Mergers & Acquisitions

June 2014

Market watchers view mergers and acquisitions as an economic yardstick. After several years of modest volumes, we've already seen substantial M&A activity in 2014 across industries including biotech, pharmaceuticals, and technology. Has the market rediscovered its mojo? Our panel from Silicon Valley and San Francisco discusses the forces driving the recent upturn in deal volume, as well as talking about trends in shareholder activism, and current patterns in pre-Series A tech acquisitions. *California Lawyer* met for an update with David A. Lipkin of Morrison & Foerster; Michael Kennedy of Shearman & Sterling; Dana Kromm of Shearman & Sterling; and E. Thom (Todd) Rumberger of Foley & Lardner. The roundtable was moderated by *California Lawyer* and reported by Cherree P. Peterson of Barkley Court Reporters.

Related Articles

Mergers & Acquisitions
August 2013

Comment

Print

Reprint

MODERATOR: Mergers and acquisitions have seen a significant uptick in the first quarter of 2014; what's driving this?

DAVID A. LIPKIN: There are many possible explanations, but it may just be M&A activity finally catching up with the increase in the stock market and private company valuations. The S&P 500 rose 30 percent last year and NASDAQ even more. Every year since the recession, M&A practitioners have debated whether the level of M&A activity will return to the high-water mark of 2007. In the first quarter of 2014, we've seen aggregate deal values in proposed and consummated biotech and pharma deals that exceeded prior records, and aggregate deal values in the tech space that have rivaled comparable 2007 figures.

MICHAEL KENNEDY: There are a number of macro-factors. The first is that the Fed and other central banks have been providing for a sustained period of unprecedented liquidity, which has the effect of propping up stock prices because it effectively forces investments in equities. You'd think there would be more deal volume in this setting, but what's happening is the larger companies are merging in specific industries as David [Lipkin] said, and many of those deals are horizontal. They're not necessarily growth stories. They're about getting together to be defensive. For example, hospitals are merging in response to Obamacare, because they have to be bigger to cut costs. But if you look at the volumes worldwide, they're essentially flat.

The other effect of excess liquidity, and partly the reason private equity funds aren't doing as many deals, is that assets have become very expensive, because the equity market is up. People are bidding high multiples of earnings before interest, tax, depreciation, and amortization because of that liquidity and because private targets have the public market to rely on as an exit. So even though it's seven years away from 2007, it's still not a normal market.

E. THOM (TODD) RUMBERGER: Focusing primarily on tech and deals that I was involved in or familiar with, a lot of the M&A activity coming out of 2008 was fueled by big tech's excess balance sheet cash. This surplus has supported much of the M&A deal flow over the last couple years. But as stock prices have steadied, we've seen a growing shift from mostly cash deals to stock, or cash and stock.

LIPKIN: The resurgence in the use of stock consideration has also been a contributing factor to the rise in deal volume. For most of the years since the dotcom bust, we saw a very low percentage of stock deals. In the last 12 months, that percentage has almost doubled, particularly as a result of deals with combined stock/cash consideration. This has certainly enhanced deal values; nobody believes that Facebook would have paid $19 billion to buy WhatsApp if the consideration were all cash. And given the rising stock market, most of these have been fixed exchange ratio deals; the target is happy not only to accept stock but pleased with the potential for a value increase, even before closing.

KENNEDY: If you're a buyer and you think your stock is more than fairly valued (being effectively supported by the trillions of dollars in liquidity), why not use it? In effect, the liquidity provided by the central banks drives the stock price.

LIPKIN: There's also the increasing number of professionals whose livelihood depends on continuously making deals happen. In addition to investment bankers, business development teams, and M&A lawyers, we now have private equity and hedge fund managers who have recently been active not just on the buy side but on the sell side.

KENNEDY: With hedge funds, the reason more of them are being activists is that with all this liquidity it's more difficult to make money purely by trading. With a recent case like Valeant's bid for Allergan, if you buy 10 percent of a $60 billion deal at 15 percent below market price and it goes up, that's a lot of money.

RUMBERGER: By definition, the activist can cause a rise in stock price just by buying in and demonstrating interest.

KROMM: Last year approximately half of the money that went into hedge funds went to activist hedge funds. So they have a ton of cash. Even if they don't make any changes at the target company, they make money.

KENNEDY: As an industry, private equity firms have effectively brought down their stated returns to their investors from 30 percent to somewhere near 15 or 20. That's over a five- to six-year investment horizon. If you can make an activist investment and make 30 percent in a week, that's a lot more attractive.

LIPKIN: Activist hedge funds and large institutional holders have become an additional seat at the bargaining table. We're seeing significant holders, both publicly and privately, increasingly seeking to exert influence over deal terms even in cases where there is no competing bid. Most recently, in the context of Valeant's bid for Allergan, we've even seen activist hedge funds on the buy side, using what some might consider a weakness in our Rule 13(d) regulatory scheme that gives 5 percent stockholders up to 10 days to file a Schedule 13D. The 9.7 percent toehold position that Valeant and the hedge funds amassed by the time the offer was announced provides a lot of insurance against a failed deal because team waiting in the wings.

KENNEDY: Many of them will often have the shadow management team. What's different about Allergan is the degree of sophistication to achieve what they want without running afoul of the law. I haven't seen how they did the options, but that's not a simple tactic to pull off.

KROMM: It was non-voting options.

KENNEDY: This is not going to go away, because there's too much money to be made. My guess with Delaware is that the use of pills designed to keep activists out or at a lower threshold will proliferate.

KROMM: This is what happened with Sotheby's recently. They put in place a poison pill that had a different threshold depending on what kind of investor you were. So if you're a 13(g) filer the threshold was 20 percent, and if you're a 13(d) filer the threshold was 10 percent. The Delaware Chancery Court recently indicated, in its opinion in *Third Point LLC v. Ruprecht* (No. CA9469-VCP (Del. Ch. Ct. injunction denied May 2, 2014)), that such a bifurcated pill could withstand judicial scrutiny.

KENNEDY: The other key component in that case is that it allows the company to take into account derivative positions when determining ownership. So even if an activist isn't filing a 13(d), the pill could be triggered by additional derivative positions. Ignoring the question of how one discovers an unreported position, that's a powerful disincentive.

MODERATOR: As companies try to cope with these kinds of activist investors, what other trends are you seeing?

KENNEDY: There's going to be much more communication between companies and activists. If you go back to the early '80s, the standard operating procedure to deal with an activist was to play hardball. Ignore them, say no, put in a pill. Now these companies are actively engaging in dialogue ahead of the transaction. Proactively knowing who the folks are and knowing what their interests and tactics are is now part of the boardroom dynamic.

LIPKIN: Communicating effectively with significant stockholders isn't just a way to head off trouble, but a means to learn what deal will be most saleable. The increasing influence of activists has been accompanied by a reduction in the significance of recommendations from the ISS and Glass Lewis shareholder advisory firms, partly because their respective recommendations have diverged in several high-profile situations. Public pronouncements of support from key stockholders have become standard communications strategy for many deals.

MODERATOR: How are these communications handled?

KENNEDY: It's really done for the most part among the business folks. There's a fine line about how these conversations should happen between a company and an activist. Obviously you can't give out material non-public information.

KROMM: Do you think there'll be a trend where you see other would-be acquirers teaming up with activists as a source of capital? One of the things we are doing is talking to our corporate clients about methods to be acquisitive. I'm curious to see if that's actually something that continues and whether company and the company already has a counter-activist lined up ahead of time.

KROMM: There was a story recently about Bill Ackman and Carl Icahn railing against this idea that they're value destroyers. At the Berkshire Hathaway meeting Charles Munger and Warren Buffett were quoted as saying that activists are bad for the U.S. economy, and Ackman and Icahn railed against that and said, "No, think of us differently. We're not for short-term return."

LIPKIN: Another significant factor in the M&A upturn has been the reaction on the buy side to M&A deals with public buyers. Over the last 10 years, in most cases the acquirer's stock declined on deal announcement. In the last year we've seen a significant trend toward acquirer's stock prices bumping up on deal announcement. This has given CEOs on the fence about proposed deals a renewed level of deal-making confidence.

RUMBERGER: Is it seen as doing something better with the cash?

KENNEDY: You've got to look at the cost of capital for these transactions. There was a shock period from 2008 to 2012 where CEOs were uncertain about the future. Now it's back to where it was in 2007. You can borrow without covenants. So you can get more optimistic. And optimism is what drives M&A.

LIPKIN: Some people feel that the increasing size and dollar volume of M&A deals has not really pushed the edges of technological change, that too much money (both at the fundraising level and in M&A) is being deployed into social apps. But now even Apple, long regarded as preferring to develop its technology in-house, has gone outside to acquire a technology/service it coveted (the $3.2 billion Beats acquisition). This could accelerate the trend of companies utilizing an effective M&A strategy to find the "next new thing."

RUMBERGER: Even a company like Apple is now looking outside; as opposed to say, Google, which has traditionally built a lot of their products based on start-up teams and technology they acquired. There's been an engineer land grab as the tech sector has continued to perform, start-ups continued to proliferate and management is aggressively competing for talent. Apple had not been in a position over the last decade-plus where they needed to compete head-to-head to attract the best and the brightest. But if you're a superstar engineer, you've got a lot of choices now, and it's not a big technology company necessarily anymore.

KROMM: The Beats acquisition is about talent acquisition. They want Jimmy Iovine to run their music content business. And for $3.2 billion, Jimmy Iovine is a big Apple hire. Acqui-hires are a way to get people in after they've gotten some experience. Buy the people instead of buying the company.

KENNEDY: What you're describing, a bigger company buying a smaller company to grow, was the paradigm of technology deals in the '90s. Todd [Rumberger] and David [Lipkin], I'd be curious: To what extent do you think that's also a function of healthier venture financing for the last four years?

LIPKIN: We're at a record low in how much capital it takes to get viable businesses going.

RUMBERGER: I have a pretty robust start-up practice and companies don't have to make it to Series A necessarily to grow a business. There are many examples where they've grown organically. And when they've achieved this success and going for their first round, they're able to demand a very high liquidity events for private tech companies has also been a factor. Founders no longer have to get to an IPO or an M&A exit to become wealthy.

RUMBERGER: Exactly, now there's another option. It's not necessarily going public or having to sell 100 percent. I've been involved in several recent deals where well-known funds are taking some money off the table by selling a part of their equity stake, but letting the rest ride. Because high-growth tech has traditionally needed venture dollars, it's been the VCs dictating "sell or hold." But now, if they are getting in later, they're happy with a multiple of four or five, depending on how long they've been in the deal. Is that going to change the landscape for the larger exits?

MODERATOR: What are the longer-term tech shifts influencing M&A activity?

RUMBERGER: Over the past few years, I teamed up with another firm to put on a series of events focused on early-stage exits. The events focused on different spaces in tech - enterprise, mobile, cloud, media - and I was surprised that we were getting corporate development folks from companies who weren't public at the time, like Evernote, Groupon, and Twitter. This was three or four years ago, back before they would have been considered serial acquirers. But here they were, with robust corporate development groups, looking to pick off pre-Series A companies.

LIPKIN: Previous acquisitions have also contributed to deal volumes staying lower. If we go back 8 to 10 years, there were many acquisitive tech companies such as PeopleSoft, Siebel, and Quest Software that were later swallowed themselves by companies like Oracle and Dell, reducing competition for many deals. Of course, some recent stratospheric deal values have been primarily the result of competing for strategic assets.

KENNEDY: If you can consolidate an entire industry it's quite helpful from an economic perspective. What the tech industry has done is amazing. From the '80s it was hardware and then you had software and now you have social media. It has basically reinvented itself over a 30-year period. The real key is what's next.

KROMM: The tech companies that you were talking about, Oracle, SAP, maybe Intel, are not as active, but now we're into these web 2.0 companies: Facebook, Apple, Google, Twitter, and LinkedIn. That group will become the old guys at some point, but there's always going to be something new.

MODERATOR: We mentioned the first dotcom bubble; is there another underway?

KROMM: It definitely seems like the valuations are inflated and it is bubble-like. It remains to be seen if the recent acquisitions are successful.

RUMBERGER: With social media in particular, the concern is that maybe people are being irrational with the valuations they are ascribing to these companies. But are all tech stocks overvalued? The consensus seems to me that there are certain pockets like social media that may be in a bubble, but certainly not all of tech.

KENNEDY: The 2001 bubble was very different because you had multiple companies chasing very narrow spaces. Take pet food, for example. There must have been 15 online pet food companies, which implied a demand for pet food that would have exceeded the solar system. When that went bust, it had primary thing. WhatsApp doesn't do advertising, so they're trying to diversify because they're aware that the marketing person is going to come and say no one clicks on the ad. Companies like Facebook will be looking at other ways to generate revenue.

RUMBERGER: A lot of companies are using massive user bases for revenue potential other than advertising, as a platform to push through other services. As they build out the social media pipes, they're looking at revenues from a vast array of partnerships, many content-driven such selling music, games, chat or what have you. You could liken the social media land grab to the build-out of "dark fiber" before the 2000 bubble burst, but now it's virtual pipes instead of glass. n

---