M&A Market Analysis

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2015 Middle-Market M&A Outlook

After falling short of expectations over the past few years, the global M&A market made up for lost time in 2014. Powered by large deal activity, reported dollar volume rose 53.0% on a global basis, with the $2.90 trillion total representing the highest volume since the record mark of $3.38 trillion in 2007. Volume for deals valued above $1 billion jumped 82.1%, benefiting from pent-up demand for large strategic deals. The M&A recovery carried across transaction sizes, as the 13.2% increase in the global deal count incorporated 14.5% growth in the middle market, where private equity firms focused. The U.S., Europe, and Asia each generated higher transaction totals along with substantial dollar volume growth that was augmented by robust cross-border activity. The upturn in deal-making was spurred by greater conviction among leaders of increasingly well capitalized companies that their economic futures were bright. Most M&A deals seemed to be welcomed by equity investors, as share prices rose for deal-making firms. Heading into 2015, market signals point to continued M&A momentum, as second-half 2014 global deal counts and dollar volume exceeded first-half levels.

The necessary ingredients are in place for further strength in M&A during 2015, even if the market pauses at some point to digest the tremendous activity of 2014. Nearly all of the factors affecting the M&A market seem supportive or neutral. In fact, a recent survey conducted by Mergermarket projected growth in the M&A deal count in 2015. In addition, positive investor feedback to large deals throughout 2014 could push more companies to execute on planned M&A transactions of various sizes in 2015. Furthermore, corporates will continue to be drawn to M&A in a growth-constrained global economy, while private equity firms face pressure to deploy committed capital and exit older holdings.

Historical context suggests the M&A market may be in the early stages of cyclical strength. The U.S. M&A market has shown the capacity for a multi-year run twice in the past two decades; both 1998-2000 and 2005-2007 featured three straight years of M&A dollar volume well above $1 trillion (as seen in 2014), as the surge in acquisitions early in these periods compelled competitors to strike deals of their own. Also of note, average middle-market volume gains in years two and three of these upturns exceeded year-one growth rates.

The historical performance of the M&A market relative to equity market values may also prove instructive. U.S. dollar volume as a percentage of total equity market capitalization was slightly below its historical average in 2014. Given past peaks well above the average level, upside from 2014's record volume is possible. Relative to past cycles, interest rates are lower, corporate balance sheets are stronger, and private equity firms have more untapped capital, underscoring the potential for continued robust M&A activity in 2015 absent softening in the credit markets or unforeseen market shocks.

- **Corporates Continuing to Consolidate.** Following a year filled with transformative deals, corporate acquirors still have the means (with cash positions estimated to exceed $5 trillion globally) and motivation to pursue key targets. In the U.S., the post-announcement stock gains of acquirors in $500+ million deals provided critical support to large transactions in 2014, when stock reactions were the most positive on record for this deal segment. With the U.S. economy seemingly on firmer ground, company leaders witnessing the favorable response to increased strategic activity should be more comfortable capitalizing on consolidation opportunities across sectors and deal sizes. The sluggish economies of the euro zone may curtail M&A levels in Europe, where companies will continue to focus on overseas deals in order to supplement growth. Corporate acquirors based in China and Japan also should remain aggressive in seeking complementary outbound M&A transactions in 2015.

- **Private Equity Firms Primed to Deal.** After taking a back seat to strategic acquirors in 2014, financial sponsors are poised to be prominent players in the M&A market. Private equity firms continue to have access to large stores of dry powder due to several factors: substantial uninvested capital enhanced by another strong year of fundraising, relatively moderate growth in spending on acquisitions in 2014, healthy levels of exit activity via stock offerings and M&A transactions, and access to financing at reasonable terms. While wary of overpaying for public company takeovers, sponsors should remain active buyers of ongoing corporate divestitures. Any downturn in the equity markets could enhance the appeal of M&A as a liquidity event for current holdings.

- **Modest Economic Acceleration Projected.** The global economy is expected to build on its gradual recovery with an uptick for growth in 2015. The World Bank anticipates worldwide expansion of 3.0% in 2015, up slightly from last year's rate due to higher growth in the U.S., Europe, Japan, and India. The economist survey of the National Association for Business Economics also forecasts faster U.S. expansion. Expectations of minimal inflation reflect cratering oil and gas prices, which will have a multi-faceted impact across markets, including lower costs for consumers and businesses. The U.S. Federal Reserve plans to raise interest rates from historically low levels beginning in 2015, while monetary policies could become even more accommodative in Japan, China, and the euro zone as leaders strive to boost growth.

- **Lending Markets a Potential Wildcard.** The global credit markets should be conducive to M&A activity, although perhaps not to the extent seen in the last couple of years. Entering the year, issuers may be reluctant to wade into the turbulent waters seen recently. Nevertheless, borrowers are likely to be drawn to rates that remain historically attractive even after rising toward year-end. Standard & Poor's projects U.S. loan volume down 25-35%, largely due to a more restrictive regulatory environment that will pressure leverage levels. Moreover, high yield investors may pull back amid concerns about oil and gas sector exposure for this asset class. The market will continue to closely monitor flows for leveraged finance funds due to the potential impact on liquidity for middle-market leveraged loans and M&A financings, even as an expanded CLO investor base has become a more important capital provider. In Europe, many market participants expect increased volumes for 2015, especially if the economy stabilizes and if sovereign debt troubles are avoided.

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