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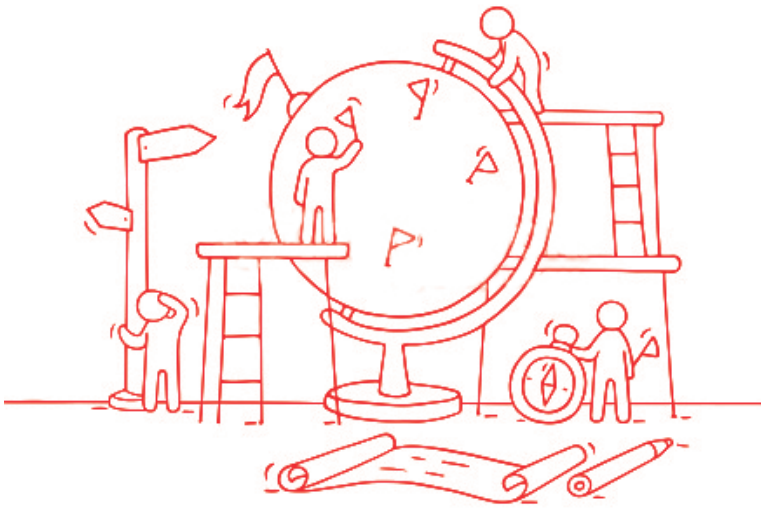

Brave New World

What next for strategic M&A?

Near record levels of M&A over the last 18 months suggest a rosy outlook for the global economy, with companies seeking top line growth through acquisition strategies. Yet those headlines hide a more complicated picture. As global transactions evolve, so do the factors that determine their success. The proliferation of regulation and increasing popular scepticism towards globalisation and its associated business practices, has placed large mergers under the spotlight, with an abundance of stakeholders weighing in from all sides.

As such, dealmakers find themselves facing two distinct challenges: negotiating the transactional complexities themselves and then demonstrating deal value both within and outside the organisation. Here, Baker McKenzie explores strategies for success on both fronts, drawing on conversations at the firm's recent M&A seminar, its work with companies at the coalface of some of the world's largest mergers and its relationships with the regulators who police those deals.

Successfully closing a complex deal is difficult. Putting aside, for the moment, all other considerations, securing clearance from competition authorities alone can be a daunting task. On the one hand, the number of jurisdictions with merger filing requirements is growing steadily and authorities appear increasingly willing to intervene in a deal. In the UK in 2016, 71 mergers were filed and 16 of those deals saw remedies imposed, while another two were abandoned by the merger parties.

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At the same time, however, none of those deals were blocked outright, and tie-ups that reduced the number of players in the market from five-to-four, and even four-to-three, managed to secure regulatory approval. The BT Group/EE merger was approved despite opposition. In reviewing the effectiveness of the UK competition authorities, economists KPMG recently suggested that in some cases, competition authorities have in fact been too lenient, with certain deals, including the tie-up of Zipcar and Streetcar, found to have led to higher prices for consumers.

In the light of these findings, the UK's Competition and Markets Authority (CMA) may consider reforming its merger assessment regime. Global consolidation across a broad range of sectors – from beer, to heavy industry, to chemicals – may therefore feel the glare of even closer regulatory scrutiny in the coming years, and dealmakers should expect higher hurdles to securing competition clearance.

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In this climate, it is now incumbent upon companies to take a more substantive assessment before pursuing a deal that could otherwise amount to little more than a costly diversion for the business. Part of that assessment requires analysing what might be sacrificed to win merger clearance. That is, at what point do potential merger remedies reduce the value and efficiencies of a deal to such an extent that the merger no longer makes commercial sense?

More deals are now being structured to address in the transaction documents the possibility of remedies. Initially, there was a reticence on the part of merger parties to deal with potential concerns so overtly, for fear of raising a red flag with the authorities. In reality, that fear has proven largely unfounded – particularly among more sophisticated authorities – and it has been beneficial for companies to consider who they might sell to and under what terms. Ultimately, this is a commercial decision and a company will benefit from conducting its own due diligence, rather than leaving it to competition bodies.

In addition to tighter merger control rulings, the business community should expect greater cooperation between competition authorities in the coming years. Though this has been a goal of the International Competition Network for some time, post-Brexit, the UK's CMA will be relying on information-sharing, memorandums of understanding and other levers for cooperation from its international counterparts, as it adapts to cope with a vastly increased caseload once the UK no longer falls under the European Commission's 'one stop shop' for large transactions.

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For businesses, this may mean adding the UK to the growing list of jurisdictions where a merger filing is required, but it could also be in their interest to facilitate information sharing across borders, as the worst thing regulators could do with their power is to have disparate impacts in different regions.

Rising protectionism

Of course, the UK's merger control regime weighs the impact of a tie-up on competition in any given market, but it doesn't take account of the social implications of a deal, which are difficult to capture. The national mood, which led the UK down the path to Brexit, has seen far greater scepticism towards globalisation. Before coming to power, Prime Minister Theresa May hinted at the introduction of a new public interest test in merger control, which would weigh considerations other than competition concerns during the merger review process. In July 2016, May discussed the impact of Cadbury's takeover by Kraft, and the near sale of AstraZeneca to Pfizer, stating that companies investing other people's money 'are not the only people with an interest' when firms are sold or closed.

'Workers have a stake, local communities have a stake, and often the whole country has a stake [...] A proper industrial strategy wouldn't automatically stop the sale of British firms to foreign ones, but it should be capable of stepping in to defend a sector that is as important as pharmaceuticals is to Britain,' May said.

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That rhetoric has softened somewhat since May came to power, as the UK attempts to encourage inward investment as it embarks on the Brexit process, yet the notion of an extended merger review remit persists. There are certainly champions for a national interest test, including former business secretary Vince Cable. At present, the UK has additional protections in place only for the defence, media and financial sectors.

Questions abound as to which body would bear the responsibility for this extended merger scrutiny: would this fall to the CMA or to a new and separate body, a British equivalent to the Committee on Foreign Investment in the United States (CFIUS)?

For the business community, new public interest considerations would add another layer of considerations to the merger process. In addition to negotiating the terms of a deal, and assessing what remedies may be applied, companies would also need to consider the public perception and shape a positive narrative for the deal, early in the process, to help allay the risk of government intervention on national interest grounds.

A bigger piece of the pie

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National interest concerns of a different sort extend to the realm of tax, where governments compete on an international scale for lucrative corporate tax spoils. The 'BEPS' measures saw more than 100 countries and jurisdictions collaborating to tackle base erosion and profit shifting – taxation strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.

But country-by-country tax reporting and increased media coverage has shined a light on tax structures and encouraged competition between different tax authorities. What began as a collective endeavour with the 'BEPS' measures, has increasingly become a competitive attempt to win a bigger piece of the tax pie.

The UK's impending withdrawal from the European Union will further complicate that battle: Brexit appears to make the country a less attractive regime for investment, but the UK government has implied that it will do whatever necessary to make the country competitive.

Meanwhile, the election of Donald Trump in the US also brings with it the prospect of major changes in US tax policy and legislation – which would have ramifications far beyond US borders. Mooted changes include sharp cuts to corporation tax and actions to discourage tax inversions by US companies, as well as driving the repatriation of corporate profits held as cash offshore.

This profit repatriation could act as an incentive for US multinationals to acquire businesses and other assets before any new tax rules come in, to covert their cash to non-cash holdings. One possible result will be increased M&A activity – potentially with UK companies as targets, given the dollar/sterling exchange rate.

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From the perspective of deal-makers, this means that tax considerations have risen from a box-ticking exercise to a fundamental equation in assessing the value of transaction. Looking at transactions in a tax context requires getting beneath the skin of a business to understand the substance and value in its supply chains. Standard due diligence questions may no longer be enough to glean an insightful response.

Tax authorities are also becoming more and more inventive with their investigatory techniques and understanding that shift may help to stave off trouble further down the line. At the height of the tax controversies of 2013, when multinationals faced Margaret Hodge and the public accounts committee to defend their tax structures, one newspaper looked at the LinkedIn profiles of all UK employees and revealed a plethora of people with significant responsibilities. This was picked up by tax authorities and used to challenge the basis of companies' claims that value-creating activity was located in other jurisdictions.

When conducting deal due diligence, it is important to consider the intended business structures post-transaction, in addition to looking at the existing framework. In the world of tax, there has been a decided shift from managing rate, to managing risk.

A likely story

'... it is vital to craft a narrative around a deal that works for as many stakeholders as possible.'

With so many stakeholders eyeing each deal – often with competing or contradictory interests – it is vital to craft a narrative around the deal that works for as many of those stakeholders as possible. Planning this story well in advance is essential, as the initial messaging will set the tone for the deal, dictating how it is interpreted by the parties and reported in the press. If control of that message is lost, it can be close to impossible to regain.

Selling the concept of a deal requires careful management of all stakeholders, both within and outside the organisation. This demands consideration of the form, price and value of an acquisition and how to secure regulatory certainty that will allow a deal to close. But it also demands an awareness of the social repercussions of a deal, with regards to management, employees and works councils, and when it comes to those social implications, perception can be as important as reality. There may be a reluctance to sell to PE houses, for example, for fear that they will carve up and sell off assets. Showing support for a company, and a willingness to take it to the next level, will help to allay those concerns.

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It is beneficial to get inside the head of the seller to consider the factors that would allow them to deem the deal a success. What would the seller say in a 'victory speech' after a deal has closed? It is vital to ensure both sides have a positive story to tell, and to craft that message appropriately for different audiences and different countries, in concise points that are easily distilled and shared. There will only be one chance to set the tone for a deal, and this can be the difference between success and failure, as Kraft Heinz recently learned to its peril, in its attempted takeover of Unilever.

Meanwhile, dealmakers must also craft a narrative for internal stakeholders who may be sceptical about value creation through M&A, a perception that can be difficult to manage and disprove. That requires pointing to a successful track record, which means measuring the success of past deals in delivering the returns that were promised. Indeed, companies should place more emphasis, including during bonus and remuneration discussions, on the delivery of value, rather than simply the completion of a deal. Ultimately, a successful narrative for M&A is built on a strategically advantageous strategy.

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