M&A IN A CHANGING WORLD: OPPORTUNITIES AMIDST DISRUPTION

SUPPLEMENTAL REPORT

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Foreword

In October 2017, Herbert Smith Freehills sponsored a report by The Economist Intelligence Unit (**The EIU**) entitled *M&A in a changing world - Opportunities amidst disruption*.

The EIU Report assessed the state of play on global M&A in this current period of unprecedented and unanticipated political change. The report focused on the headwinds created by the political environment, and the increased appetite from politicians to scrutinise and intervene in M&A. The EIU Report also drew attention to the strong drivers of global M&A activity, in particular the disruptive effect of technology across every sector, and the prevalence of new players active in or driving M&A, such as the new tech giants, Chinese buyers and activist shareholders.

The Economist Group and Herbert Smith Freehills then held a series of events to discuss these issues and polled senior executives and advisers involved in M&A, across four commercial hubs to gauge the current mood in the UK, Continental Europe, Asia Pacific and the US. This Supplemental Report sets out the views from those hubs and reports back on further insights gained from those engagements.

Those engagements confirmed a number of legal and regulatory themes familiar to Herbert Smith Freehills throughout 2017. These are themes where clients have sought our advice to answer questions such as: What investment screening regimes will my M&A deal be subject to? What political considerations may come into play or how will these regimes change in the future? How should we respond to activist shareholders? To what extent might shareholders influence my proposed M&A deal and how could shareholder activism be a catalyst for new M&A activity?

Clients from China have sought help in navigating outbound investment restrictions and in presenting themselves to US, European and other Asia Pacific sellers as counterparties or partners on deals. Clients considering transacting with Chinese companies have also sought help in assessing them as counterparties or partners. And we are seeing an increasing need to help clients assess the evolving legal and regulatory frameworks around new technologies, in particular the use of data, as businesses seek to join the fourth industrial revolution through M&A.

Accordingly, this Supplemental Report includes our views on those key legal and regulatory issues which are a common theme across our global M&A practice.

The views from The Economist Group engagements and the polling conducted confirmed the conclusions of The EIU Report. The benign conditions for M&A globally of a surplus of cash and record private equity dry powder, combined with continued low borrowing costs, and generally strong underlying economic fundamentals, explain the recovery of M&A to pre-global financial crisis levels. Notwithstanding political surprises and uncertainties, corporate leaders are engaging with M&A, albeit with measure and care, rather than unbound "animal spirits". Equally, private equity's business model needs to continue to transact, notwithstanding the challenge of high valuations on the buy-side.

Major global issues remain unresolved that are relevant to M&A. At the time of writing these vary from the outcomes of US tax reform, the shape of Brexit, the North Korean situation and the issues raised by the AT&T Time Warner antitrust case. Each of these, and many other issues, could have a significant effect on appetites for M&A, and which geographies or sectors might be most active.

But there is reason for cautious hope that business leaders will not lose sight of economic fundamentals, and that those leaders will continue to seek the necessary growth and technological transformation through M&A, despite present uncertainties or future challenges.

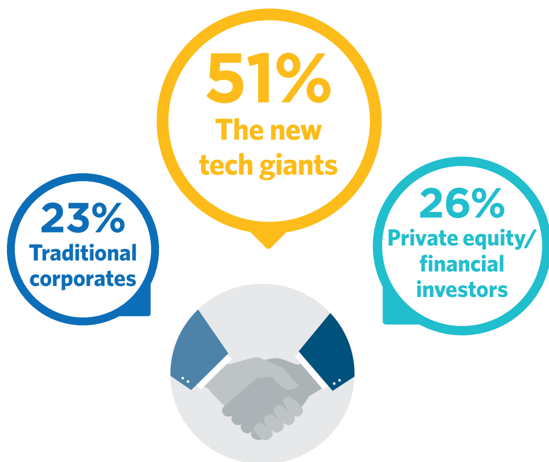
Gavin Davies

Gavin Davies
Global Head of M&A
Herbert Smith Freehills LLP
December 2017

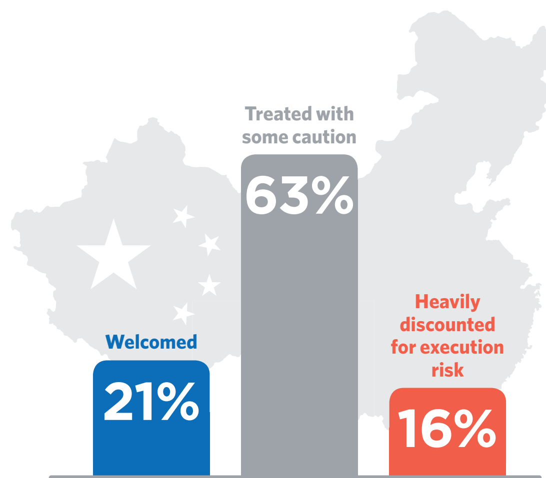
The future of dealmaking

This spread reveals the results of our global survey, conducted with over 200 senior M&A dealmakers and advisers from diverse industries across the UK, Continental Europe, Asia and the US during the fourth quarter of 2017.

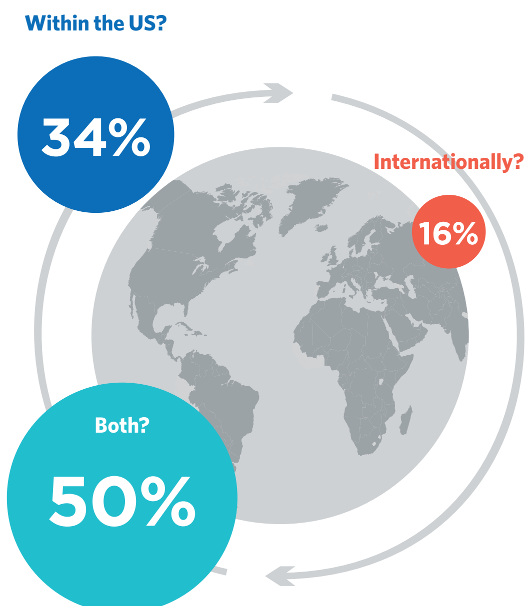
Who will produce the most significant deals in the coming year?



Will Chinese buyers be welcomed by the sell-side in M&A?

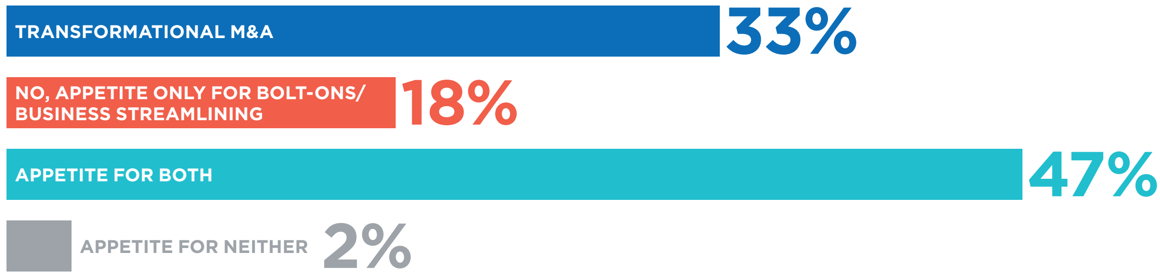


Will M&A by US-based businesses focus most...

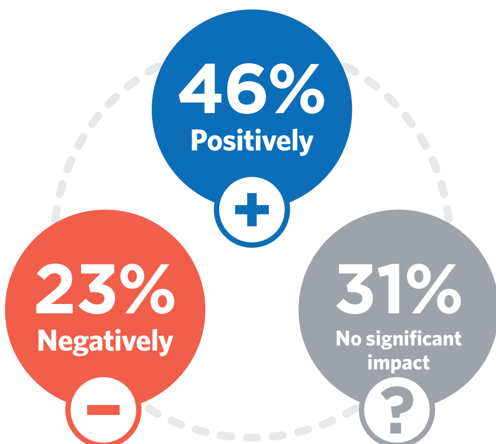


Is Brexit impacting European M&A activity...

Do you think there is now appetite amongst corporate CEOs to undertake transformational M&A?



Do you see activists, and active shareholders, impacting M&A...

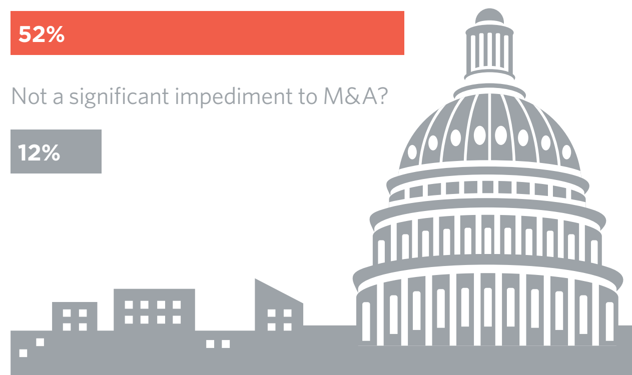


Is the global trend of increased political involvement in M&A...

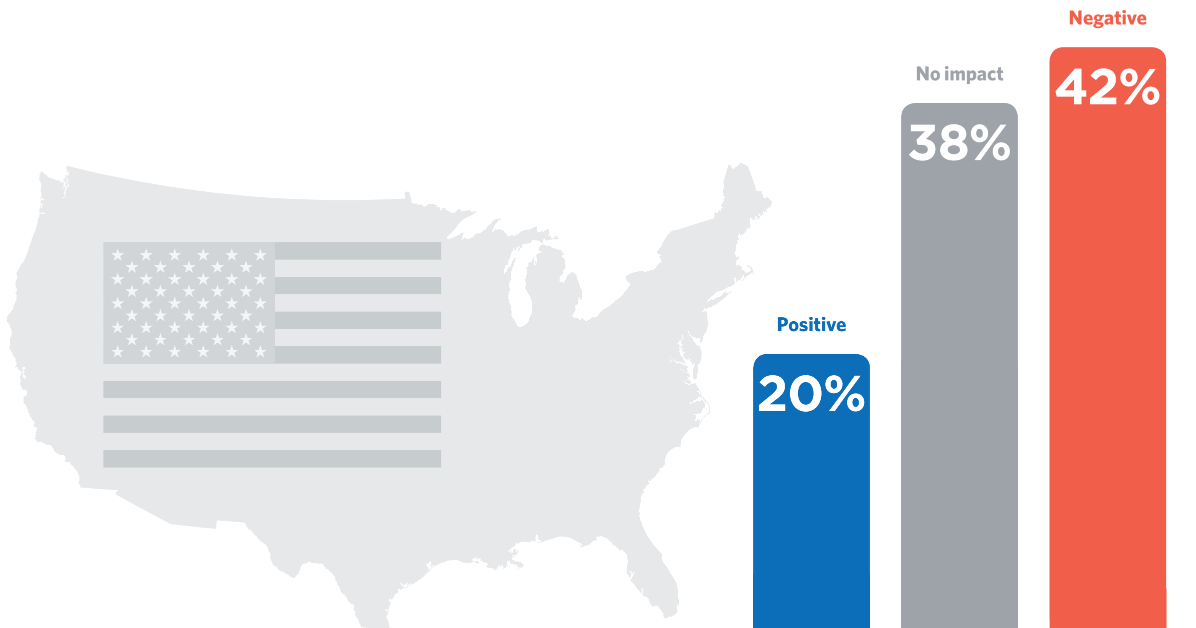
An impediment to M&A, and not welcome?

An impediment to M&A, but necessary for wider social, economic and/or policy reasons?

Not a significant impediment to M&A?



What will President Trump's impact be on M&A over the next 1 - 2 years?



Views from the UK

The Economist Events' London event was inevitably influenced by Brexit concerns. Brexit dominates the headlines in the UK, and there is little current expectation in the business community of a positive outcome in the short term. The pressures of negotiating Brexit are creating further strains on an already fragile political situation. Businesses are struggling to know what to plan for, let alone when to begin their transitions.

The full complexity of the Brexit process has become evident. But, even though both process and timetable to divorce and the post-Brexit landscape remain unclear, UK companies remain under the same pressures as their international counterparts to demonstrate growth and fend off competitive challenges. They cannot stand still awaiting clarity and outcomes, just as their North American peers facing policy and administrative uncertainty in the US need to advance with their plans, which often include M&A.

The London event expressed confidence that the environment for M&A in the UK is still more accommodating than European peers, in particular Germany and France, despite Brexit. The UK government faces the same pressures as other developed economies, including populist sentiment around job losses, industrial policy concerned with protection of R&D, and security concerns around Chinese (and certain other foreign) companies in technology or national infrastructure. But the UK has a more open foreign direct investment history, and in a post-Brexit world will want to continue to demonstrate that competitive differentiator compared to other European investment destinations.

> "The UK faces the same pressures for foreign investment screening as other developed economies, but in a post-Brexit environment, the UK also needs to reaffirm its traditional openness to international investors. The challenge for the UK government is treading the fine line between those competing pressures"
>
> **CAROLINE RAE, PARTNER, HERBERT SMITH FREEHILLS**

The UK traditionally looks to the US as much as Europe, and is likely to do so increasingly in contemplation of new trade relationships in a post-Brexit world. A particular focus of the London event was the proposed US tax reform, the effect of lower corporate tax rates and an easier environment for US companies to repatriate overseas earnings, and how this may diminish European and global M&A in favour of US domestic acquisitions or returns of cash to shareholders.

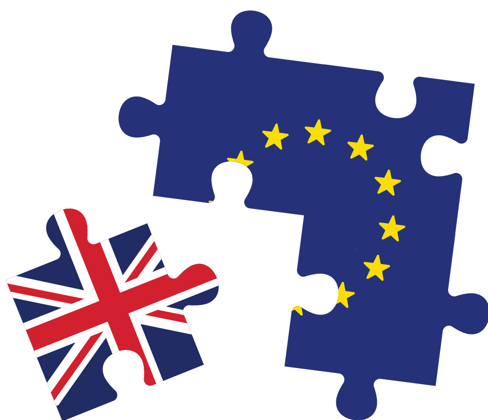
> "If there are opportunities to buy good businesses and good brands, we will take them, notwithstanding political risk around the edges. If the fundamentals of the business we are looking to acquire are good, we will acquire"

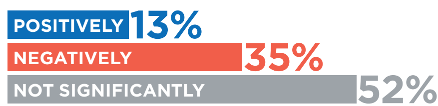
Technology, disruption and responses to that disruption were also a focus in the London event. From the importance of fintech in financial services, to the popularity of "craft" in the consumer sector, incumbents are searching for ways to meet the competitive challenge of agile disruptors, to understand new eco-systems and to accelerate their own IP development and product offering. Corporate venture capital is one strategy that has come to the fore in recent years, for companies to seed early stage entrepreneurial ventures that might be of interest to them, supporting their product development while they assess their potential.

2018 will see a shift in clients' focus from Brexit analysis to implementation

Action to mitigate risks or seize opportunities may include strategic M&A, devising alternative legal structures, uprating customs capabilities, changing geographical footprint, revising compliance frameworks, engaging with regulators, restructuring supply chains and any dispute resolution strategies required for evolving business models. Navigate to www.hsf.com/brexit for industry insights and subscribe to our Brexit blog at www.hsfnotes.com/brexit for latest legal developments.

Is Brexit impacting European M&A activity...





Globally, over half of the respondents did not consider **Brexit's** impact on European based M&A activity would be significant. Of the rest, most of the respondents thought the impact would be negative. Views in the UK were the most negative, with 52% of the respondents saying Brexit would have a negative impact.

Is the global trend of increased political involvement in M&A...

An impediment to M&A, and not welcome?

An impediment to M&A, but necessary for wider social, economic and/or policy reasons?

Not a significant impediment to M&A?

Political intervention in cross-border acquisitions is on the increase globally, against a back-drop of protectionist rhetoric in some countries. 88% of respondents considered increased political intervention an impediment to M&A. However, a majority of all respondents also acknowledged that such an impediment to M&A was necessary for social, economic and policy reasons. It is worth noting that just over a quarter of respondents in the US did not regard increased political involvement as a significant impediment to M&A activity.

Political intervention in M&A

Is the tide turning?

Political intervention in cross-border acquisitions is on the increase globally, against a back-drop of protectionist rhetoric in some countries: the blocking by President Trump of the bid by China-backed Canyon Bridge for Lattice Semiconductor being the latest high-profile example. Jurisdictions traditionally reluctant to intervene on national interest grounds have expanded the scope of their foreign investment regimes and, in some cases, have started to block deals or extract strict conditions for clearance. When planning a deal, foreign direct investment (**FDI**) regimes need to be considered alongside competition based merger control rules, but governments tend to have much broader discretionary powers to intervene on the FDI front.

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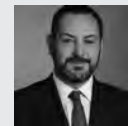

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The OECD has compiled a Regulatory Restrictiveness Index plotting the scope of FDI regimes in over 60 countries on a sliding scale. This shows that EU countries collectively have the fewest restrictions on FDI. However, the EU has recently announced plans to introduce a framework for its Member States to operate foreign investment regimes on security or public order grounds: Member States will not be obliged to introduce new rules but, if they do, they must follow the broad framework and will also benefit from a co-operation and information sharing arrangement with other Member States and the European Commission. It remains to be seen how this will fare through the EU legislative process, given the sharp disagreements between Member States on this issue.

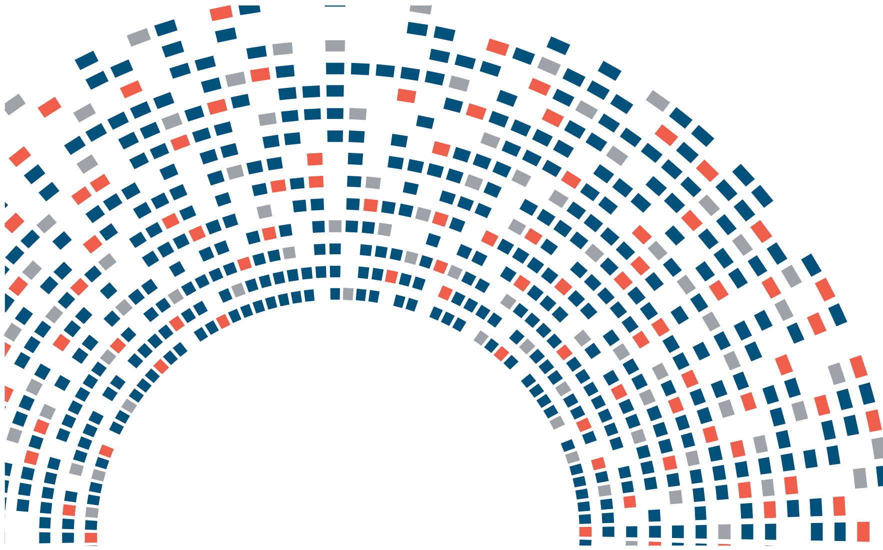
At the same time we have seen a reverse trend elsewhere. The OECD's Index shows that the biggest reformers in the last 20 years have all been in Asia. Countries such as South Korea, Vietnam and the Philippines have seen a significant inflow of foreign investment at least partly as a result. We continue to see reforms of the traditionally most restrictive regimes: India and China liberalised their FDI rules last year.

Why is it, in this context, that we are seeing traditionally more liberal countries start to flex their interventionist muscles more?

UK tempers free movement of capital

One of Theresa May's first acts as UK Prime Minister was to announce a review of the build contract for the Hinkley Point C nuclear power station, amid security concerns given Chinese involvement. This marked a significant departure from previous Conservative policy. After several high-profile deals involving foreign acquirers of 'national champions' – the Kraft takeover of Cadbury, Pfizer's unsuccessful hostile takeover bid for AstraZeneca, and more recently Softbank's acquisition of British microchip maker ARM – protectionist rhetoric has intensified in the UK.

Scarred by Kraft's perceived reneging on a key deal promise, the UK bolstered its takeover regime with measures such as a limit on the time bidders had to formally launch an offer and to make parties stand by promises often made around "softer" (mainly employment) issues. Despite recent measures, the UK regime remains grounded in an objective, competition-based legal framework with intervention on the basis of national interest limited to a small number of sectors (national security, media plurality and stability of the UK's financial system).



But is this set to change? The Conservative's 2017 manifesto made clear it will reform takeover rules. It set out three main proposals - requiring bidders to make their intentions clear from the outset of a bid, making promises made in the course of bids legally enforceable, and allowing government to freeze bids to allow greater scrutiny. The manifesto cites the protection of critical national infrastructure, mentioning telecoms, defence and energy.

The UK Takeover Panel has since published a consultation paper on statements of intention under the Takeover Code and the government has recently launched a consultation on the scope of proposals to address national security concerns in foreign investment.

> What is considered "critical national infrastructure" and which national champions government will seek to protect remains to be seen

How far the government can go with its proposals will depend on the shape of Brexit. If the UK-EU relationship falls outside of the existing EU regime, or if no divorce deal is agreed, the UK will be open to set its own restrictions on all foreign investors. The more challenging constraint is likely to be a practical one however - balancing increased state intervention with the mantra that Britain is open for business post-Brexit.

2017 M&A deal flows suggest the potential for public interest interventionism has not dampened M&A activity. One thing is clear – foreign investors in the UK and their advisers should expect, and plan for, increased political and media scrutiny.

'America First' – will M&A suffer?

While the UK is focused on securing new international trade deals, the Trump administration has set about unpicking several of America's international trade agreements and threatened punitive tariffs on importing manufacturers. Popular tax inversion deal structures have also been targeted with proposals to cut corporation tax rates and scale back taxation of companies' non-US earnings.

This raises the question of whether President Trump's protectionist agenda will impact deal activity. There have been a number of recent reviews by CFIUS (Committee on Foreign Investments in the US), particularly relating to Chinese acquirers. As well as the Lattice Semiconductor blocked deal mentioned above, several other Chinese investments have been referred to CFIUS in recent months. However, this is not a new trend - the number of CFIUS reviews increased by 40% under the Obama administration compared to the previous administration.

So far, M&A activity remains buoyant – with the number of announced North America M&A deals in 2017 predicted to increase by approximately 10% year on year. President Trump's proposed tax and regulatory changes may well prove to be a boon for M&A activity – provided that acquirers are prepared to weather political uncertainty and potential CFIUS scrutiny.

Navigating FDI

In most countries, the national interests at stake are the same: defence, critical infrastructure (energy, transport, communications, data storage, financial infrastructure, sensitive facilities), access to sensitive information and employment. And more assets are being added to the list, most recently critical technologies, which the European Commission has defined broadly to include semiconductors, AI, robotics, cybersecurity, space and nuclear. This is seen by many commentators as a reaction to mainly Chinese attempts to buy up key European IP assets (for example, the takeover of KUKA by Midea).

Sometimes it will be obvious that a deal might have an impact in one of these areas. But there will always be an element of unpredictability: in previous cases the Australian government blocked the acquisition of a grain handling company and the French government has objected to the acquisition of yoghurt company, Danone.

So, what does this all mean for deal planning? The way many of the regimes work in practice can make it difficult to predict with any certainty how - or at what stage - a government will react to a particular deal.

The FDI decision-makers do not publish decisions explaining non-interventions.

> Even where a deal is prohibited or conditions imposed, the underlying rationale is not always clear; for example CFIUS does not publish any decisions or opinions

The appeal process for those who do have the appetite to challenge unwelcome decisions can be so lengthy that the deal opportunity is missed in the meantime. Some FDI regimes even allow governments to intervene in deals post-completion.

This makes the FDI process very different to merger control, where independent competition authorities publish reasoned decisions, companies usually have to wait until they receive merger clearance before completing a deal, and fixed timetables apply. The emphasis in the EU FDI proposals on transparency, judicial review, and process is therefore welcome.

An additional complication is the potential for inter-governmental pressure, such as when the US successfully persuaded the German government to withdraw its earlier approval for the acquisition of chip equipment maker Aixtron by Fujian Grand Chip Investment Fund, because Aixtron's chips could be used in nuclear technology.

The key to resolving at least some of this uncertainty is to plan the global regulatory and communications strategy around the transaction from the outset. Track the general trends in FDI outcomes across the different regimes and make early contact with the relevant authorities. Some of the reported cases show that taking the time to explain the impact and proposed structure of a transaction to the FDI authorities can make a difference. Where time is of the essence, it may be possible to structure transactions so that the deal can go ahead and parts of the target are held separate in those countries where the FDI regime could apply and more time is needed.

Of course, there are likely to be cases where political interests end up being the decisive factor: the current US administration's focus on "America First" is one example of this. We may well end up also seeing some "tit for tat" decisions between the different FDI regimes. But hopefully this will remain the exception rather than the norm.

Views from Continental Europe

In Continental Europe delegates confirmed an optimistic outlook on M&A fundamentals, in particular low interest rates and access to capital, as well as the need for companies to respond and adapt to the advancement of disruptive technologies like artificial intelligence and robotics. Wider European economic positives are also seen to be encouraging of the M&A environment, in particular the recovery of southern Europe.

The Brexit vote is seen by the major Continental countries, notably France and Germany, as an opportunity to articulate their attractiveness as pro-business hubs, as they seek to appeal to the talent and investment that the UK might lose. Yet government intervention in deals on the Continent is a consistent theme, against a history of such European countries having tended more towards protectionist than the UK when it comes to M&A. Chinese buyers are the main target of such governmental concern, but regulation can apply equally to acquisitions from companies controlled by other European Union member states, which causes a degree of disquiet.

Activist investors have appeared on the Continent and prompted strong reactions in both directions. They have been portrayed as important agents for change in public companies, or alternatively as short termist market players damaging value, though some commentators take a more agnostic position and argue they fit neither stereotype. But high profile situations, in particular in major European consumer companies, have confirmed the seriousness and ambitions of activists in Continental Europe, notwithstanding the challenge for a US activist of adapting to different governance rules in each country.

"It's very easy in the US because, even though you have 50 states, you really only have one when it comes to corporate governance, and that's Delaware. You have one set of legal rules and the playbook is pretty clear. In Europe, shareholder activism is a bit more difficult because every single country has a different set of rules"

CEOs are bracing themselves for a rise in this activity, and considering defensive measures. And it is recognised by the European M&A market that activists impact M&A because, as they agitate for change, they often push for structural and strategic shifts that require M&A to achieve.

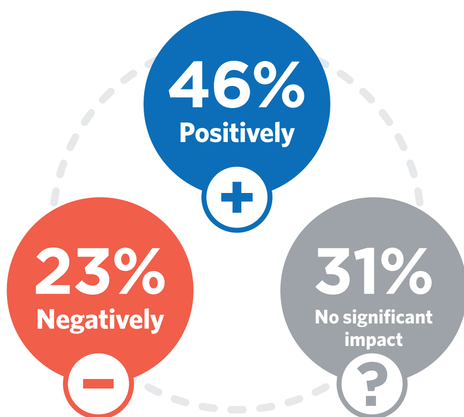
"We see certain clients creating 'war rooms', getting prepared and asking, 'What could happen? How could I react if at some point I have an activist that starts to make a lot of noise?'"

FRÉDÉRIC BOUVET,
MANAGING PARTNER, PARIS
HERBERT SMITH FREEHILLS

The GDPR: The "whole of business" issue

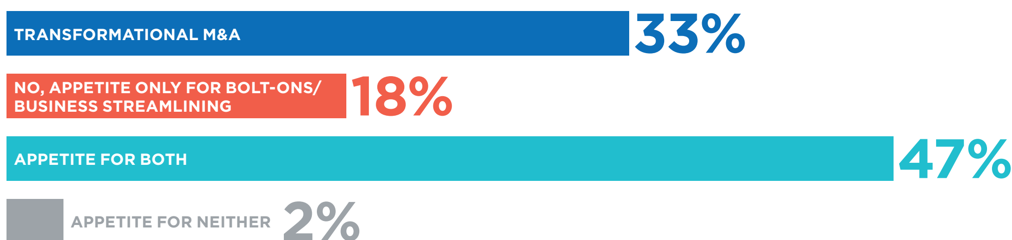
The EU General Data Protection Regulation ("**GDPR**") comes into force in the UK and across Europe on 25 May 2018 and the run up to this date is set to be a busy period for many organisations preparing for compliance. Amongst other things, potential large fines under the new law mean that GDPR compliance is becoming a key consideration in acquisitions and divestments. Navigate to www.hsf.com/gdpr to subscribe to our GDPR briefings and webinar series.

Do you see activists, and active shareholders, impacting M&A...



Shareholder activism is a theme which resonates globally, with 69% of respondents considering it as having an impact on M&A - the results were consistent across all regions. Activist investors are now playing a bigger role in driving M&A deals. Traditionally a North American phenomenon, powerful activist funds are now also demanding divestments to boost shareholder returns in Europe and in Asia.

Do you think there is now appetite amongst corporate CEOs to undertake transformational M&A?



Shareholder activists in Europe

Raiders or settlers?

Shareholder activists remain commonly viewed as short-term, opportunistic, foreign "corporate raiders"; seeking new targets in Europe after having already picked-off the easier targets on the other side of the Atlantic. However, like many raiders over the centuries before them, have shareholder activists now settled in Europe, permanently?

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Arguing whether activism is on the rise, has peaked or is falling in Europe is to miss the point: shareholder activism is now here to stay in Europe and the question really is whether this is a good or bad development?

Shareholder activism has long been a feature of US markets but the large US activist funds increasingly look overseas for appropriate targets. This is in part due to the industry in the US itself maturing with a few very large funds emerging as the key protagonists, such as Carl Icahn's eponymous fund, Nelson Peltz's Trian and Paul Singer's Elliott and the need for those funds to identify very large targets in order to generate and maintain the level of returns which their own investors have come to expect. In 2015, the number of companies subject to public activist campaigns was 673 globally of which 255 were outside of the US. In 2016, that number increased to 758 globally of which 302 were outside the US. Europe and in particular the UK were at the vanguard of this expansion in global shareholder activism: 27 campaigns in the UK in 2015 compared to 43 in 2016. In 2017, to date, while there has been a small decline in volume in the numbers of public activist campaigns the targets have been among Europe's largest companies and most recognised brands.

Take for example, Elliott's recent campaign against the board of Dutch listed Akzo Nobel in respect of its stance on the proposed takeover approach from PPG, during which Elliott built a stake of approximately 9.5% in Akzo Nobel. The campaign resulted in Akzo Nobel agreeing in August 2017 to divest its specialty chemicals division (leaving it focused on its core business of paints and coatings); appointing three new directors to the board; and declaring a special dividend to shareholders of US$1.6 billion. Activism in Europe is increasingly event driven, where the activists seek to instigate or put pressure on the board to agree to a merger, or to pursue a disposal, or declare a return of value to shareholders.

Shareholder activism can also be sector focused. Large multinational consumer companies currently face challenges around focus and efficiency, against slowing revenue growth and reduced margins. Take for example Nelson Peltz's recent successful campaign to be appointed to the board of P&G in the US and Third Point's recent campaign against the board of Nestlé (headquartered in Switzerland) which resulted in the board announcing a US$21 billion share buyback. Arguably, at this stage of the cycle, the US activist funds have already forced change at the easier and more vulnerable targets in the US and are now looking for equivalent targets in Europe.

Seen in the broader context of global investment opportunities, in what is currently a global low interest and low yield environment, the large hedge funds with a proven track record present interesting opportunities for absolute returns, without limits on timing, without restrictions on permissible kinds of investment or sectors and without regular public financial reporting requirements - unlike other funds. One of the strengths of activist funds is that they can

Campaign activity H1 2017 ■ 2016 ■ 2017

The volume overall of new campaigns launched in Europe decreased as local funds struggled with high valuations. Significantly, more midcaps were targeted in H1-17.

Total campaigns (live and potential) by market capitalisation

(Activistmonitor – Activism in Europe, First half review 2017, p. 2)

take a longer-term view compared to PE funds with fixed exit periods to deliver returns. In addition activist funds can also take a minority stake in a company and need not acquire control.

> "... the arrival of activist pressure or campaigns allows for the activist to become a 'lightning rod' to channel previously private dissatisfaction felt by a wider group of shareholders"

Accordingly, it is not surprising that it is not only US hedge funds which are pursuing an activist agenda. More and more, European investors are: seeking more active engagement with the companies in which they invest; using activist methods; allying themselves with, and even investing in, activist funds. The result is that traditional institutional shareholders make demands and become more activist in nature. For example, whereas traditionally in the UK institutional investors have refrained from voicing their concerns or criticisms of management publicly, the arrival of activist pressure or campaigns allows for the activist to become a "lightning rod" to channel previously private dissatisfaction felt by a wider group of shareholders. The increase in votes against the directors' remuneration report at AGMs in the UK is an example of this, high profile examples include Babcock, Shire and Smith & Nephew. In short, activists can tap into general shareholder dissatisfaction and shareholders can encourage activists to step forward publicly in a way that traditional institutional investors are not willing to do.

The legal rights that activist shareholders seek to take advantage of will vary across company laws in the different jurisdictions they operate within. However, the key is the ability to call for a general meeting of the company's shareholders. In the UK, as well as in Germany, provided that a shareholder holds at least 5% of a company's issued share capital, it may requisition a general meeting of fellow shareholders and propose one or more resolutions to be considered at that meeting. In addition, activist shareholders in Germany often threaten to challenge resolutions in court - a powerful tool that does not require the holding of a significant stake. In France, minority shareholders holding at least 5% of the share capital cannot call directly for a general meeting of shareholders but they can ask the President of the Commercial

Court to appoint an ad hoc agent whose role will be to convene the meeting if the board of directors refuses to convene a meeting following a specific request.

Activist investors do not only rely on their legal rights as shareholders. In addition, the successful activists are adept in using other means, such as a dialogue with the company or external PR or social media campaigns. For example in the UK, a board can seek to refuse to allow a resolution to be put at a meeting requisitioned by shareholders on the grounds that it is "frivolous or vexatious" or defamatory or on the technical grounds that it is a resolution without any legal effect (eg merely advisory). Winning this legal argument and having a resolution disallowed may at first look like a "win" against an activist but may in the long-run prove to be a tactical error because this can be presented in a media campaign as an overly defensive board unwilling to listen to shareholder concerns and concerned only with protecting their own jobs. In any event, the activist may then put a second resolution in such a way as to address the technical objection.

In fact, entering into a constructive dialogue with activist shareholders can always be presented positively to investors at large and can even be a good way for chief executives to initiate discussions about strategic decisions usually considered taboo, like divesting core assets. Therefore, regulators or policy makers can even encourage active shareholder engagement. It is apparent that corporate attitudes towards activists are changing as well.

Activism is no longer a foreign, US phenomenon, but is a permanent feature of European markets. This means that for all listed European corporates, being prepared to respond to an activist campaign is imperative. More than that, boards of European listed corporates will, in certain situations, want to consider a strategy of constructive dialogue with activists, recognising that this can be in the best interests of all shareholders and may in fact be welcomed by institutional shareholders.

Activists have settled in Europe: they have become part of and have forever changed the communities around them.

Views from Asia Pacific

The Economist Events' Hong Kong event reflected that Asian M&A - historically a small fraction of global deals - has constituted a more significant proportion of total global deal volume over the last decade, mainly driven by outbound Chinese activity.

The boom years that reached a crescendo in 2016 were marked by the US$45 billion ChemChina-Syngenta deal, and a notable step up in activity by serial acquirers such as Fosun, HNA and Wanda, across a wide range of non-traditional sectors. Those Chinese outbound deals fell significantly in the first half of 2017, following China's capital controls imposed in late 2017. The protectionist mood in the US and European markets, including in the UK and Germany, contributed to the cooling effect on those deals. A perfect moment to pause and regroup.

> "There was a time when acquisitions were done with great fanfare, done to acquire trophy assets. But there are quite a few companies from China that are much smarter about it, much lower key, more interested in preserving the reasons why they bought the company in the first place"

Activity has recovered somewhat, and market participants generally welcome the slowdown from the heights of 2016, and the more disciplined approach that seems to have replaced the approach of last year.

> "Nowadays, you have Chinese acquirers that very much want to keep management intact, because they know how to run the business better than they do. So they want supervisory rights, but they want the management to stay and run the business"

Alongside a fall in deal volume is evidence of more careful strategies among Chinese firms, and of a new sophistication on the part of Chinese acquirers.

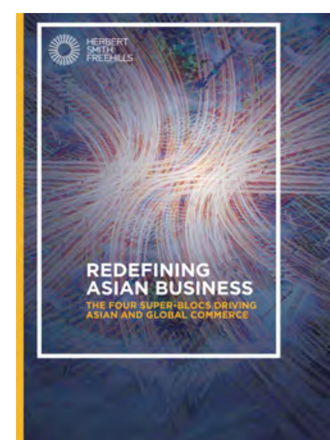
There is a prevalent view that Chinese buyers have learnt the lessons of some past deals, which have entailed significant re-structuring, produced poor results or even failed, with a particular new focus on retaining local management. There is also evidence that such buyers, in particular the serial acquirers, are evolving their approach, such as by using more financial advisers and M&A specialists, and by ramping up their own teams with those international expertise.

Asia's M&A fundamentals look strong despite the slowdown, and China's Belt and Road Initiative, an ambitious infrastructure and trade network touching numerous markets, is expected to contribute to that M&A activity.

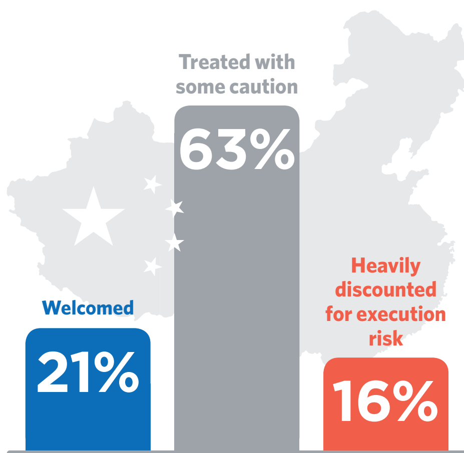
> "All the traditional drivers are in place in Asia Pacific, more so than ever, with global low interest rates, liquidity, and the wide spectrum of players involved. Traditional businesses are looking to up their game in the face of competition, from state-owned and private enterprises in China, to sovereign wealth funds and private equity, and of course, from the new innovators. All of these are looking to expand their businesses"
>
> **TOMMY TONG, PARTNER, HERBERT SMITH FREEHILLS**

Redefining Asian business

In this new report we look beyond borders and sectors to demystify this valuable region. Rather than define companies by country or sector alone, the report examines history, culture and strategy, and defines companies into four new super-blocs – the Old Guard, State Standards, Young Innovators and Asset Hunters. Understanding each bloc's culture, aspirations and issues provides a valuable guide for those working with and for these companies as their influence spreads throughout the world.
www.hsf.com/rab

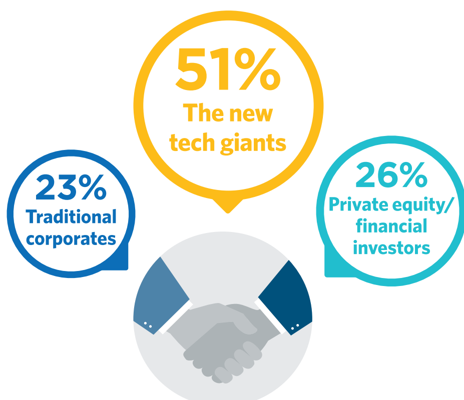


Will Chinese buyers be welcomed by the sell-side in M&A?



Despite tightened control on capital outflow since late 2016 and a significant slow-down in 2017, **outbound M&A deals from China** are widely expected to pick up in 2018. According to the poll, most sellers across all regions were cautious towards Chinese buyers. The prevalent view of over three-quarters of the respondents, was that the sell-side would treat Chinese buyers with caution, and within those a small proportion would discount Chinese buyers heavily for execution risk.

Who will produce the most significant deals in the coming year?



Globally, the **new technology giants** have emerged as the group to watch. Over half of the respondents predicted that this group will produce the most significant deals compared to traditional corporates (23%) and private equity/ financial investors (26%). Asian respondents were even more bullish on tech's role in M&A, with 63% betting on the tech giants to produce the most significant deals.

China outbound M&A

Down, but not for long

In 2016, China's outbound investment surged, reaching a record high of US$170.1 billion, and surpassed inbound investment for the first time. Investment came from all types of Chinese companies, from state-owned enterprises to privately owned innovators, and in everything from chemical companies to football clubs.

Not everyone was pleased. The rapid drop in China's foreign exchange reserves and rise in risky state-owned bank lending that accompanied this boom resulted in a regulatory backlash against "irrational" and "non-genuine" outbound transactions.

As a result of various responses to this alarming drop, China's non-financial outbound investment fell in 2017, and stood down year on year by 41% to US$81 billion at the end of October.

However, the somewhat kneejerk reaction to 2016's capital outflows has developed into a much more transparent policy and procedures for Chinese outbound deals.

Capital crunched

The response to the unprecedented drop in capital reserves and increase in systemic risk was swift.

In December 2016, the state's key regulators issued a rare joint statement, warning that the government was paying close attention to certain types of outbound investments, such as "irrational" outbound investments in real estate, hotels, cinemas, entertainment and sports clubs.

The two approving authorities for outbound transactions, the National Development and Reform Commission (**NDRC**) and the Ministry of Commerce of China (**MOFCOM**), struck first. In December 2016, they beefed up their approval requirements, adding substantive review procedures for outbound transactions.

Simultaneously, banks in China were advised by State Administration of Foreign Exchange (**SAFE**) and the People's Bank of China (**PBOC**), the country's monetary regulators, to increase scrutiny on outbound transactions and refer to them any over US$50 million.

With little transparency and clarity, this new scrutiny caused considerable market uncertainty around China outbound transactions.

New deals – what China wants now

Nearly a year on, new guidelines, policy announcements and statements have helped to clarify China's goals for dealmaking.

In August 2017, several ministries jointly issued guidelines that classify investments into encouraged, restricted and prohibited categories:

The **encouraged** category includes infrastructure investments under the Belt and Road Initiative, investments promoting the development of high-tech and advanced manufacturing, and those in agriculture, trade, culture, logistics, energy and resources. Encouraged projects also enjoy additional support from the government in terms of tax treatments, foreign exchange, insurance, customs assistance, information, etc.

Investments that do not align with State foreign policy and those in real estate, hotels, cinemas, entertainment or sports clubs or made by certain investment funds are **restricted**. Such projects are not off the negotiating table, but will be guided by the government so that they can be carried out 'in a prudent way'.

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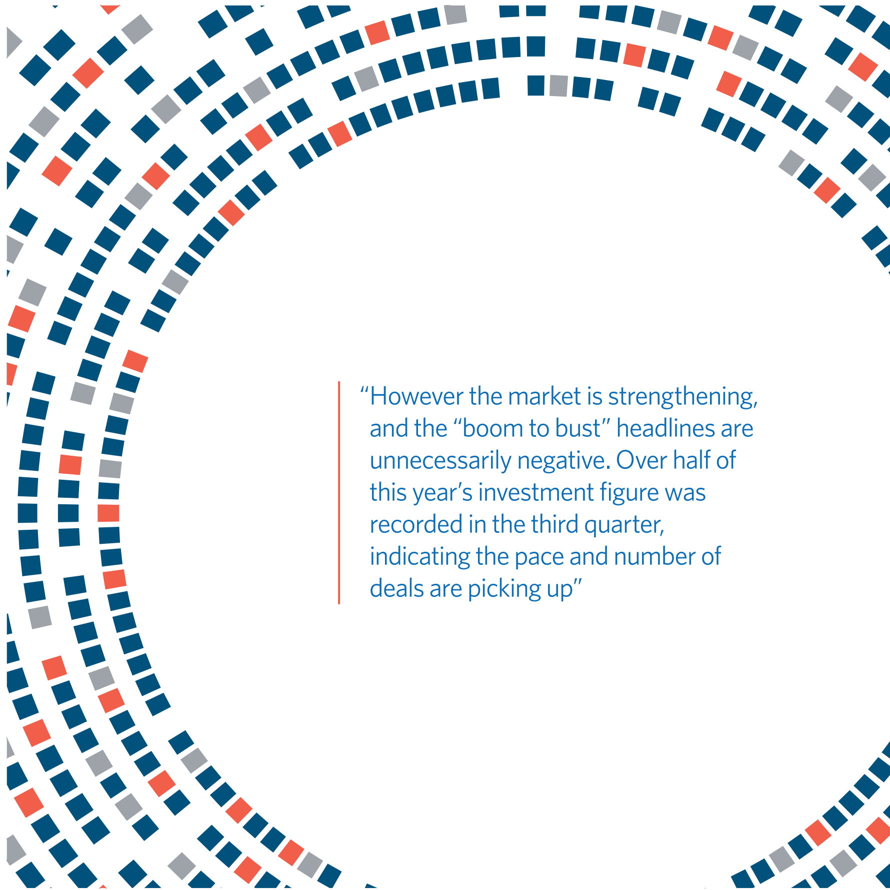


> "However the market is strengthening, and the "boom to bust" headlines are unnecessarily negative. Over half of this year's investment figure was recorded in the third quarter, indicating the pace and number of deals are picking up"

Prohibited investments include those involving the export of technologies prohibited for export, those prohibited by international treaties, and those which may harm State interests. Strict controls will prevent any investments in prohibited areas.

Reflecting these principles, NDRC recently issued a new draft of measures for management of outbound investment.

The draft measures streamline the approval process for outbound investment, yet at the same time increase oversight on the investment of Chinese companies' offshore subsidiaries.

So far activities of those subsidiaries have not been on the radar of Chinese regulators. Under the draft measures, however, the Chinese parent companies must obtain NDRC approval if their offshore subsidiaries wish to invest in deals in 'sensitive' sectors.

Positive words from the podium

Following these changes, the 19th National Congress of the China Communist Party concluded in October with a very strong message that China aspires to become a global leader in the coming years.

President Xi Jinping called for the country to develop "new ways of outbound investment" and emphasized that China will continue to push forward the US$90 billion Belt and Road Initiative. Combining the greater regulatory clarity with a very strong policy direction delivered from the top means that Chinese buyers are likely to get back into the deal markets in 2018.

Our recent report, Redefining Asian Business, identifies the four 'super blocs' of Asian companies driving growth– the Old Guard, State Standards, Young Innovators and Asset Hunters. The last three of these are prevalent in China, and will drive the next phase of China's economic development.

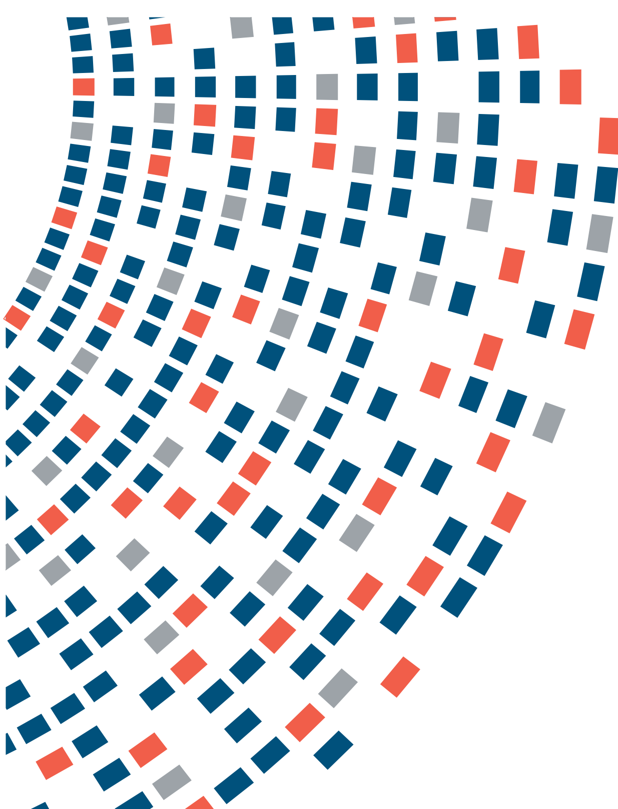
The country's State Standards are deeply involved in the Belt and Road Initiative, dominant in agriculture, industrials and energy. They also have the financial clout and political connections to pull off the mega deals that require presidential signing ceremonies.

China's Young Innovators are ending the year on a very high note. In early November, Tencent joined the US$50 billion "market cap club", with Alibaba excruciatingly close on its heels. Both are moving steadily into overseas markets as well as investments, and can finance outbound deals from their massive domestic operations.

Many assume that China's Asset Hunters have the most to lose. Perhaps not so – for every hotel or football club deal that cannot proceed, there are solid manufacturing acquisitions and purchases of IP or technology that will be deemed perfectly sensible.

Overall, the signal from Beijing is that China is still buying, but selectively, carefully and with due attention to long-term goals. Sectors that will benefit are those tied to the Belt and Road Initiative – just under half of this year's investments so far were made in Belt and Road countries. Also high on the list will be deals that will benefit China's economy and people's wellbeing such as tech, advanced manufacturing, green industries, healthcare and education.

From a deal execution perspective, China has done much to streamline its approval process for outbound investment, but uncertainty in the regulatory approval and filing processes does remain, particularly for mega deals and those in sensitive sectors. It is important that the buyers and sellers anticipate and plan ahead for these possible hurdles.



Views from the US

The US leads the global M&A market, which accounts for a huge share of deals. The US also hosts many of the most disruptive technology companies that are breaking down barriers between sectors, whether Amazon's purchase of Whole Foods, taking online into the high street, or GM's acquisition of Cruise Automation, a sign of software's growing role in manufacturing. Following the election of Donald Trump as President, M&A activity initially fell, but Dealogic data at the end of October indicates merger plans totaling US$22 billion, with a further US$150 billion under negotiation.

The policy agenda of President Trump, in particular the focus on nationalism and protectionism, inevitably has a bearing on M&A. Similarly to Brexit, this narrative criticises unfettered globalisation for not creating inclusive wealth growth. Any acquirer in the US must now take account of that new political environment, and give thought to whether synergies will be seen as job losses. There is a new pressure on deal doers to demonstrate that their M&A is good news for US jobs, for research and development in the US, and for US national interest generally. But evidence suggests that, while deal-making has become more politicised, M&A activity is now little dimmed. Corporates' search for growth is outweighing their political worries, despite ongoing uncertainty and ambiguity, in particular about tax reform. Companies have to move forward regardless, and their primary focus remains the search for growth.

> "Uncertainty, when it goes on for a long time, forces market participants either to hunker down, or to cope with the new normal. We think that participants are coping with the new normal and working through those uncertainties, because the imperatives of M&A - the hunt for growth, the need to spend money, the need to get into whatever technology you need to get into - are greater than the uncertainties"
>
> **GAVIN DAVIES, GLOBAL HEAD OF M&A, HERBERT SMITH FREEHILLS**

The current M&A wave in the US is correlated with rising stock markets, and greater commercial confidence, as evidenced in the strong growth of the S&P 500 and the Dow Index. But this raises the challenge of deal pricing: where a lot of money is chasing assets, a mismatch is created between the views of sellers and buyers, and the odds of overpaying increase. There is more scrutiny of the relative merits of cash versus stock-based deals: premia paid in cash benefit from the trajectory of growth that is priced into the target by the market. Sellers inevitably seek cash to lock in those market gains, while buyers prefer to share that trajectory risk with the sellers through stock consideration. This tension is thought to be leading to more hybrid deals involving cash and stock. It also generally requires buyers to work harder to explain their acquisition rationale to their own investors as prices rise, through trackable, defendable synergies and a clear business plan that identifies value creation that could not be otherwise achieved organically.

> "If you pay a premium now, that premium has trajectories of performance already built into the share price. If I'm a buyer, do I really want to pay in cash? Because if I pay cash, I'm locking in that trajectory. I'd rather pay with my stock, because now I share the risk with the seller. But if I'm a seller, I want cash"

Disruptive technology and innovation

Advancements in technology, changing business models and the evolution of workforces, are transforming the global economy. Business leaders and the rain-makers of tomorrow need to embrace innovation to remain competitive in an ever developing business landscape. In the reports below we explore artificial intelligence and connected and autonmous vehicles as two technologies that are disrupting today and that will shape tomorrow.
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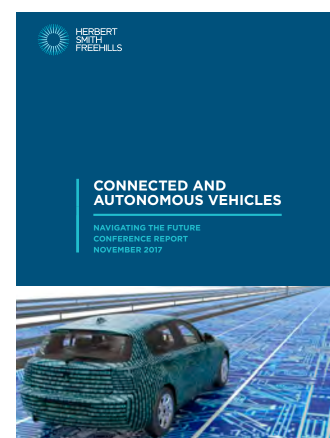
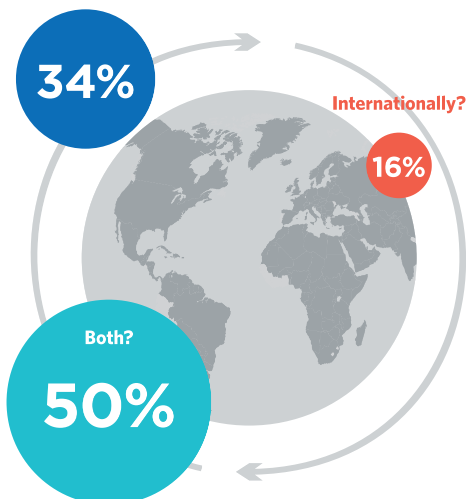


What will President Trump's impact be on M&A over the next 1 – 2 years?

When asked what **President Trump's** impact on M&A would be over the next 1-2 years, the views differed greatly by geography. The response in the US was more evenly divided - 28% thought the impact would be positive, with 32% voting negative and 40% suggesting no impact.

Will M&A by US-based businesses focus most...



Globally, half of the respondents predicted **US-based businesses** would focus on M&A targets both internationally and within the US. Over a third of the respondents said the focus would be domestic.

Technology driving M&A

Data, data everywhere

Data is now one of the most valuable commodities in the world, with a market predicted to be worth US$92 billion globally by 2026.

It's not surprising. Everything we do each day leaves a digital trace, capable of being collected, analysed, manipulated and sold. Most of us give up this valuable resource for free, or in exchange for a helpful app.

In just ten years, data has become perhaps the most disruptive and pervasive aspect of the world's business landscape, and a major driver for, and feature of, M&A.

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Shifting the goalposts for new and old alike

Of the world's ten most valuable public companies in September 2017, seven were tech companies. Back in 2007, as the iPhone launched, Microsoft was the only tech company in the top ten.

And for most of these companies, this stellar growth has been achieved largely by the smart collection, interpretation and use of data.

Data and underlying technological developments are also disrupting almost all sectors and new and old companies alike.

For many companies, data-driven M&A is now part of their strategies. In any event, data as a feature of M&A is on the ascendance, with resulting issues for doing deals in the data-age.

Data-driven M&A

Opportunities to acquire data assets or data-rich businesses are being perused by companies across nearly all sectors, from financial institutions to media players, with spill-over into adjacencies such as analytics, artificial intelligence and data centres.

There are no shortages when it comes to data-driven deals. Microsoft's purchase of LinkedIn in late 2016 gave its sales system access to LinkedIn's massive database of contacts. One of the key drivers for Amazon's recent acquisition of Whole Foods was the treasure trove of consumer data that came with the acquisition.

There are examples across almost all sectors, with accounting firm BDO recently finding that data-driven deals in the energy sector were up tenfold in 2017.

The devil's in the detail

Buyers need to ensure they upload value and not problems with their acquisition of data.

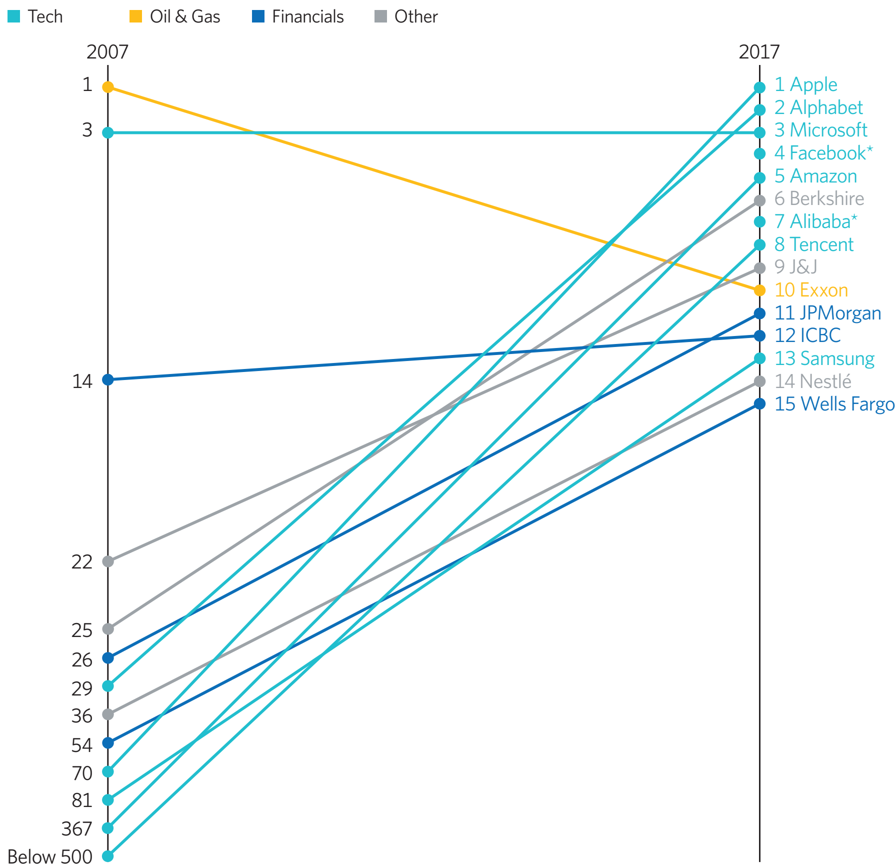
Good due diligence of data is now critical, given the growing reputational and legal risks of bad data management.

Legal due diligence must now extend to every aspect of the target's data collection, protection, storage and documentation, including all related contracts. Restrictions on the anticipated use or transfer of data can be value-destructive.

Privacy concerns have been heightened by high-profile thefts, disclosures and loss of data. The legal, ethical and commercial implications of a big data leak are now painfully evident and routinely publicised.

Smartphone Era

Market-value ranking since first iPhone was released



Note: Based on closing prices of June 28, 2007 and September 8, 2017

Source: Bloomberg

As data protection regimes expand to keep up with the industry and public concerns, M&A due diligence of will become deeper and denser, particularly if you are buying a dataset gathered and stored in numerous countries.

An acquirer needs to be sure that the prior handling of data complies with all applicable laws in every country in which the target operates and protect against liabilities for non-compliance.

Beyond a country's general data laws, there may be sector-specific requirements to consider, particularly in banking and telecommunications.

Regulations are getting stricter and regulators are being armed with greater powers, including to issue severe penalties.

Moving data across borders is becoming more challenging from a number of markets. Existing and anticipated arrangements for data centres and outsourced functions must be validated.

The way in which these issues are handled during negotiations has changed. There is now a much greater emphasis on representations and warranties, conditions precedent, indemnities and post-closing remediation and integration planning.

Antitrust concerns increase

More and more antitrust regulators are considering broadening their criteria to measure mergers and other business activities against data-related concerns or even social inequality, rather than a simple economic calculation.

The cases have already started. In May 2017, the EU fined Facebook US$122 million in relation to statements regarding the ability to match Facebook and WhatsApp accounts when it acquired WhatsApp in 2014.

The practice of using data-lakes during due diligence, where buyer and target data are combined into a common location to assess synergies, overlaps and value, needs to be structured and monitored carefully. The use of data-lakes featured, for example, during Johnson Control's acquisition of Tyco.

Antitrust and market regulators worldwide are also revisiting rules to address major players in the data space that are already apparent. This could lead to restructuring within those players and increased focus of regulators on data-related mergers.

One challenge is that the traditional antitrust focus on the effect on pricing works poorly in industries built from data freely offered up by users using ostensibly "free" services.

Expect a sharpened focus interest from regulators during acquisitions on this, as well as on behavioural issues.

A very public eye on data

The fact remains that very often the primary producer of acquired data – the individual – is not being paid for its labour. These 'producers' are realising that their online lives are now very useful to companies richer than countries and may be sold to the highest bidder.

Public activism is steadily rising in these areas, and governments and regulators will be forced to react. This public pressure will also increase scrutiny on mergers and the fate of data after a purchase.

The challenge for regulators and companies in the years ahead is to achieve a delicate and fair balance between facilitating innovation and growth including from use of data, on the one hand, and regulation, privacy and security, on the other. It will need cross-border and cross industry understanding to achieve both outcomes successfully.

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