NORTH AMERICA DEAL VOLUMES

Why prospects are brightening

After a wobble in the first half of last year, North American mid-market deal activity has good momentum in 2017. **David Brackett** of Antares Capital explains why and identifies some of the year's hot sectors

Overall North American M&A activity slipped in 2016 versus lofty 2015 levels, but still logged its second-highest level of the decade. According to Mergermarket, total North American M&A deal volume peaked at almost $2 trillion in 2015 against $1.6 trillion in 2016. Deal volume has increasingly been driven by large ($1 billion-plus) and "mega" deals both among strategic players and in the private equity arena. Much activity also was driven by foreign buying of US companies, which climbed to record levels[1].

Turning to a more private debt-focused view of the sponsored "mid-market", total US sponsored mid-market loan issuance rose 5 percent to $52.6 billion in 2016 according to Thomson Reuters LPC, with the core portfolio at Antares up 29 percent; however, LBO-related issuance lagged. In H1 2016, LBO loan volume was particularly weak – down 14 percent both versus H1 2015 and H2 2015. This likely reflected the negative impact of Brexit as well as concerns related to paltry US GDP growth of only 0.8 percent in Q1 and 1.4 percent in Q2 2016.

However, mid-market LBO volume recovered 15 percent YoY in H2 2016, likely reflecting improved GDP growth (+3.5 percent in Q3), Brexit acclimatisation, and a rise in economic optimism post US elections. As a result, full year 2016 US syndicated mid-market LBO loan volume ended up about flat versus 2015, with good momentum moving into 2017. (It should be noted that the reported syndicated loan data as shown in the graph (right) only paints part of the picture and understates true activity with LPC's Q3 survey of the private/club deal market suggesting a significant pickup in Q3 2016. Q4 survey data was not available at the time of writing.)

David Brackett

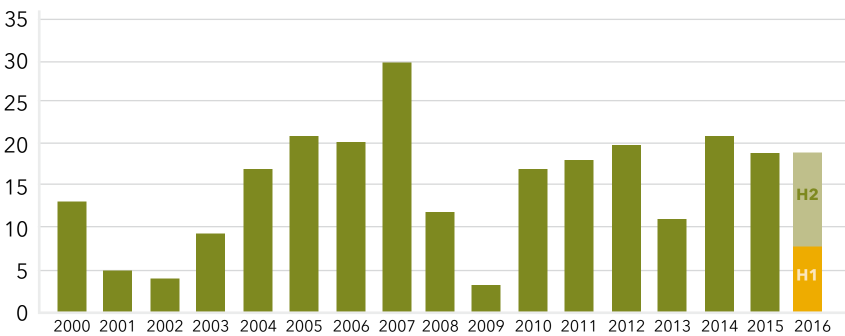
A PICKUP IN 2017?

Looking forward, several Q4 2016 surveys from accounting/consulting firms, trade magazines, banks and others generally suggest brighter prospects for M&A in 2017 [2]. Reasons most commonly cited as catalysts for a pick-up include new policy initiatives from the Trump administration such as lower corporate tax rates, reduced regulations, repatriation of cash held by corporations abroad and a potential surge in infrastructure spending. Other supportive economic fundamentals include improving GDP growth prospects, very high cash levels at corporations, record high levels of dry powder at PE funds, still low interest rates, a surge in consumer confidence (to the highest levels since 2001), and record highs for the S&P500.

Our own very recent survey of US mid-market sponsors taken in December 2016 also suggests at least tepid optimism. When asked: "How do you see middle market M&A/LBO activity shifting over the next 12 months?", 21 percent indicated they expect M&A to be more active in 2017 and 73 percent indicated they expected M&A activity to be flat with only 6 percent expecting a decline.

One cause of reservation noted in our survey comments was belief that there could be a potential pause by sellers until there is a clearer picture on taxes which may be just a timing issue. Other factors not specifically

US MID-MARKET LBO SYNDICATED LOAN VALUE ($BN)



Source: Thomson Reuters LPC's Middle Market 4Q16 Review – Jan 2017 cited, but likely of concern, include sector-specific trade and regulator uncertainties, geopolitical risks and potential economic woes abroad, "late in cycle" worries, and reticence related to elevated purchase price multiples and the quality of deal flow.

On balance, we believe ample liquidity in credit markets, renewed optimism for US growth prospects and a more favorable regulatory and tax environment will likely help lift sponsored mid-market M&A activity by 10-15 percent in 2017.

WHAT'S HOT, WHAT'S NOT

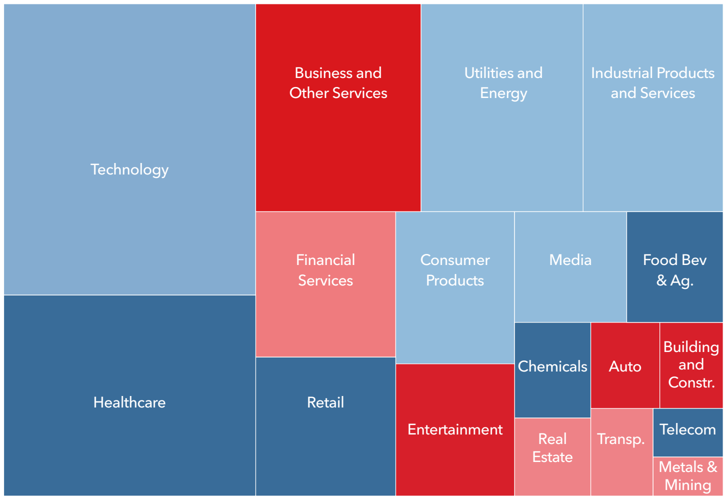
One method of assessing potential shifts in deal flow across various industry sectors over the next several months is comparing shifts in the numbers relating to companies rumored to be or officially up for sale in North America. The intelligence comes from a range of sources, including press reports, company statements, and Mergermarket's own intelligence from M&A practitioners across the region.

In the heatmap graphic we've created, we compare counts for each industry sector for the period of September-December 2016 versus May-August 2016. The size of each box indicates the size of its relative news count and the colour indicates whether that count has increased/heated up (red), or decreased/cooled off (blue). This heatmap tool does not differentiate between small and large transactions or between deals that could happen in the short or long term, but is believed to be a decent indicator of potential M&A activity trends.

Looking at industries, two areas that appear to be heating up are business and financial services. Business services, a diverse area that is a large segment of our portfolio, may be seeing accelerated M&A activity for a variety of reasons including improving corporate confidence, outsourcing and investment activity. In the financial services area, the drive to acquire "fintech" assets and help offset tepid inorganic growth are no doubt driving forces. The prospect of deregulation and rising interest rates also may be boosting confidence of bidders in the sector. Construction, transportation and metals & mining are other "hot" areas that may be benefitting incrementally from the potential surge in new infrastructure spending as well as potential roll-back of environmental regulations.

Healthcare continues to be one of the most active areas (as denoted by the box size), but the count of companies for sale appears to have cooled of late. This may reflect some temporary uncertainty for some sub-segments related to the impending repeal of the Affordable Care Act. However, longer-term secular trends remain positive for healthcare and we continue to expect a healthy level of growth in PE investment activity, particularly in areas such as healthcare IT and medical devices.

NORTH AMERICAN M&A HEATMAP



Source: Mergermarket database; "For sale" news count for 4-month trailing period ending Dec. 2016 vs. August 2016

THERE WILL ALWAYS BE CYCLES

Although default rates remain low and prospects for a second wind in M&A/LBO activity currently look favorable, as a debt investor, it pays (literally) to remember there are always going to be down-cycles. Things can change quite rapidly and most prognosticators' success in forecasting recessions is not impressive. During the nadir of the last down-cycle in 2009, the mid-market was a relatively good place to be with the "large" mid-market seeing just over a 4 percent default rate versus 12 percent for broadly syndicated loans (source: LPC, Fitch). However, these favorable loss rates along with attractive yields have attracted a spate of new unseasoned lenders to the middle market in the intervening years. History has shown loss rates vary by lender so investors should do their homework before jumping into the market. ■

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1. *Source: Mergermarket Global and Regional M&A Q1-Q4 2016 report*
2. *Examples include VENUE Market Spotlight - 2017 M&A Outlook survey dated Dec 2016 by Donnelley and Mergermarket; Deloitte M&A Trends Year End Report 2016; KPMG 2016 M&A Survey Report; Mergers & Acqusitions Mid-Market M&A Conditions report.*