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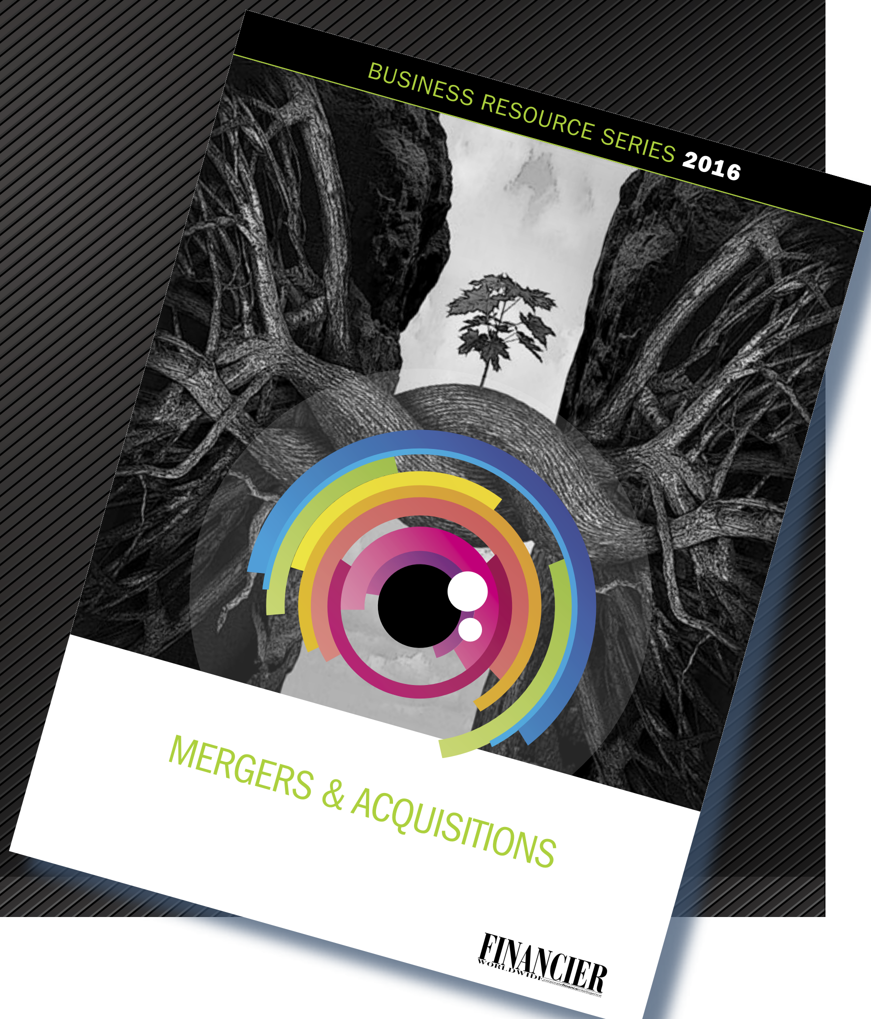

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DRIVERS OF M&A IN THE UK

BY Daniel Domberger

Acquirers and investors seem unperturbed by these unusually uncertain times, shrugging off concerns about a slowdown in China, the success of radical politicians and parties across the UK, Europe and in the US, the risk of Brexit, unconventional monetary policy and so on. There's a lot of talk of risk, and yet a lot of transactions being completed. Why the disconnect? What's driving these deals?

The China question

Firstly, what's not driving them? Inbound buyers from China, for a start. A couple of years ago, there was a widespread perception among entrepreneurs that their company was exactly what an (unspecified) Russian billionaire might be looking for. As Russia's economy turned for the worse, the excitement moved to China – and now we frequently hear from entrepreneurs that several (unspecified) Chinese billionaires or companies should be added to the list of buyers.

Actually, of more than 500 inbound UK M&A transactions in 2015, only seven involved Chinese counterparties (15 if you include Hong Kong) – and these were in the predictable sectors of industrial, automotive, property-backed leisure and real estate. The wave will come – China is the world's second-largest economy, after all – but it isn't here yet.

Going beyond ego

So, if it isn't China, what is driving M&A volumes in the UK? Well, inbound interest from the US (50 percent in 2015) and Europe (25 percent) remains a major factor, with corporates in particular holding their nerve and making sensible strategic moves. This is not a market characterised by headline-grabbing megadeals and CEO ego, but by disciplined and judicious applications of cash reserves in pursuit of growth, in a low interest rate environment.

How to reconcile this assessment of discipline with the current sellers' market? The acquisitive corporates are very clear on what fits their strategies, and therefore on what targets to pursue. They are not wasting time on tangential opportunities merely because there is a process. This means they can allocate their attention – and cash – to where it will drive the greatest return, and this in turn means they are willing and able to pay a real strategic premium for a business which furthers their goals. Call it quality, rather than quantity, in M&A strategy.

Evolving transaction structures

This set of market conditions is also driving evolution in transaction structures. Earn-outs, traditionally a way to bridge a valuation gap between seller and buyer, are not as common as they used to be. In some situations, buyers are concluding that intricate earn-out provisions – including post-acquisition management independence and the need to keep track of how the target is performing as an autonomous entity – simply get in the way of integration and synergy, let alone the aligned pursuit of strategic objectives.

Instead, they are working out what the target is worth, on a standalone basis today, then comparing this to the value it can bring to their own organisation – whether in filing a product or service gap, driving incremental revenues, catalysing organisational change, moving into new verticals, or colonising a strategically-adjacent part of the market.

> "Combine high demand with low supply, add a lot of money and pressure to spend it, and you have a recipe for strong valuations."

They are then sharing this synergy value in a highly-compelling valuation for the sellers, paid all in cash at completion. This has become a much more frequent characteristic in parts of the market traditionally dominated by earn-outs, especially people-based sectors such as consultancies and marketing services.

Private Equity investors

And what about private equity (PE) investors? High-quality businesses of the appropriate scale are scarce, and can drive very competitive behaviour among investors if the business has the right characteristics for a PE transaction – a strong management team, high growth, good revenue visibility, etc.

Meanwhile, PE investors remain under consistent pressure to deploy the funds they have raised. There is a lot of 'dry powder' unspent, and for a time-limited fund keen to make acquisitions in the first three or four years of a 10-year life, the clock is ticking.

Layer this with the progressive easing of debt markets, and the cheapness of debt compared to historic norms (the impact of higher margins offset by the lower base rate) and there is a surfeit of capital – which in turn reinforces the low-return environment.

Combine high demand with low supply, add a lot of money and pressure to spend it, and you have a recipe for strong valuations.

The future looks bright

While the macro picture necessarily hides individual-sector variations, we are seeing these drivers of M&A transaction values and volumes pretty consistently across the economy as a whole. Despite – or because of – all the talk of risk and uncertainty, these drivers of transaction activity are unlikely to decline in the medium term. Until the economy returns to steady growth, capital will remain cheap and acquirers and investors will continue to seek high-quality, fast-growing business – and will pay good value for them. ■

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