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The Outlook For M&A In Southeastern US

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The post-election outlook for 2017 merger and acquisition activity in the Southeast is bright, although not without challenges. M&A activity in the first part of 2016 was adversely influenced by uncertainty surrounding the U.S. election, as well as world economic and geopolitical concerns, and expectations of rising interest rates, among other things. These factors combined to create a widespread "wait and see" attitude. The result was that activity in the first three quarters of 2016 was down by 19.2 percent compared to 2015, and down by 22 percent compared to 2014, according to MergerMarket.

Since the election, optimism about the economy and M&A markets has been building, as graphically illustrated by the post-Nov. 9 stock market rally. This is due in large part to expectations that the new administration will deliver tax relief, broad deregulation and stimulative economic policy, together with the uncertainty caused by the election being lifted. Optimism being up and uncertainly being down means that many businesses are more actively considering engaging in business combinations, both selling and buying. Anecdotal evidence suggests that businesses based in the Southeast expect to participate in this uptick in M&A activity.

This newfound optimism about the economy comes as macro themes driving demand in M&A markets for the last several years become increasingly significant. These include relatively low interest rates, even with the recent uptick, growing amounts of accumulated cash on corporate balance sheets (and the expectation of more being repatriated from abroad due to more favorable tax treatment), and private equity dry powder at historically high levels. And the private equity dry powder is increasing within older vintage funds where pressures to invest are heightened. In addition to these market forces, exits into an initial public offering have become increasingly difficult, making the sale of a business a more attractive exit alternative.

The lending environment in the Southeast is also robust, particularly for middle-market transactions, and with the potential rollback of Dodd-Frank limitations, that environment is expected to strengthen further. Many alternative lenders have entered the Southeast market, providing more competition to traditional commercial banks.

The most active industry sector for recent M&A activity in the broader Southeast (including Texas) has been the energy sector. This is expected to continue, as the consolidation trend to achieve synergies remains strong in the oil and gas sector. Foreign inbound interest in southeastern M&A over the last five years is led by buyers from Canada and the U.K. China and Hong Kong have shown the most rapid growth in completed foreign inbound deals with southeastern companies in that period.

Despite the confluence of these macro factors driving activity, there remain challenges to growing or even maintaining southeastern M&A activity levels in 2017 and beyond. The chief among these is that the factors stoking demand have bid up valuations of potential targets to the point where bidders often lose their enthusiasm. Multiples in completed transactions were up in 2016 as a result, as was the competitive nature of bidding for attractive assets. A recent nationwide survey of businesses reported that the two biggest reasons transactions were not completed in 2016 were the inability to solve valuation issues and losing out on a bidding war, and these are common refrains heard in the Southeast.

Another potential impediment to a more active M&A environment is that a rosier economic outlook may make potential sellers less willing to monetize their investment in the near term. The chairman of SunTrust Banks, headquartered in Atlanta, recently stated on "Squawk Box" that the new administration's pro-business slant, together with the brighter outlook caused by an improving economy and higher interest rates, may embolden companies to perform strongly on their own rather than seeking business partners or selling. He believes this environment provides an opportunity to realize on all the investments that financial institutions such as his have made in their own business, rather than cashing in those investments now.
This perspective demonstrates the dilemma facing potential sellers — cash in now on the high multiples and in the competitive bidding environment or hold out and build profitability in the strengthening economy for a more lucrative exit later.

Another notable trend in southeastern M&A activity is the usage of representation and warranty insurance, which has exploded in the last three to five years and is facilitating the closing of many M&A transactions. While this coverage has been available for many years, historically it was usually very expensive, came with exclusions of important areas, and took forever to underwrite, resulting in very infrequent usage and only in unique circumstances. The dramatically increased usage in recent years is due to less expensive premiums (typically 2-4 percent of coverage amount), less significant coverage exclusions, and the compressed underwriting process timeline. The result is a more meaningful opportunity for buyers and sellers to take risk off the table, which is being utilized in a wide variety of transactions.

The use of earnouts to facilitate closing a deal by bridging valuation gaps also appears to be on the rise in middle-market private transactions in the Southeast. But earnouts can lead to post-closing disputes over how the sold business is managed. The best way to avoid such disputes is to address post-closing operating controls in the definitive agreement. Negotiating these matters can delay signing or even kill a deal, but is worth the effort where earnout payments are important to the seller.

Overall, attitudes of businesses in the Southeast are increasingly positive, building on strong macro factors already in place, and M&A activity is expected to benefit from this combination. The biggest impediment to stronger M&A activity may be these same positive attitudes and the incentive they create to stay the course rather than sell.

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