. The 2017 M&A outlook could change in an instant, but for now, however, we are broadly optimistic and look forward to an active year in both the US and global markets.

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