Minnesota M&A in 2018? Land of 10,000 Mergers

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Minnesota's mergers and acquisitions (M&A) market has been strong the past few years, but can this trend continue in 2018? Will buyers continue to be willing and able to pay the high valuations we've seen recently? How will the recent tax changes impact the M&A market? Based on national historical trends and expert predictions for 2018, following are some predictions about what this means for Minnesota companies.

Overview.

U.S.-based buyers were the drivers behind half of the top ten global deals in 2017, and North America, as a whole, accounted for 43.4% of the global M&A market. However, the overall deal market last year was slower than in the years since the 2008 recession.

In 2017, U.S. mid-market M&A totaled just over $1.5 trillion, with 10,104 U.S. companies being acquired across the nationwide. The 2017 U.S. deal market had the lowest deal value since 2014, down from $1.7 trillion in 2016. The number of M&A deals was down from 12,524 in 2016; neither year surpassed the red-hot market in 2014 and 2015, which each saw enormous M&A activity. Deal volume in the 4th quarter of 2017 increased, however, which is normal as deals rush to close before year end. Also, it should not go unrecognized that data aggregators often do not reflect small, unreported deals in their statistics, which is where much of the action occurred in 2017 and in smaller markets like Minnesota.

Nationwide Expectations.

Companies are generally in good health and well positioned to engage in M&A activity. According to Deloitte's *The State of the Deal: M&A Trends 2018*: corporations and private equity firms will likely see increased M&A activity in 2018. Both the number of deals and the size of deals will likely exceed those of 2017. Acquiring technology or a digital strategy will be driving forces behind nearly a third of corporate M&A deals in 2018. For private equity firms, more than half of M&A transactions will be motivated by strategic transactions. Other strategic drivers for M&A deals include expanding customer base into existing markets, expanding or diversifying products/services, and talent acquisition.

An additional anticipated driver for 2018 M&A activity is the aging population of baby boomers. Baby boomers own an estimated 4.5 million firms valued at a total of $10 trillion. These business owners will need to address the future of their companies as they reach retirement. Realistically, deal flow will increase in the next ten years as baby boomers seek exit opportunities from their businesses. Wise baby boomers should be planning now and exploring opportunities while the M&A market remains strong.

Companies' cash reserves and financing availability have increased, meaning they have dry powder for M&A deals in the upcoming year. According to Bloomberg Businessweek, private equity investors have a record $963 billion cash on hand awaiting promising opportunities. Mid-market M&A deals will likely be a strong focus for that cash in 2018. Corporate cash on hand is at a record high since 2009 and will likely be used to accelerate company growth through strategic, targeted acquisitions and consolidations. Finally, mid-market leveraged loan volume was up 53% from 2016 to 2017, making debt financing readily accessible for M&A activity. All of this cash and available debt likely means competition will remain strong and well managed sellers can expect multiple offers and high prices. Buyers will also continue to look for deals outside of the traditional middle market, including smaller deals with excellent growth opportunities.

In the first three quarters of 2017, as reported by PwC, the technology, financial services, health care, and life sciences sectors had deals totaling $126.4 billion, $34.7 billion, $74.9 billion, and $157.3 billion, respectively. These four industry sectors are expected to be the big areas for growth in 2018 – especially the technology and health care sectors. Companies will enter more deals across markets, such as the convergence between health care providers and health care plans and the technology industry merging with the retail industry. The Amazon, Berkshire Hathaway and JP Morgan deal announced on January 30th where they are joining forces to address rising healthcare costs. The health care and technology industries can expect to see increased convergence driven by technological advances and pricing pressures. Health care M&A activity specifically will be driven by the aging baby boomers and increased regulatory activity. Technology is a disruptive force in nearly every industry – from automated delivery systems in the retail industry to self-driving cars in the automotive industry. Artificial intelligence companies will be targeted by buyers looking to take advantage of these opportunities.

Horizontal mergers in both the technology and the health care sectors seem to have reached their maximum; many companies in these industries are turning to creative vertical mergers, integrating buyers and suppliers. Healthcare M&A saw deals such as CVS Health's $69 billion purchase of Aetna, an attempt to combine Aetna's insurance with CVS's pharmacies and retail clinics to increase their efficiency, reduce consumers' cost of healthcare…and fight off competition from larger new entrants like Amazon.

What's working for deals?

A higher percentage of deals in 2017 were reported to have generated the expected return on investment (ROI) than deals in the previous year. Effective integration, accurate valuation, and economic certainty were reported as the top three factors ensuring successful deals. While accurate valuations may be a harder to manage in 2018, economic certainty seems to be more favorable. The 2018 midterm elections may shake everything up and turn all markets in circles.

The recent tax reform may have a positive impact on the M&A market. Decreases in both corporate taxes and personal income taxes would benefit the deal market and privately owned mid-market companies – and their owners. The repatriation of foreign earnings at promising tax rates will likely encourage the return of nearly $1.2 trillion held overseas, with such repatriations already happening. Companies with cash on hand are twice as likely to spend that cash on deals than they are on capital expenditures, suggesting that a company bringing home cash from overseas is more likely to engage in the M&A marketplace.

Approximately 75% of the cash pools outside of the U.S. belong to companies in the technology or health care sectors; historically, both of these industries prefer to participate in M&A activity rather than in capital investments and buybacks. One notable example is Apple, who recently announced its plan to return hundreds of billions of dollars to the U.S. given the tax reform.

What obstacles does the deal market face?

Historically, corporations and private equity firms have worried about global economic uncertainty, interest rates, market volatility, and deal valuation concerns; however, they are less worried now than they have been in previous years. Companies are more resilient in navigating major global economic shifts. Interest rates are historically low, despite the Federal Reserve implementing a series of hikes in 2017. The CBOE Volatility Index just traded at the lowest historical level, shrinking concerns related to market volatility. Lastly, deal multiples will likely rise over the next year as businesses continue to perform well and competition for deals increase.

Despite the overall optimism about the M&A market, there are still several concerns. Vertical mergers will pose an array of complex and interesting questions for antitrust regulators. As companies enter creative vertical deals, antitrust enforcement will need to address tough legal issues and determine the impact on competition that different arrangements may bring up. Concerns over these issues may lead to lawsuits, such as the Justice Department suing to stop AT&T from acquiring Time Warner for $85.4 billion. The Justice Department is worried about the potential of increasing cost for competitors and the disruption of online video development. Many companies are waiting to see the outcome of this case, as it is one of the most high-profile antitrust cases to occur in decades. This case could determine whether antitrust regulators can prevent vertical deals that do not include direct competitors, potentially creating a large obstacle for the M&A marketplace's future as inter-sector combinations gain favor.

Forecast for Minnesota.

Minnesota companies have historically purchased companies of varying sizes both across the country and worldwide. The number of Minnesota mid-market M&A transactions declined about 10% from the previous year, with only 166 acquisitions in 2017 compared to 184 in 2016. Deal volume was the lowest since 2014, rounding out at $23.4 billion. The fourth quarter recorded a more than 30% dip in deals compared to the fourth quarter of 2016. In early December, however, UnitedHealth Group announced its acquisition of DaVita Medical Group for nearly $5 billion – bringing the healthcare vertical merger trend to Minnesota.

Based on the nationwide predictions, Minnesota's mid-market business owners can expect an increase in the volume of deals under $50 million (lower middle market or small deals). But that does not mean big deals are out the window – just look at the recent buzz around the highly contested idea of Amazon purchasing Target. Target would be Amazon's biggest acquisition to date, potentially costing somewhere around $50 billion. This predication by Gene Munster has received plenty of pushback – just check out this article in the Minneapolis/St. Paul Business Journal.

Of the top four nationwide sectors that are projected to do well in 2018, Minnesota is strong in three: health care, financial services, and technology. The health care sector employs 16%, the financial services sector employs 4.8%, and the technology sector employs 5% of Minnesota's ework force. Together, these industries make up just over a quarter of Minnesota's employment (employment indicates the relative size of each industry). These sectors are active in both horizontal and vertical merger opportunities.

For mid-market business owners – both in Minnesota and nationwide – who have been thinking about selling their privately held businesses, now is the time. The 2018 M&A market is expected to be a sellers' market, but who knows how long it will last.

Authors: Todd Taylor helps business owners and their companies solve legal and business problems related to M&A, financing, startup, formation, shareholder disputes, contract drafting, negotiations, SEC compliance, company sales and purchases. No matter the situation, Todd helps his clients.

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