M&A Market Analysis

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2016 Middle-Market M&A Outlook

Despite a choppy market environment in Q4, the global M&A market in 2015 soared to record dollar volumes on the strength of mega-sized deals. While the global M&A deal count declined 3.0% in 2015, large deal activity drove a 37.0% increase in announced dollar volume to $4.0 trillion, which was well above the prior peak of $3.4 trillion in 2007. Dollar volume for deals valued above $10 billion more than doubled, accounting for 41% of overall volume and 78% of volume growth. A wave of consolidation among top rivals across sectors resulted in record dollar volumes in the U.S and Asia and an eight-year high in Europe. Strong volumes also reflected cash-rich strategics seeking to augment growth, as well as increased spending by financial sponsors. In the global middle market, the number of transactions increased 5.0% and dollar value was up 6.3% in 2015 on top of high-teens growth for these metrics in 2014. Although the backdrop for deal-making remains relatively supportive, this year's M&A results may not reach the levels of 2015, particularly with more challenging market conditions entering 2016.

Assuming the equity and lending markets regain firm ground, conditions generally seem well suited for M&A activity. Most variables influencing the M&A market appear supportive or neutral, even though certain factors recently shifted negatively from being positive. The favorable investor reaction to large deals during 2014-2015 could encourage management teams to pursue key targets in 2016, with strategic buyers still prioritizing expansion via M&A in a low-growth economy. In addition, private equity firms have the means and motivation to transact, with $500+ billion of uninvested capital on the sidelines. During Q4 2015, Intralinks projected a 7% increase for global M&A deal announcements in Q1, suggesting a solid start to 2016. In separate surveys conducted by Mergermarket and KPMG, most M&A practitioners anticipated M&A transaction growth in 2016. However, all of this is predicated on stable markets; if the volatility seen so far in January persists (or increases), M&A activity will decline proportionally.

Historical context indicates the M&A market may be in the later stages of cyclical strength. The U.S. M&A market has demonstrated capacity for a multi-year run twice in the past two decades; 1998-2000 and 2005-2007 featured three straight years of dollar volume well above $1 trillion (as seen in 2014-2015), as large acquisitions in the earlier years of these periods compelled competitors to strike sizable deals of their own. Compared to past cycles, interest rates are lower, corporate balance sheets are stronger, and financial sponsors have more available capital, highlighting the potential for robust M&A activity in 2016.

- Strategics Still Seeking Growth. Corporates will remain busy on the M&A front in 2016. Companies continue to have capacity to pursue targets aggressively, as cash positions are estimated to exceed $7 trillion globally. With investors rewarding acquirors due to the subdued outlook for organic growth, corporates across key M&A markets will be on the prowl for opportunities. Following a round of large-scale consolidation in the U.S., newly combined companies will divest non-core assets, and smaller rivals will seek to join forces in order to enhance competitiveness. Strategic activity is poised to ramp up in Europe, where 2015 M&A metrics were far below all-time highs, in contrast to record dollar volumes and near-peak deal counts elsewhere. Domestic growth trends in China and Japan should lead to further strength in outbound M&A activity from those markets.

- Financial Sponsors Supporting Deal Flow. Private equity firms should be active M&A participants, with substantial access to capital given successful fundraising and frequent exit activity. Despite being crowded out by strategic buyers in many cases during 2015, sponsors registered cyclical peaks for acquisition spending and LBO purchase price multiples. In 2016, the higher cost of financing should result in a more judicious approach on valuations, which could cause private equity firms to prioritize add-on deals over new platform investments. With sponsors needing to achieve realizations on the thousands of firms acquired earlier in the M&A cycle, 2016 should be another year of healthy exit activity, sending high-quality assets into the market for potential strategic and private equity acquirors. Relative to the equity markets, M&A should be an attractive means of realizing liquidity, as dollar volume for sponsor-backed IPOs fell over 50% in 2015.

- Lackluster Economic Expansion. Growth for the global economy is expected to remain tepid in 2016, in line with the last few years. The World Bank projects worldwide growth of 2.9% in 2016, slightly above last year's increase but less than previously anticipated. The U.S. economy is projected to maintain its recent growth trend, even as strength in the dollar limits export activity, with the Federal Reserve seen raising interest rates at a measured pace. The World Bank described economic recoveries as fragile in Europe and Japan, where monetary policies are geared toward stimulus. Downside risks to global projections appear significant, as further weakening in China, Brazil, and Russia, three of the largest emerging markets, would dampen activity in other economies. As in past years, divergent outlooks for regional economies should drive cross-border M&A activity in 2016.

- Cautious Credit Markets. While lenders continue to actively look for high quality opportunities to deploy capital, near-term conditions in the leveraged finance markets are likely to remain challenging as markets contend with cross-currents such as lower oil prices, Fed rate hikes, and geopolitical issues. Credit quality has become increasingly important, with the backdrop favoring borrowers having stable revenue and margin profiles. Standard & Poor's projects moderate declines in U.S. leveraged loan and high yield issuance in 2016 while noting a wide range of potential outcomes; volume growth is possible in a scenario of gradual economic expansion and firmer energy prices, but downside risks are prominent with investors currently concerned about macroeconomic uncertainty and looming defaults caused by plunging commodity prices. Amid turbulence in the global equity markets in early 2016, lending market participants were in no hurry to test the waters, as evident in modest issuance and further fund outflows in the first two weeks of January. Nevertheless, forward volumes on the latest calendars for both leveraged loans and high yield were above 2015 averages, suggesting that issuers plan to remain active in Q1 2016, even if not securing the peak leverage levels and pricing of mid-2015.

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