M&A Icebergs Ahead: Public Opinion, Regulatory Enforcement and Communications Strategy

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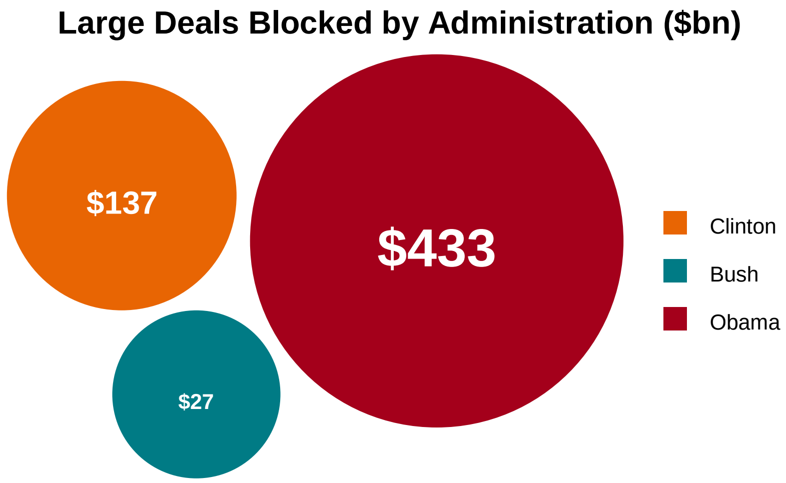
Introduction

Public skepticism of big business and increased regulatory scrutiny of merger transactions have emerged as significant threats to large M&A deals. This risk is particularly evident following a string of regulatory decisions that have upset several major announced deals this year.

In April 2016, the Treasury Department adopted new regulations related to so-called tax inversions, derailing the largest announced deal of 2015, the proposed $190 billion merger of Pfizer and Allergan. That same week, the Justice Department filed a lawsuit to block the $34 billion acquisition of Baker Hughes by Halliburton, leading the two companies to abandon the deal. The DOJ then took measures that effectively ended Canadian Pacific Railway's pursuit of rival Norfolk Southern, valued at $28 billion. And in July, the Justice Department filed lawsuits to block two insurance mega mergers: the $48 billion combination of Anthem Inc. and Cigna Corp., and Aetna Inc.'s $37 billion takeover of Humana Inc.

Coming off a record year for mergers and acquisitions in 2015, many predicted the factors that drove over $3.8 trillion in announced deals last year would continue and that 2016 would be another strong year for merger deals. Indeed, while the $2.2 trillion in announced deals for the first three quarters of 2016 was down from the year earlier, it still exceeded the 10-year average by about 15 percent. The promise of cost savings and operational synergies, as well as slowing organic growth opportunities, has led corporations to look for strategic combinations to provide the growth that their investors demand. Interest rates, while ticking up slightly in the U.S., look to remain low for the foreseeable future, and private equity firms are sitting on a record amount of capital. A slowing economy in China actually meant that corporations there began to look abroad for acquisition targets to drive earnings growth, with Chinese firms announcing a record $141 billion worth of overseas acquisitions this year.

Risks to continued growth in the M&A market remain, however. Market volatility continues, and macro unease, including fallout from Brexit, instability in the Middle East and anemic economic growth, also weigh on CEO confidence to undertake substantial merger transactions. After a record year for merger deals, many corporations are now focused on integrating their most recent acquisitions.



*Deals greater than $10bn withdrawn because of regulatory actions

Source: Thomson Reuters / Financial Times

At the top of the list of concerns is a public increasingly skeptical of big business and an administration actively using its regulatory powers to block transactions it views as anticompetitive or otherwise against the national interest. During the Obama Administration, corporations have terminated seven transactions larger than $10 billion because of regulatory or political opposition. The announced value of these transactions was about $433 billion. This compares to just one transaction over $10 billion that was withdrawn for similar reasons during the previous Bush Administration (valued at $27 billion), and two such deals under the Clinton Administration (valued at $137 billion). *[Thomson Reuters/Financial Times]* Since 2009, of the 23 transactions above $10 billion that were announced but failed to close, regulatory and political opposition to the transaction was the cause 30 percent of the time. *[Thomson Reuters/Bloomberg]*

Industry Consolidation

To be sure, this increased regulatory scrutiny partly reflects significant concentration that has occurred in many industries. Much of the activity in the current wave of mergers and acquisitions has been strategically driven, as opposed to the more private equity-driven wave leading up to 2007. In 2015, corporations announced 67 transactions above $10 billion, more than double the number from the previous year.

Research published last year by professors Gerard Hoberg at the University of Southern California and Gordon Phillips at Dartmouth College said nearly one-third of U.S. industries compete in markets that would be considered highly concentrated under current federal antitrust standards, up from about a quarter in 1996. This consolidation has been a result partly of M&A activity. But this is also a function of corporations becoming more focused on their best performing businesses, and either exiting or slowing investment in their underperformers. As a result, in certain sectors in the U. S. (for example, wireless, cable, and airlines), it is unclear that any additional, significant merger transactions are possible.

In April, President Obama issued an executive order, calling on executive agencies to take actions to increase competition in the industries they oversee.

Jason Furman, the chairman of the President's Council of Economic Advisers, and Peter Orszag, former head of the White House's Office of Management and Budget, have suggested that lack of corporate competitiveness has increased income inequality in the United States. And in another study, Professor John Kwok of Northeastern University found that corporate mergers resulted in increased prices for consumers 75-80 percent of the time.

These factors are helping drive an increasingly anti-corporate attitude amongst politicians and the public.

The Public Mood

Since the 2008 financial crisis, the unpopularity of big business and the public perception of corporate greed have emerged as significant factors in the increased scrutiny of large merger transactions. A February 2016 poll by Pew Research found that 65 percent of Americans believe the economic system in the U.S. “unfairly favors powerful interests.” Big business is seen to have benefited from free trade deals and from an increasingly globalized and interconnected world. Large merger transactions driven by cost savings through layoffs or moving production overseas have met with vocal opposition from labor organizations and politicians, and this trend is likely to continue.

Regulatory activities ultimately reflect politics as well as public opinion. And the Obama Administration has emphasized the importance of antitrust enforcement in maintaining competitiveness in the U.S. economy.

Adding to this sentiment is the tendency in a U.S. presidential election year for the discourse around big business to turn increasingly populist. Both Democratic and Republican candidates for president have criticized companies for moving operations overseas and opposed free-trade deals. The proposed Pfizer merger with Irish-domiciled Allergan, in particular, drew heated criticisms across the political aisle, as politicians characterized the tax-driven transaction as unpatriotic and increasing the burden on middle class taxpayers.

With six of the largest firms in the agriculture sector announcing deals to combine into three in the past year, consolidation in this industry led the Republican chairman of the Senate Judiciary Committee, Chuck Grassley, to question the “tsunami” of agriculture deals. These transactions may “reduce incentives to invest in research and development” and “foreclose market access”, he has stated.

Politicians are emboldened to take these stands because of big- business's unpopularity among the American public. A Gallup poll in January 2016 found that 63 percent of Americans were dissatisfied with the size and influence of major corporations. Business has gone through similar cycles of unpopularity in the past, but the current rhetoric has been particularly heated, with people increasingly questioning the value of business, trade, and globalization to Americans. As Jeffrey Garten, dean emeritus of the Yale School of Management, stated in an article in Fortune Magazine, "The winds of populism, protectionism and, in some cases xenophobia, are blowing in ways that we have not experienced in our lifetimes." Outside of business and its lobbying organizations, fewer advocates are touting the benefits that big business brings to the average American. All this skepticism has affected merger activity.

The Obama Administration's Record

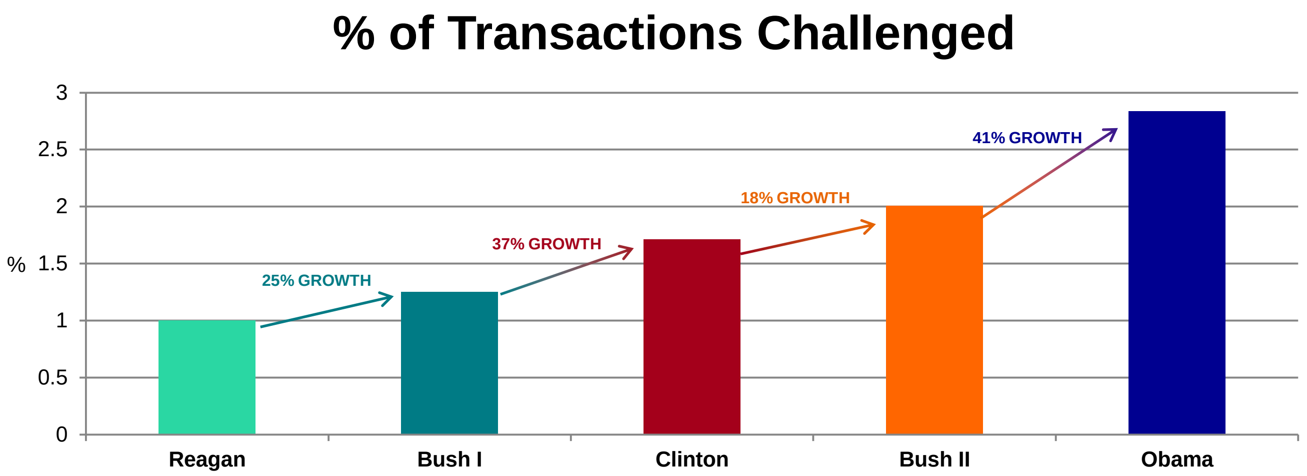
On the campaign trail in 2007, Barack Obama promised that:

> ***"Antitrust is the American way to make capitalism work for consumers."***

In recent years, in particular, his administration has followed through on this rhetoric.

Regulatory review processes now take longer and are more exhaustive. A study published in the National Law Review of the first six years of the Obama Administration's antitrust efforts shows that the Justice Department has issued second requests for additional information on 37 percent of the transactions it has reviewed, compared to 23 percent during the Bush Administration. Over the same period, the number of enforcement actions pursued by the DOJ has almost doubled as a percentage of transactions reviewed. *[Daniel Powers and Gregory Heltzer, National Law Review, October 27, 2015]* The mere prospect of lengthy regulatory reviews damps the appetite for corporations to undertake large transactions, given the significant costs both in money and in management attention required over many months.

Regulatory scrutiny of merger transactions has been on the rise since 1980, but the trend has accelerated under the Obama Administration. According to analysis of Federal Trade Commission data by TheStreet.com, regulators in the Reagan Administration challenged about 1 percent of merger transactions they reviewed. Under subsequent administrations, that number increased to 1.25 percent under George H.W. Bush; 1.71 percent under Bill Clinton; and 2.01 percent under George W. Bush. By contrast, the Obama Administration has challenged 2.84 percent of merger transactions, a 41 percent increase over the Bush Administration.



Source: TheStreet.com

Under previous administrations, and indeed earlier in the Obama Administration, the government seems to also have been more willing to reach a negotiated settlement with corporations around structural remedies, usually entailing the divestment of certain businesses, in order to satisfy antitrust concerns. However, particularly since it blocked AT&T's proposed acquisition of T-Mobile in 2011 and accelerating on the back of record M&A volume in 2015, the Obama Administration has taken a much tougher stance and is frequently unwilling to even discuss potential remedies. In 2015 alone, the administration moved to block some 20 deals of all sizes on antitrust grounds.

To be sure, not all such regulatory actions succeed. Last September, for example, a federal judge rejected the FTC's bid to block U.S. infection-prevention company Steris Corp. from acquiring the U.K.'s Synergy Health PLC. However, many companies would still rather walk away from a proposed transaction than fight the government in court.

While we are nearing the end of President Obama's final term in office, if Hillary Clinton follows him as the next President, we are likely to see a continuation of these trends, based on her statements on the campaign trail. She outlined an aggressive agenda for antitrust enforcement in a recent speech in October, focusing not just on the impact of industry concentration on consumers, but also on workers, suppliers, and small businesses. "With less competition, corporations can use their power to raise prices, limit choice for consumers, cut wages for workers, [and] crowd out start-ups and small businesses," she said.

To get more perspective on these issues, it helps to focus on two deals that ran into regulatory and political trouble in recent years, as well as one that appears to be progressing without significant opposition.

Case 1: *Pfizer and Allergan*

On November 23, 2015, Pfizer and Allergan announced plans to merge their businesses in a transaction valued at $190 billion. The joint announcement emphasized the deal would “create a new global biopharmaceutical leader with best-in-class innovative and established businesses” and “bring together two biopharma powerhouses to change lives for the better.”

The merger was structured with Irish-domiciled Allergan as the technical acquirer. By moving its tax domicile to Ireland, Pfizer would be able to access billions in earnings trapped at its foreign subsidiaries, and going forward, the combined entity would take advantage of Allergan’s lower corporate tax rate. For Pfizer, this transaction was a culmination of years of vocal efforts to reduce its U.S. tax bill, including a failed attempt in 2014 to acquire UK-based AstraZeneca for $120 billion. That unsolicited transaction was contested by AstraZeneca, and was roundly criticized by both U.K. and U.S. politicians.

The proposed Allergan transaction also met with immediate criticism from the media and political leaders as a major act of tax avoidance. A same day piece in The New Yorker called it a “disgrace” and a next day column in The New York Times said dealmakers had descended into “silliness.” The Atlantic published an article that questioned whether the proposed deal was “unpatriotic.” Presidential candidates Donald Trump, Hillary Clinton, and Bernie Sanders quickly released statements decrying the deal as unfair to American taxpayers.

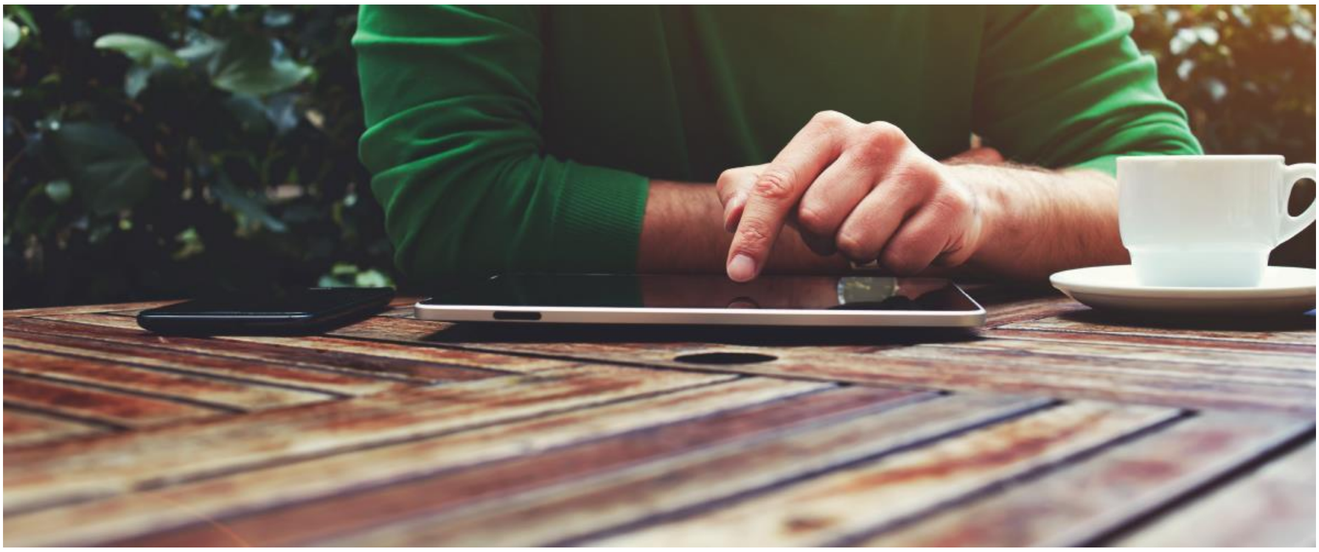
In response to these criticisms, Pfizer CEO Ian Read and Allergen CEO Brent Saunders published a joint op-ed in USA Today arguing the deal would allow them to expand R&D investment in the US, which would lead to new pharmaceutical innovations. The op-ed did not receive any significant attention from other news sources.

Negative media coverage continued in the following weeks. CNBC's Jim Kramer told viewers on his "Mad Money" show that no one liked the deal, including investors on Wall Street. In mid-December, Hillary Clinton proposed an "exit tax" on US-foreign country mergers as a result of the deal. Activist investor Carl Icahn wrote an op-ed in The New York Times calling the deal a "travesty."

The Treasury Department, under the Obama Administration, had taken several steps after 2014 to limit the ability of U.S. corporations to undertake so-called "tax inversion" transactions. In their public statements, both companies emphasized that the transaction was structured to comply with existing laws and regulations and was not technically structured as a "tax inversion."

Despite these assurances and the support of some Republican congressmen who said this deal merely emphasized the need for comprehensive tax reform in the U.S., the Obama Administration adopted new regulations in April 2016 that seemed to specifically target the Pfizer-Allergan transaction. So-called "serial acquirers," such as Allergan, were no longer allowed to count the stock accumulated in any U.S. deal over the past three years in calculating the ownership of the combined company for tax purposes. Under these new regulations, its shareholders would no longer own over 40 percent of the combined company, negating most of the tax benefits. The next day, the two companies terminated their planned merger, criticizing the administration for changing the tax rules after the fact to block the deal.

Case 2: *Comcast and Time Warner Cable*



In February 2014, Comcast announced its plan to acquire competitor Time Warner Cable for $71 billion, which would create the largest cable company in the U.S. with about 30 million subscribers. Initial opposition to the deal was minimal, and the view of most analysts was that it would meet with regulatory approval, as the combined company, while controlling approximately 30 percent of the pay-television market, would still have many strong competitors.

Soon after the deal was announced, however, the Obama Administration urged the Federal Communications Commission to regulate broadband Internet access as a utility, and the two companies' combined control of broadband access became the subject of regulatory scrutiny. This came as a result of an increasing debate in Washington over Net neutrality and open access to the Internet. Under a revised FCC definition of broadband Internet services, the combined Comcast-Time Warner entity would control some 57 percent of the U.S. market.

A coalition of more than 50 public interest groups wrote an open letter to regulators criticizing the deal as "unthinkable": "Everyone from the biggest business to the smallest startup, from elected officials to everyday people, would have to cross through Comcast's gates." The publisher of Consumer Reports Magazine took out full page ads criticizing the merger as leading to: "Higher prices. Fewer choices. Worse customer service."

Companies such as Netflix, Discovery Communications, and the DISH Network also became vocal critics of the transaction, claiming that the merger would provide the combined company with too much pricing power over providers of content and with the ability to slow download speeds for consumers, unless companies paid additional fees.

Comcast and Time Warner aggressively fought back, emphasizing their efforts to expand broadband access among low-income Americans, connecting over 450,000 households, and labeling corporate critics of the deal as engaging in “extortion.” The two companies spent over $32 million lobbying members of Congress and the Administration trying to get approval for the transaction.

Facing opposition from both the Justice Department and the FCC, Comcast withdrew its offer for Time Warner Cable in April 2015. Charter Communications and Time Warner subsequently announced their intention to merge, which met with less public criticism and regulatory scrutiny as the combined market shares in both the cable and Internet businesses are much smaller. This transaction was completed in May 2016.

Case 3: *AB InBev and SABMiller*

In October 2015, Anheuser-Busch InBev announced plans to acquire its largest competitor, SABMiller, in a transaction valued at $110 billion. The combined company would produce almost a third of all beer sold worldwide and would allow AB InBev to quickly expand its reach in the emerging markets, with SABMiller making 29 percent of its profits in Africa.

Following the announcement, the companies took immediate steps to address regulatory concerns by planning for the divestment of SABMiller's 58 percent stake in MillerCoors to Molson Coors Brewing Company, as well as the sale of their Peroni and Grolsch brands in Europe. In China, where the merger also faces anti-trust review, the companies are also selling SAB's stake in Snow, the world's largest beer brand by volume, which it produces in a joint venture with China Resources Enterprise.

In its anti-trust defense, AB InBev has emphasized this growing competition from craft brewers, as well as the opportunities this acquisition provides for extending iconic American brands such as Budweiser to markets outside the U.S., given the strength of SABMiller's international operations.

Some concerns have been raised about the combined company's control of wholesale beer distribution,, and the Justice Department, in its approval of the transaction, has required the company to refrain from practices that would limit the sales of competitors' products by its distributors.

The two companies expect to close the deal in the fall of 2016.

Key Takeaways & Differentiating Factors

These three examples share much in common. All three were significant, headline-generating mergers in consolidating industries. In the case of both the SABMiller and Time Warner transactions, the combined companies would be the largest competitors in those industries in the U.S.. All three would affect consumers in tangible ways. All three were structured in ways to meet with existing laws and regulations, and to address anticipated concerns from regulators. The SABMiller transaction, however, has met with little public opposition.

First, the Pfizer and Time Warner Cable transactions were victims of bad timing. They both were caught in a broader political debate in which they were made scapegoats. In the case of Pfizer, while the deal was structured to meet with existing laws and regulations around "tax inversions," coming where it did in the presidential election cycle, the letter of the law became less important than the sentiment of the electorate, which has turned increasingly populist and anti-corporate. Efforts to reduce its corporate tax rate were readily branded as "unpatriotic." Given the outspoken and concerted efforts of the Obama Administration to curtail these types of transactions, the immediate and overwhelming backlash should have been anticipated.

For Comcast's bid for Time Warner Cable, the proposed transaction raised the specter of a corporate behemoth controlling how a majority of Americans would access the Internet and the speed at which they could access data. Amid a broader debate over Net neutrality, the transaction was doomed.

Second, an aggressive and proactive plan to address any objections from regulators is clearly an essential element of any merger plan. Similarly, getting ahead of any potential criticism on the loss of jobs or competitiveness is also key. AB InBev immediately announced their plans to divest the Miller brand and has framed their acquisition of SABMiller as an expansion of opportunities for the U.S. While Pfizer and Allergan emphasized that their merger was not driven by a plan to move jobs overseas, this point was lost in the criticisms raised about the loss in U.S. tax revenues. And in both the Pfizer and Time Warner cases, from a communications perspective at least, the companies failed to anticipate the firestorm that erupted and were forced to play defense.

In both of these instances, as well, regulators revised the rules after the fact to effectively block the deals from occurring. By relying on adherence to the existing laws and regulations, the corporations misjudged the public mood and the increased assertiveness of regulators and the administration.

Whether the prevailing sentiment will be permanent is unclear, but it is evident that the risk pendulum is unlikely to swing in the other direction anytime soon. For companies contemplating a large merger transaction in the current environment, it is essential to develop a proactive and comprehensive communications strategy to get ahead of potential public and political opposition.

For any transaction that necessitates a regulatory review, a communications strategy that relies solely on promoting the benefits of a transaction to shareholders is no longer sufficient. A more sophisticated approach is necessary: one that anticipates the broad range of risks – often having little to do with the business or investment rationale – that can potentially threaten or derail a deal; addresses those risks across an increasingly diverse array of stakeholders; and articulates the broader benefits to society and the economy, including, when relevant, employment, industrial competitiveness, science and technology, tax revenues, national security, and the environment.

Such a strategy must take a multi-faceted campaign approach that extends well beyond traditional deal risk assessment, audiences, communications channels and lobbying efforts. Outside experts and influencers who can advocate on the deal’s behalf should be identified and engaged. Workers, unions, customers, activists and other potentially vocal stakeholder groups who may be affected by the merger also need to be identified and engaged with an effective communications strategy. Social media and its disintermediating effect on deal information flow increasingly means that engagement must be coordinated real-time across multiple channels and stakeholders.

Given the current public mood and the increasing vigilance of regulators, even with such an approach, certain large mergers in already consolidated industries may ultimately prove to be too difficult to navigate through the political and regulatory mazes, and communications in and of themselves are unlikely to be the deciding factor in any merger transaction. However, for those corporations determined to move ahead in the current environment, a comprehensive communications plan has become a critical component of successfully managing a complex merger through to completion. And an advisor who understands the current public and political temperament and can advise corporations at the beginning stages of a transaction can provide an additional and critical perspective on both the merits of a deal and the strategy for executing it successfully.

Thank you

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