WHITE PAPER | VENUE MARKET SPOTLIGHT

M&A Financing

2018 Edition

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Methodology

Mergermarket interviewed 25 global dealmakers from across the corporate, private equity and investment banking communities for their views on the environment for M&A financing in 2018. Respondents were split between the U.S. (36 percent), Europe (32 percent) and APAC (32 percent).

Foreword

The global M&A market is expecting a significant increase in activity over the next 12 months. The broad implications of U.S. tax reform are still being digested by the market, but expectations are high that companies being forced to bring cash back to the U.S. will use some of that for M&A activities, and the lower base rate will free up corporate funds as well. Private equity firms are also sitting on record amounts of dry powder after another good year for fundraising.

Even over the past 12 months, the market has seen a major structural shift in the size of cash reserves available to both companies and investors, driving stock-to-stock deals to record lows. Cash was king last year in the M&A financing space, with the proportion of all-stock deals falling to just 10 percent of the market, a record low compared with a long-term average of around double that level. Sky-high equity valuations contributed significantly to this trend, with buyers concerned about a market correction that could drastically change the economics of a particular deal.

Overall, our survey respondents expect financing for M&A deals to become more available over the next year, with additional cash made available by the U.S. tax cuts and a healthy global economy, and interest rates still at levels that will allow robust levels of borrowing.

Increasing competition from investors and corporates alike will inevitably change the nature of how M&A deals are financed, however. Deal activity will remain lower in some sectors, and financing harder to come by. In any case, across all sectors the calculus for how buyers pay for acquisitions is expected to evolve rapidly.

Key findings include:

- 92 percent of respondents cite cash as the most popular financing source for corporate buyers over the next 12 months.
- 84 percent of respondents chose technology and telecoms as the sector where financing will be most available, with financial services a very distant second at 28 percent.
- 76 percent of respondents believe the amount of leverage used by private equity buyers will increase over the next 12 months, with 32 percent expecting it to increase significantly.

Survey

Q1

What will happen to the availability of financing for M&A deals over the next 12 months?

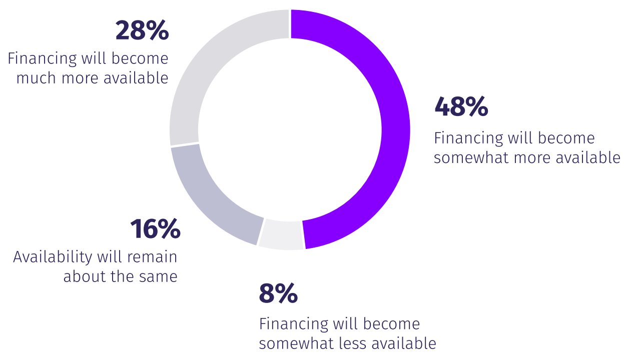
After a slump in 2017, the M&A market is expecting a much stronger 2018, and dealmakers responding to our survey expect financing to keep pace with demand. Some 76 percent of respondents believe financing for M&A deals will become more available over the next 12 months, and only 8 percent believe it will become less available.

Looking into the detail of the responses, it seems that most believe it will be M&A demand driving financing rather than the other way around. Many note that after the uncertainty of last year, a more "stable" market will encourage companies looking to buy.

According to the CFO of one Chinese corporation, "Most buyers have been waiting to make transactions, and the predictions for this year are highly opportunistic compared to the previous two years. Finances are available — it is only a matter of targeting the right company."

Deal examples from early in 2018 are demonstrating this trend. For instance, French pharmaceutical company Sanofi agreed to pay cash for two mega targets: U.S. biotech firm Bioverativ ($11.6 billion) and Belgian drug developer Ablynx ($4.8 billion). The cash consideration may have helped Sanofi secure the transactions — after all, it lost out to Pfizer in a bid for rare disease therapeutics maker Medivation two years ago when Pfizer paid all cash, while Sanofi included contingent value rights in its offer.

Other respondents believe that financing is becoming more available in its own right, with both investors and banks enthusiastic to put their money to work. "Not only do companies have access to finance," noted the chief strategy officer at a European corporate, "there are finance and investment houses too that are ready and eager to supply merger and acquisition deals."



Q2

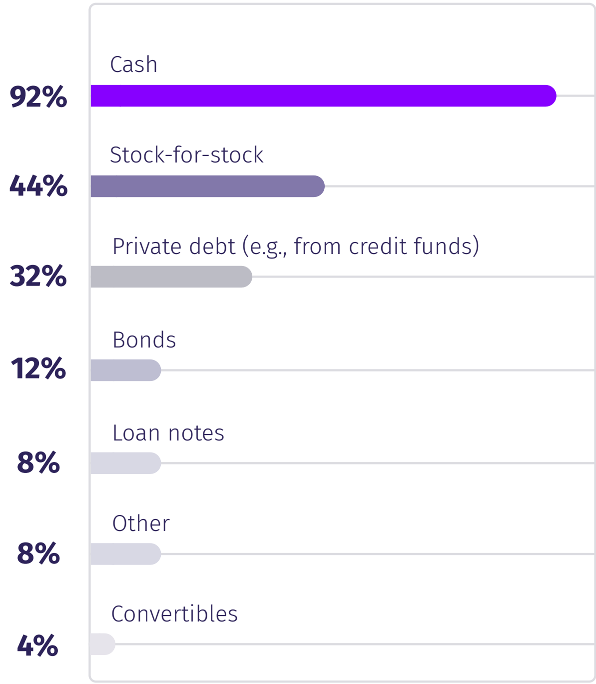
Which forms of M&A financing will be most popular among corporate buyers over the next 12 months? (Select top two)

Dealmakers believe that cash will remain king over the next 12 months, with 92 percent of respondents selecting cash as one of the top two financing methods. The second favorite method was stock-for-stock, with 44 percent choosing it. The private debt option came third with 32 percent picking it in their top two.

Although stock-for-stock came second, that would still represent a dramatic uptick from 2017. Last year, the proportion of all-stock deals fell to all-time lows with around 10 percent of the market. According to one managing partner at a private equity firm, "Cash transactions are clean, instantaneous, and do not require the same high level of management as stock transactions. Cash value is less dependent on a company's performance, except in cases involving multiple currencies."

The general availability of cash was noted by many respondents. "Companies have performed well over the past three to four years and have a lot of cash in reserve," said one private equity partner. "These reserves have not been utilized since and will be opened for any upcoming deals by corporate buyers in the next 12 months."

92 percent of respondents identify cash as one of the top two financing methods in 2018.



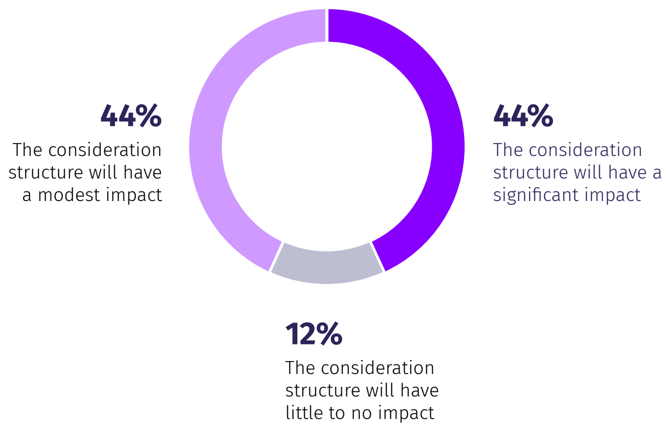
Q3

To what extent will the consideration structure offered by buyers affect their chances of winning deals over the next 12 months?

While the vast majority of respondents to the survey did believe that consideration structures were a factor in buyers winning deals (only 12 percent thought it made no difference at all), they were more split on the extent of the impact. The exact same proportion (44 percent) thought it would have a significant impact as thought it would have a modest impact.

As competition for deals rises among buyers, the ability to quickly present a financing package or pay in all cash can win over a seller. Indeed, one respondent noted, “The most important part of the deal is the consideration structure. It initiates the deal and therefore gives a basic idea to the seller whether to go ahead with it or not.”

In the increasingly complex M&A environment, cross-border buyers are becoming especially conscious of the need for seller-friendly financing. For instance, Chinese private equity firm NextView changed its financing scheme for its recent $215 million acquisition of Toronto-listed miner Lithium X Energy in order to fend off potential rival bidders, according to a Mergermarket report. The buyer agreed to exclusively use offshore resources to avoid the need for approval by Chinese authorities, which regulate the outflow of capital for foreign investment.



Q4

Which sectors will see the biggest increase in the availability of M&A financing over the coming 12 months?

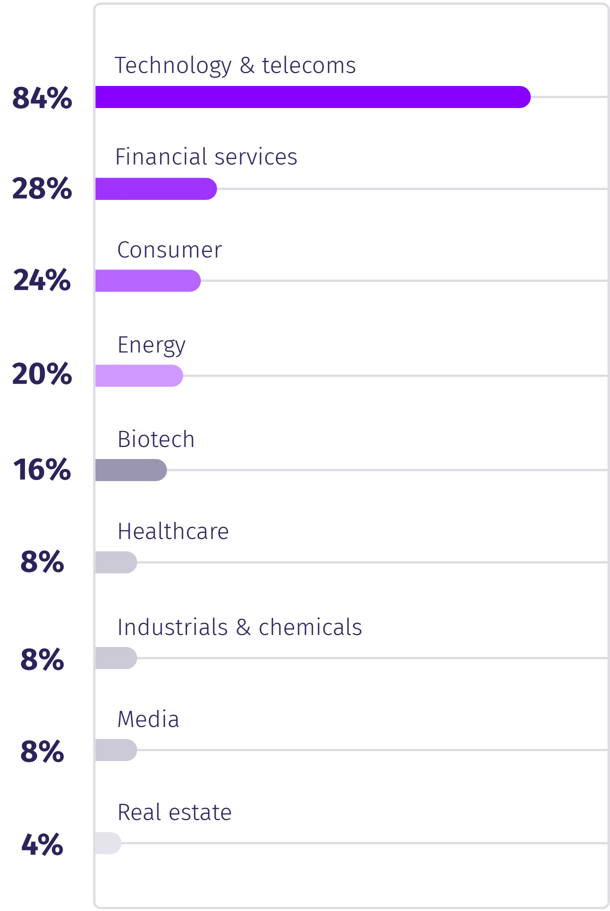
Survey respondents were nearly unanimous about the top sectors that will see an increase in availability of M&A financing over the next year: A full 84 percent included technology and telecoms as one of their top two choices. According to one partner at a North American private equity firm, “Technology is going to be a leader in both deals and availability of finance next year. The sector has been the biggest earner in recent times, and the availability of finances has been growing as tech firm profits have increased.”

The attractiveness of the tech sector can be seen from the fact that some companies are considering deals that would be nearly impossible to imagine in other industries. Take the case of Dell, which, as of January 2018, was reportedly looking at the idea of returning to the public markets or making new acquisitions — despite already having $38 billion in net debt on its books, and an alarming net debt-to-EBITDA ratio of 9.8.

In our survey, sentiment became more divided after technology and telecoms. Twenty-eight percent chose financial services as one of the top two sectors to have access to M&A financing, 24 percent chose consumer and 20 percent energy. All three sectors had strong proponents. Both financial services and energy were expected to get much of their boost from reduced regulations in the U.S.

One investment banker surmised that the kind of blockbuster deals requiring heavy financing will mostly come in a handful of sectors: “There will be bigger-value deals that will be made during this year and most of them should come from the energy and technology sectors.”

(Select top two)



Eighty-four percent of respondents say that technology and telecoms will see the biggest increase inavailability of M&A financing in 2018.

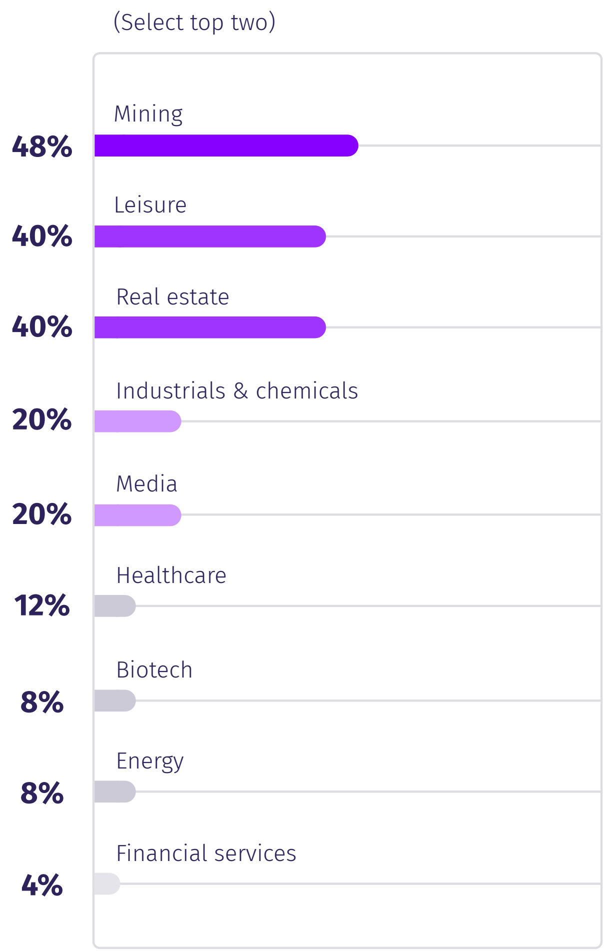
Q5

In which sectors will M&A financing be least available over the coming 12 months?

When the question was flipped around to ask which sector will see the weakest financing availability in 2018, opinion was more divided. Mining was the most common choice, with around half of respondents (48 percent) including it, but the leisure and real estate sectors both got 40 percent as well.

Mining was often mentioned as a sector entering a consolidation phase, with a distinct lack of M&A activity in the pipeline. As one CFO of a European corporate noted, “The number of deals has fallen considerably in the mining industry and is set to fall further without any advancements in environmental policy. If government policy does ease up, then new mining deals could flow in once companies recover.”

The leisure sector was described by one respondent as “mature,” with “well-established big players” limiting the scope for M&A activity. By contrast, problems in the real estate sector were suggested to be more presentational, with one investment banker describing real estate companies as “lying low.” Several respondents thought this was a lingering effect of the financial crisis.



Q6

What do you think will happen to the amount of leverage used by private equity buyers over the next 12 months?

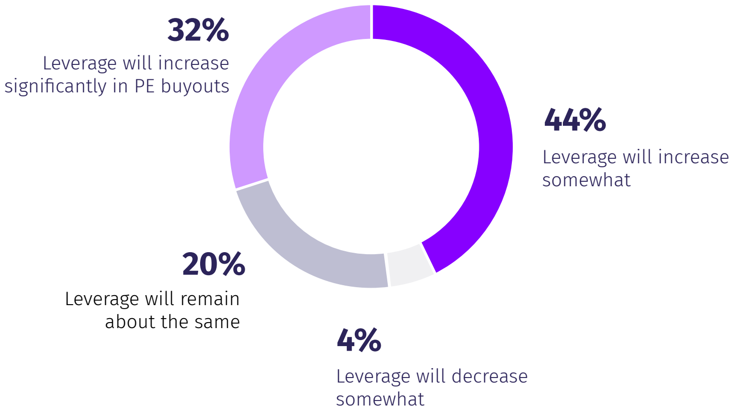
There was a broad consensus in the survey that private equity buyers would continue to increase the amount of leverage they use over the course of the next year. A full 76 percent of respondents thought that leverage would increase somewhat or significantly, and only 4 percent expected leverage to decrease.

Valuations continue to rise and competition continues to increase, with both factors pointing to an ongoing rise in buyout leverage. As borrowing levels rise, some industry players are warning that leverage may be returning to the high-risk levels reached before the financial crisis of the last decade.

“This is exactly what happened in 2007-2008, where an apparently benign environment encouraged people to continuously find riskier and more fragile ways of structuring things,” said Peter Gale, head of private equity and chief investment officer at investment firm Hermes GPE, in a recent roundtable discussion published by Unquote. “This leverage-on-leverage approach — making late-cycle investments where underlying return prospects have come down so you find more exciting ways of leveraging in order to juice those investments — is really dangerous.”

Debtwire data tracking loans and bonds for LBOs, MBOs and SBOs show that the average leverage ratio on such deals grew from 4.65 in 2016 to 5.02 in 2017.

One factor that was mentioned surprisingly little by survey respondents was the impact of U.S. tax reform. Changes to interest deductibility made in the law could have a serious impact on the profitability of the U.S. private equity market, and therefore on the leverage they can use.



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