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Trends and Developments

Contributed by Hawkins Hatton Corporate Lawyers Ltd

Hawkins Hatton Corporate Lawyers Ltd is a niche corporate law firm based in London and Dudley, dealing primarily with corporate and commercial work together with commercial property and litigation. Formed in 2005, its client base includes European and Anglo-US companies, individuals and a number of banks, notably RBS, Lloyds, HSBC and Santander, as well as a large number of small and medium-sized enterprises. Hawkins Hatton provides a full range of company and commercial services and is known for private equity work for management teams, management buy-outs, sales, mergers, acquisitions and disposals for shareholders of small and medium-sized enterprises, and a broad range of day-to-day corporate work including restructuring of companies, related tax issues and successfully negotiating the complex provisions of sale and purchase agreements. Employment specialists work closely with the corporate team to take care of all employment aspects of a transaction. This often includes consideration of TUPE, advice on terminations/dismissals and the preparation of appropriate service agreements for the period after the completion of a business sale or acquisition.

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Harminder Sandhu is the managing director and head of the dispute resolution department, acting exclusively for SME clients. With more than 20 years' experience of conducting and advising on high-value and complex commercial disputes, Harminder adopts a commercial and pragmatic approach to dispute resolution. The department undertakes litigation arising from a variety of commercial/corporate contracts including shareholder agreements, share purchase agreements, asset purchase agreements and security documents on behalf of its diverse client base across a wide sector, including manufacturing, engineering, aerospace, hospitality, insurance, pharmaceutical, social care, IT, waste recycling and professional services.

Colin Rodrigues is head of the corporate department and is the founding partner of Hawkins Hatton, with over 20 years' experience of M&A work at partner level. Renowned for his unique business acumen and ability to win clients, Colin manages the corporate department on a day-to-day basis but also retains a key fee-earning role and is best known for his ability to seek out commercial solutions to keep a deal alive. Colin set up Hawkins Hatton in 2005. In the last 12 months, he has completed multi-million pound corporate transactions in an array of industry sectors including manufacturing, engineering, pharmaceutical and healthcare, pest control and IT.

Trends & Developments (UK)

As the Brexit cloud loomed, dealmakers predicted that Corporate M&A would stall; however, in the last quarter of 2018 the actual number of deals remained consistent: in the middle market there were a number of high-profile corporate and private equity transactions as 2018 drew to a close.

Indeed, it was reported that the global M&A market in the first six months of 2018 hit an eleven-year high since the financial crash in 2007 (Financial Management 2018). Transaction volumes reached USD4.1 trillion. This trend was advanced by mega-deals, namely, those valued in excess of GBP5 billion. Notable deals include Takeda Pharmaceutical's broadcast purchase of Shire at USD62 billion, Comcast's purchase of Sky television network at U7SD40 billion and IBM's acquisition of Red Hat for USD34 billion.

In the first half of 2018, thirty megadeals were disclosed as compared to 14 mega-deals during the same period in 2017.

It seems the key factors which have driven M&A activity in 2018 were those which have existed in previous years, namely, global growth, cheap borrowing, cash reserves and investor-backing.

Trends

Foreign investment

Foreign investment made up to 31% of all deals in the first quarter of 2018, compared with 16% in 2015. 71% of deals in excess of £50 million involved a foreign investor.

The fall in the pound attracted foreign investment to the UK, particularly from the US. This was despite the uncertainty of Brexit and the impact on UK trade. Foreign investment took a long-term view and the deep-rooted trading relationship between the UK and US was evident from notable mid-market transactions, including sale of LPW Technology to Nasdaq-listed Carpenter Technology and the sale of Holchem to NYSE-listed Ecolab (www.fianancialdirector.co.uk/2019).

Additionally, there was completion of Californian-based HP's purchase of Apogee Corporation, a London-based company for GBP380 million and Zlylo of the University of Bristol being acquired by Novo Nordisk, a Denmark-based company for circa GBP630 million.

The Office of National Statistics did, however, report that the value of M&A of UK-based companies by foreign companies dropped by GBP15.8 billion in the third quarter of 2018 compared to previous periods. The number of deals continued to grow, including the sale of Waterstones to Elliott Management Corporation (US hedge fund) and the acquisition of Fenner by Michelin, which is a French-based company.

In contrast, UK-based companies purchasing foreign companies has been at an all-time low since 2013. Examples of such deals include Aviva's purchase of Friends First and JD Sport's purchase of The Finish Line, which is US-based.

UK assets, especially in the technology sector, should remain attractive to foreign buyers in 2019.

2018 witnessed China slowly easing constraints for foreign investment across a number of industries, including automotive and banking. This could see more joint ventures between US and Chinese companies in 2019.

Domestically, mention needs to be made of Tesco's purchase of the Booker Group for GBP3.7 billion and Spectris PLC's purchase of Concept Life Sciences Ltd from Equistone Partners Europe for GBP163 million.

UK retail

The UK retail sector has, however, been impacted by the growth of the online offering year on year. Take Amazon as an example, which started off just selling books and DVDs, and now sells virtually everything you can think of. But it has not stopped there; Amazon is also looking to enter the grocery market, as demonstrated by its purchase of Whole Foods in America. Maybe this is why Sainsburys was looking to buy Asda, after Sainsbury's successful acquisition of Argos, in the same way Tesco bought Bookers to defend against the potential online threat. Two of the UK's largest property shopping centre owners were in talks over a merger in December 2017, which suffered a setback. Hammerson, the owner of shopping centres such as the Bullring and Brent Cross were looking to take over Intu, the owner of shopping centres such as Merry Hill, Trafford Centre, Metro Centre and Lakeside. In money terms, if the deal between Intu and Hammerson had completed, we would have seen a sum of GBP3.4 billion paid by Hammerson. If we drill down into the issues around what caused this deal to fall away, it could be down to the recent spate of high-profile administrations such as Maplin's, Toys R Us and Carpetright, to name but a few, within the retail sector. The retail space continues to remain a difficult sector; more recently, it has seen another casualty in the form of House of Fraser and Debenhams.

Trade Wars and Tariffs

The world's largest trading nations, China and the US, have imposed tariffs, but a full-scale trade war could still be averted. The initial 90-day pause (which ended March 2019) during which neither country will increase tariffs whilst seeking to negotiate an agreement has been delayed. Whilst Trade wars and tariffs are very industry-specific, they have a direct impact on the M & A sector.

When Winston Churchill coined the phrase, "Jaw-Jaw is better than War-War", it was with a view to the fact that talking was always a good solution to fighting. What will happen if there is a trade war post-Brexit? The difficulty for the UK is that it will no longer have the protection of the EU trading bloc post-Brexit. The USA imposed the biggest set of restrictions on trade for more than 40 years on aluminium and steel imported into the USA. One may think that these tariffs were designed to prevent the cheap influx of Chinese steel into the USA; however, Chinese steel imports into the USA count for less than 3%. Given that the EU is one of the biggest importers into the USA of steel and aluminium, they hit back by announcing they would report America to the WTO but, given that Donald Trump announced these tariffs under the guise of statutes which provide that tariffs can be imposed for national security reasons, the WTO may not be able to look behind these. The EU is considering imposing its own tariffs on imported American goods. This, unfortunately, is the thin end of the wedge, as if you really want to protect the steel and aluminium market within your own country or trading block, you need to have safeguarding measures which will inevitably lead to the imposition of similar tariffs and this is how a trade war will start.

Convergence

Technology which has remained at the heart of business sectors for decades is now encouraging certain industries to consider new markets to keep ahead of the game. This is why cross-sector deals made up over one third of the UK corporate mid-market M&A in 2018. Convergence will continue to energise deals in 2019.

Expansion and Diversification

M&A activity has continued to be driven, not only by technology but also by corporates focusing on deals to expand their customer base in existing locations or to diversify their range of products and/or services.

US Tax

US tax-relief laws which allow corporations to repatriate cash held overseas at a lower tax rate have allowed corporates availability to overseas funds which has been invested at record highs in industry sectors such as technology. This trend is likely to continue in 2019.

Regulation

As US regulators increased wider regulation of foreign investment the pace of Chinese corporates investing in the US dropped significantly (by 90%). The Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), expanded the reach of The Committee on Foreign Investment in the US (CFIUS). FIRRMA is intended to address concerns in the US about foreign investment and access to sensitive US technology, especially by Chinese investors. It will achieve this by expanding the role of CFIUS in reviewing transactions which raise US national security concerns in relation to foreign investment or acquisition of certain US businesses. This has inevitably provided further obstacles to foreign investment in the US, including investment in real estate andM&A.

Despite the heightened regulation, Chinese companies are seeking opportunities to invest in the US due to the rise in the US dollar and more activity could be seen in sectors which do not attract high regulation during 2019.

Europe is following in the footsteps of the US, with the Europe Commission releasing proposals for a new framework for the regulation of foreign investment in the EU. It is expected this legislation will be finalised by May 2019.

The European Commission has also sought strictly to enforce merger control regulation, with record levels of fines being imposed on the likes of Facebook.

The UK is also seeking to bolster its foreign investment regulation, which will impact on M&A. The merger control thresholds for sectors deemed to be of national interest (such as military and technology) were amended to allow for more government scrutiny of deals with a national interest. Long-term plans for foreign investment is under consultation.

Regulation will inevitably impact on cross-border mega-deals in 2019.

Activism

Activist investors have remained prevalent in the M&A sector and will create further opportunities in 2019. The activist investor is more familiar to our US counterparts, but with the weakness in sterling, opportunities in the UK and Europe are becoming more irresistible. These activist investors are targeting publicly quoted companies and after becoming the significant or majority shareholder, the investors seek to de-list the companies in order to restructure. This activity is also becoming common amongst the junior exchange such as AIM. This is not something new, but given that the size of the targets is now so substantial, the activity is being noticed more. Not all target businesses have grown organically; most have expanded through acquisitions. It is difficult to criticise or judge activist investors who clearly identify opportunities which the current owners of the target businesses do not. Further, activist investors place their own money on risk to generate those opportunities, and to create value beyond the target current market value in the short- to medium-term, whereas target businesses are complacent and content to maintain an existing level of dividends and market value.

Looking Ahead in 2019

Businesses planning to expand or restructure through M&A in 2019 will do so against a background of changing political, trading and social conditions.

The fear is that Brexit will lead to a recession in the fourth quarter of 2019 and bring an end to the recent boom of the mid-market M&A sector. Uncertainty is the challenger of business and still questions remain as to whether the UK will leave with a no deal. Will there be a second referendum? Will there be a change in UK government? What will the trading relationship with EU look like? What will be the impact on the pound/exchange rates? Whatever the responses to these questions, businesses will need to adjust, adapt and embrace the changes and during this transitional period it is inevitable that deal volumes will fall. Hence, 2019 is predicted to see M&A at somewhat of a standstill.

Major banks have announced their exit from London to cities such as Paris, Amsterdam, Frankfurt and Dublin. This will lead to a loss of GBP700 billion of financial assets in the first quarter of 2019 to insurers and other financial services companies in the UK. Add to this the fact that manufacturers with significant capital investments in the UK (such as Nissan) are contemplating whether they remain committed to the UK or shift their operations elsewhere due to the uncertainty of Brexit.

That said, the Brexit situation is not the same as the situation UK businesses found themselves in during 2007/2008 as a consequence of the global financial collapse. There are certain UK sectors which will be unscathed by Brexit and it will be "business as usual". These are markets which have little or no recourse to Europe in relation to imports/exports or workers. The expectation is also that the Private Equity market will not be impacted by Brexit as its primary consideration is the strength of a management team.

Productivity has long been associated as one of the main things that is holding back the UK economy. McKinsey reported in September 2018 on "Advanced Manifesting Technologies". Technology is evolving faster than ever, through mediums such as artificial intelligence and 3D printing. Therefore, there needs to be innovation and investment within the manufacturing sector if it is to keep up with its ever-changing competitors. An economist's understanding of what "productivity" means would be associated with the output that is generated by an employee for each hour that they work. This may seem very obvious, but as with everything, productivity is the most important factor that will translate to the bottom line, which is the profit made by a company. The McKinsey report, when it compares the UK to Germany, identifies that there is a difference of approach which can be put down to cultural differences. Within the UK, it can be seen that we favour labour to create our productivity, whilst in Germany the focus for productivity relies on investment in new technology for equipment and software. One thing is for sure, that the UK focus on employees has led to full employment. A cynical view could be that this full employment also means that productivity cannot grow any more within the UK, as there are not the people available to fill the jobs required by the economy. This may not sit well with the outcome of Brexit, given that the current UK labour force is going to be constrained by its ability to increase its capability and quality of output, whereas robots can be made to work faster or slower where needed, without incurring significantly higher costs, other than their initial cost of purchase and installation. The new Brexit era will allow manufacturers to have a chance to re-focus on capital investment in order to upskill the existing UK workforce to use new technology, and maintain full employment, given that the economy is at maximum capacity. There will be a lack of additional workers coming into the UK economy to help increase productivity. The next issue is going to be where the money is going to come from for this new capital investment, as some of the foreign investment into the UK may slow down as a result of Brexit. However, inward investment remains cheap, due to the pound being at a five-year low.

The UK is an important contributor to the world stage and this will not change due to Brexit. The UK continues to lead in technology, closely behind the US, hence making such companies attractive to acquisition.

The UK is also rich with companies in the SME sector where there is no natural succession exit, hence these companies will need either a trade exit or a management buy-out. The outlook for M&A in the UK therefore remains promising, despite the challenges faced.

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