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INTRODUCTION

2018 was an exceptional year for M&A, despite activity decelerating in the second half: the value of M&A transactions in the first half hit an 11-year high¹ before a host of uncertainties – trade wars, Brexit, regulatory changes – took a toll in the latter six months of the year.

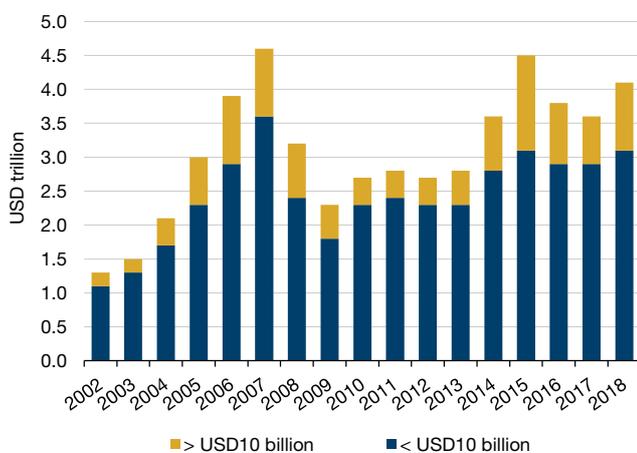
Against that background – the fear of rising interest rates, stock-market volatility, geopolitics, changing regulatory regimes, the list could go on and on – it’s not surprising that there are many prognosticators out there that think 2019 is going to be a bad year for M&A.

We, however, are of the view that M&A activity will remain strong in 2019. Indeed, we see potential alpha-generating opportunities in UK companies, in the pharma sector and in mid-sized deals.

2018 M&A ACTIVITY: A RECAP

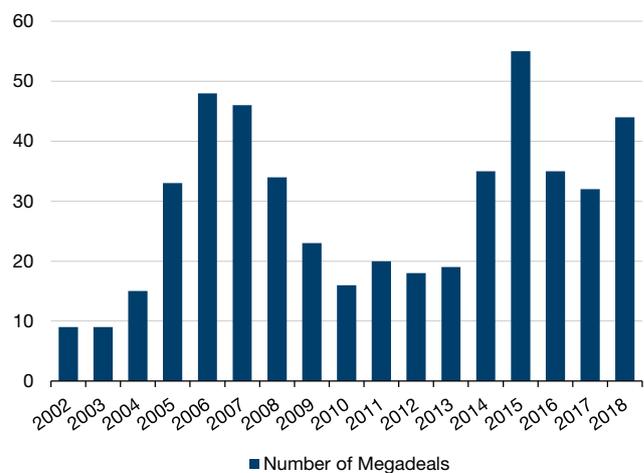
Global M&A transaction volumes reached USD4.1 trillion in 2018, the third-highest since 2002. More than half of the volumes were driven by mid-sized deals (those between USD1 billion and USD5 billion). Megadeals, or those greater than USD10 billion in size, were also a significant driver in 2018. Thirty megadeals were announced in the first six months of 2018 – the highest first-half megadeal count, before they began to normalize in the second half of the year.²

Figure 1. Global M&A Volumes, 2002-2018



Source: JPMorgan, Dealogic; as of 31 December 2018.

Figure 2. Number of Deals Greater Than USD10 Billion



Source: JPMorgan, Dealogic; as of 31 December 2018.

In addition, leverage buy-out (‘LBO’) volume surged to USD154 billion in 2018, the highest level since 2007, according to Thomson Reuters.³ From our perspective, this boom had, in part, been driven by record levels of fundraising by private equity (‘PE’) funds. In 2017, PE shops were sitting on USD369 billion, USD185 billion and USD75 billion of dry powder in the US, Europe and the rest of the world, respectively, according to data provider Preqin. Sitting on this kind of money creates pressure for fund managers to put capital to work: a buoyant 2018 LBO market was therefore not a surprise, even though valuation multiples were high.

Along with the excess supply of PE fundraising, catalysts for M&A activity included low cost of debt, improving cash flows, US tax reforms, strengthening balance sheets, positive global growth, investor support and CEO confidence, just to name a few. While geopolitics was present throughout the year, its effect only started to be felt in the second half of the year.

However, although 2018 was a strong year as a whole, turbulence in the fourth quarter is probably what investors will remember – a volatile and declining stock market, rising interest rates, along with heightened fears over Brexit and the US/China trade war, resulted in a drop in M&A activity as deals were postponed.

1. <https://www.refinitiv.com/perspectives/market-insights/mega-deals-keep-ma-boom-afloat/>
 2. JPMorgan 2019 Global M&A Outlook, published January 2019.
 3. <https://www.lexology.com/library/detail.aspx?g=bd06a7ef-eb6e-445a-9ae9-ea5026edc3ab>

2019 OUTLOOK: THE DOMINO EFFECT

Despite the dip in fourth-quarter M&A activity, we have a positive outlook for 2019.

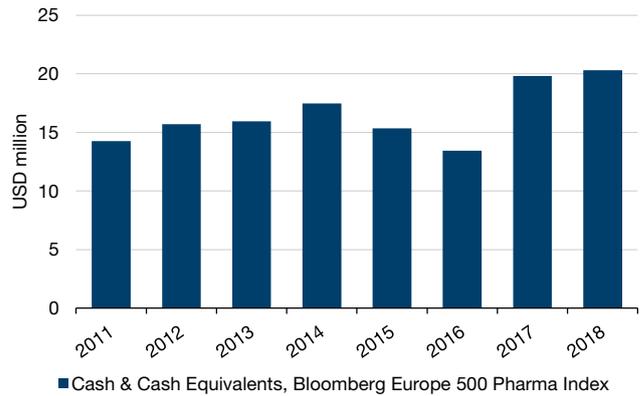
First, we believe that the pressure for PE funds to deploy the excess cash will not dissipate in 2019. As of 30 September 2018, PE funds still had USD348 billion, USD189 billion and USD99 billion of unused capital earmarked for US, Europe and the rest of the world, respectively, according to Preqin.

Secondly, we believe equity markets have stabilised, providing confidence for CEOs and company boards to pursue external growth. This has been demonstrated by the USD74 billion mega-deal between Bristol-Myers Squibb and Celgene.

Third, we see something of a potential domino effect within M&A: one large deal can trigger more, as executives seek to get in on the action. The best recent example of this has been in gold mining. The merger of Randgold Resources and Barrick Gold was announced in September 2018, creating the largest gold mining company in the world. Less than four months later, Newmont Mining, which had been the largest gold company prior to the September deal, reclaimed its title by announcing it was acquiring Goldcorp. Then, just last month, Barrick confirmed it was mulling a takeover offer for Newmont!

Looking forward, we see the potential for a similar domino effect in the pharma sector for two reasons: first, there are increasing levels of cash across the industry as a whole (Figure 3). Secondly, this coincides with a downturn in the pipeline of new drugs at many big industry names. Lapsing patents is a perennial threat for large pharma companies. In our view, a temptation will be for leading industry names to use their existing cash pile to secure smaller, single drug companies to bolster future cash flow. We would again reference the Bristol-Myers Squibb acquisition of Celgene: Celgene currently derives much profits revenue from its drug Revlimid, although its patents are due to expire in 2022. Indeed, Celgene itself had acquired Juno Therapeutics in 2018 for USD9 billion to gain access to its pipeline of cancer drugs.

Figure 3. Rising Cash Holdings at European Pharma Firms



Source: Bloomberg; as of 22 February 2019.

BREXIT: IN THE MIDST OF CHAOS ...

Despite uncertainty regarding Brexit in 2018, buyers were attracted to UK targets. Announced UK inbound volume reached an all-time high of USD251 billion in 2018, up 131% from a year earlier, according to JPMorgan.⁵ This was driven by two deals: Takeda's USD81-billion acquisition of Shire (yet another pharma M&A deal!) and Comcast's USD53-billion acquisition of Sky.

We believe that UK companies will continue to be attractive M&A targets for two main reasons: First, UK companies are attractively valued, in our view. The 12-month blended forward price-to-earnings ratio on the MSCI UK was exactly 12x as at the end of January, up from the December low of 11.3x.⁶ This is the lowest level since September 2013. In relative terms, this is 2.5 points below MSCI World, a disparity which has existed for around a year, but prior to which was the highest since April 2010.⁶ Secondly, the continued weakness in the British pound is providing potential opportunities, especially for foreign acquirers. Ongoing negotiations to buy British packaging company RPC by two American firms, Apollo Global Management and Berry Global, is a case in point.

Figure 4. Top Deals in Pharma Consolidation (Deal Value USD Billion)



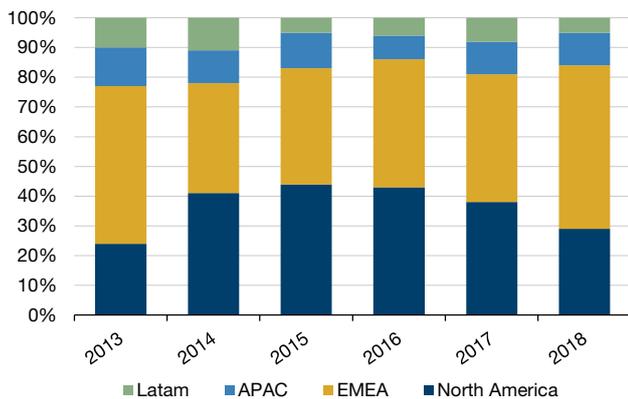
Source: Financial Times⁴, Bloomberg, Refinitiv; as of 3 January 2019.

4. <https://www.ft.com/content/d78fe796-0f70-11e9-a3aa-118c761d2745>

5. JPMorgan 2019 Global M&A Outlook, published January 2019.

6. Source: Bloomberg, MSCI; as of 31 January 2019.

Figure 5. Cross-Regional Announced Volume by Target Region



Source: JPMorgan, Dealogic; as of 31 December 2018.

SHOPPING: THE PERKS OF BEING MID-MARKET WALLFLOWER

The potential deal between RPC and Apollo also serves as an example of another key dynamic of the M&A market: deal shopping. Large deals are usually well-covered by the sell-side, as these can earn high fees. This filters through to pricing: deals are offered to almost all potential buyers, creating an ‘auction’ where the highest bidder wins. When a large deal is announced, it is then relatively rare to see another buyer emerge later in the process; after all, nearly all potential buyers will have already been offered the deal.

However, mid-sized deals tend not to be shopped around in the same way, with fewer potential buyers contacted. After a deal is announced, more buyers often enter the arena, increasing the potential price boost of the target company.

This is currently playing out in the RPC deal. Apollo, the US PE firm, announced a GBP3.3 billion takeover for RPC on 23 January, 2019. On 31 January, plastic packaging supplier Berry Global announced that they had approached RPC for due diligence information, driving up RPC shares by 3.7% on the day.⁷

This is the key source of attraction for mid-sized deals. In our opinion, there is a greater element of optionality after a mid-sized deal is announced, which can aid in alpha generation.

CONCLUSION

We therefore would conclude that there are a number of reasons to be cheerful about M&A in 2019, especially in the pharmaceutical sector, in the UK and in mid-sized deals. Most importantly, whilst the macro-environment may continue to deteriorate, the amounts of dry powder on hand should offer support for the market if we were to experience another selloff. In our view, it’s full speed ahead for M&A activity. Investment bankers are likely to continue being stressed and overworked in 2019.



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CIO of Man GLG

Pierre-Henri Flamand is the Chief Investment Officer of Man GLG. He joined Man GLG in June 2014. Before that, Pierre-Henri ran Edoma Capital Partners – a European-focused, event-driven hedge fund. He also spent 15 years with Goldman Sachs, where he ran the Principal Strategies Group. Pierre-Henri graduated from the Ecole Polytechnique, the Ecole Nationale de la Statistique et de l’Administration Economique and the Institut d’Etudes Politiques de Paris.



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7. Source: Bloomberg, as of 23 January 2019.

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