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Buyers Struggle To Stomach Valuation Gap Amid Uncertainty

By **Chelsea Naso**

Law360, New York (July 6, 2017, 6:24 PM EDT) -- The U.S. mergers and acquisitions market is turning out to be a choppy one, a trend that's slated to continue into the second half of 2017 as uncertainty in the political and economic climate makes the valuation gap more difficult to bridge.

Deal makers at the beginning of 2017 often described their outlook for M&A in the coming year as "cautiously optimistic." Although the election of President Donald Trump was a shock, it ultimately spurred a rise in the stock market dubbed the Trump bump, suggested that a lighter regulatory environment was imminent and ushered in the promise of corporate tax reform.

While the stock market remains strong, debt remains cheap and companies still have stockpiles of capital on their balance sheets, a persistent uncertainty about the political climate is making it difficult for buyers to judge whether they can truly justify paying the high valuations demanded by sellers.

Trump's planned tax changes have yet to move forward, spurring questions about when, and if, such reform might be put into effect. There's confusion around what a repeal of the Affordable Care Act might actually look like, and whether such a bill would make it through Congress. Some uncertainty persists around the investigation into the president's campaign's alleged ties to Russia and what potential disclosures from that investigation could ultimately mean for the country.

"When people feel better about some of those peripheral issues, a buyer may very well jump that final valuation hurdle to hit a price the seller wants and when they don't, they are less likely to do it," said Daniel Wolf, a Kirkland & Ellis LLP partner.

And that domestic uncertainty is further compounded by issues in other countries, like the impending Brexit and the recent U.K. election. That could stem U.S. outbound M&A to the region, although those looking for stability might set their eyes on the U.S.

However, inbound China deals are down and not expected to rebound anytime soon. At the end of last year, China's State Administration of Foreign Exchange put into effect new regulations aimed at curbing the flow of capital outside the country amid concerns that certain transactions were merely a way to maneuver money into other areas.

The SAFE regulations make it more difficult for Chinese buyers to get money out of the country at the speed they might need to win an auction. And there's always the added concern that Chinese buyers may have a more difficult time securing approval from the Committee on Foreign Investment in the United States, an interagency committee tasked with reviewing the national security risks associated with inbound control transactions.

“Probably one of the biggest overhangs over the market continues to be the regulatory situation in China and the resulting decrease in China outbound deals this year,” said George Casey, head of Shearman & Sterling LLP's global M&A practice.

But even the pressure from the political uncertainty and changes overseas are not poised to stop M&A. Deals have been, and will continue to be, announced, but larger transactions are expected to be more sparse in comparison to the megadeal frenzy seen in recent years.

“We've seen and I think we'll continue to see good M&A activity in the nonmegadeal and middle market tier. We've seen less and I think we'll continue to see less activity than the most robust years in the megadeal area, but overall it's been a busy year for M&A in 2017," said Jack Bodner, a Covington & Burling LLP partner. "Having said that, I don't know that we'll be breaking too many M&A records this year."

Companies still have a lot of capital they need to put to work, and there is a continued push for inorganic growth and a continued need to acquire technology to remain at the forefront of various industries.

That, along with the fact that companies can use stock as capital and have access to cheap debt, should make it easy to get a deal done once a buyer and seller see eye to eye on valuation.

“Even though folks have been a little more cautious and waiting to see if the optimistic projections for the change in administration would become a reality, I think things are still moving ahead toward continued M&A activity,” said Goulston & Storrs PC's Gregory Kaden.

Aside from that, shareholder activism is expected to continue to be a major catalyst for M&A activity going forward. Activism is taking root among more traditional, long-term players that used to be more passive, and more companies are feeling the pressure to put their capital to work and engage in a strategic review of their portfolio, which includes considering everything from acquisitions, carveouts and a full-on sale of the company.

“There are people who before sat on the sidelines and are now either being more vocal or following what the activists are doing. It's not just a handful of activists. Pension funds and other institutional investors are moving the needle on some of these,” said Jane Goldstein, co-head of Ropes & Gray LLP's M&A group.

And, public companies may draw more investments going forward from private equity firms. They're still sitting on large piles of dry powder and looking for creative ways to put it to work. More private equity firms are taking smaller stakes in public companies, in hopes of getting a leg up in a potential take-private.

“PE sponsors are taking toe-hold positions in public companies,” said Paul Scrivano, global head of M&A at Ropes & Gray. “Less so like an activist would, more so taking a stake and wanting to discuss what a future might look like, if a future might be in the cards.”

--Editing by Rebecca Flanagan and Edrienne Su.