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USA - South East

W. Todd Carlisle, John H. Cooper,
R. Michael Murphy and David W. Drum
Dentons Sirote PC

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USA - SOUTH EAST

Trends and Developments

Contributed by:

W. Todd Carlisle, John H. Cooper, R. Michael Murphy and David W. Drum

Dentons Sirote PC see p.6



M&A Outlook for 2021

When writing this article in 2020, there was no way of predicting the full impact that the COVID-19 pandemic would have on business generally and M&A activity in particular. It could be seen, even in March 2020, that the pandemic would likely have a negative impact on M&A activity, but no one could have predicted the severity of that impact. In fact, 2020 proved to be a turbulent year for M&A overall.

The resultant consequences of pandemic-induced lockdowns exposed vulnerabilities in many industries and their supply chains, which historically had been very strong, including industrials, consumer and hospitality. Some sectors, such as life sciences, saw a decline in transaction value in 2020 versus 2019, but the overall volume of deals increased perhaps as a result of opportunities created by the pandemic, such as the technology, gaming and cloud sectors.

After a relatively normal first quarter in 2020, the second quarter in 2020 proved disastrous for M&A activity. However, by the second half of 2020, companies had pivoted and adjusted, and the third and fourth quarters of 2020 saw a major rebound in M&A activity. While the overall value of M&A activity in 2020 was lower than 2019 (approximately USD1.4 trillion in 2020 versus approximately USD1.8 trillion in 2019), the value of M&A activity in the second half of 2020 was greater than the same period in 2019. Despite the upheaval and uncertainties, 2020 still ranked

as the sixth best year for M&A activity on a total value basis since the financial crisis of 2008.

Rebound optimism

Because of the stronger than expected rebound in M&A transaction value in the second half of 2020, there is optimism about M&A activity in 2021. In fact, conditions could be ripe for M&A activity to accelerate in 2021 as a result of:

- an expectation of continued improvement in economic activity due to the presence and widespread availability of COVID-19 vaccines;
- a perception of greater geopolitical certainty after the US presidential election;
- a pent-up demand from transactions deferred in 2020;
- the COVID-19 induced urgency for digital transformation;
- the availability of a record amount of capital held by US private equity firms that needs to be deployed;
- favourable interest rates; and
- the possibility of higher US federal income tax rates on capital gains.

As a general rule, the overall economic outlook is the most significant factor in a company's consideration of an M&A transaction. In 2021, however, COVID-19 considerations and tax policies of the Biden administration are expected to be major factors. M&A transactions are expected to spike if the Biden administration succeeds in pushing a significant increase in the capital gains tax rate as sellers will seek to complete transactions prior to the effective date of any

such increase. In addition, the disruption in M&A activity in the first half of 2020 may have created a backlog of demand for M&A transactions in 2021.

Sectors adversely affected by the pandemic, such as restaurants, health clubs, hospitality and venues, which experienced significantly lower M&A activity in 2020, may offer attractive targets at reasonable valuations in 2021, especially as vaccines become widely available and these industries begin to recover from the pandemic.

In the second half of 2020, M&A transactions in the technology sector represented almost one-third of the total value of all 2020 M&A transactions in the US. The COVID-19 pandemic underscored the importance of digital technologies, which triggered the acceleration of digitalisation across all sectors. In a study conducted by Ernst & Young, almost two thirds of corporate executives who responded indicated that they believed businesses must pursue drastic digital transformation over the next two years. This strategy is likely to stimulate digital M&A transactions in 2021 as organisations seek to accelerate digital capabilities.

Concerns

Despite this general level of optimism, however, there are still concerns that the COVID-19 pandemic will continue to have a negative impact on the M&A market during 2021, not the least of which is the efficacy of the various vaccines and whether they will be able to restore a sense of normality in social and commercial activity. In addition to the pandemic, other factors that could act as headwinds for M&A transactions in 2021 include:

- the availability of quality acquisition targets;
- economic uncertainty caused by the ongoing pandemic concerns and adverse impact on certain sectors;

- financing;
- buyer competition; and
- valuations.

There are also signs that the social upheavals in 2020 could have an impact on M&A transactions in 2021. Environmental, social and governance concerns seem to be emerging as business imperatives that can affect long-term success and value, and as a consideration of prospective acquirors of businesses. More than 50% of executives in PWC's late 2020 survey indicated that their company planned to increase diversity and inclusion training for employees.

In another survey, almost 60% of responding consumers indicated that a company's purpose or values play an important role in their buying decisions. These factors, which could impact profits, will cause buyers and sellers to evaluate the workforce, the composition of the management team and board of directors, the overall brand promise and other factors differently when considering a company's valuation and the potential returns on a transaction.

The top industries for M&A transactions in 2021 are expected to include healthcare, technology, automotive, aerospace and defence, consumer products, and real estate.

Healthcare

The COVID-19 pandemic impacted healthcare very differently from life sciences in 2020. In the healthcare sector, curtailments or deferments of elective surgeries, wellness visits, and chronic illness checkups led to sporadic and uneven patient volumes and visits. Healthcare M&A transactions slowed in the second quarter of 2020 but rebounded through the end of the year. In contrast, the life sciences sector experienced steady transactions throughout 2020, driven in part by the optimism created by government investment in COVID-19 vaccines and treat-

ments, and increased interest in breakthrough drugs.

COVID-19 was one of the top two factors that affected M&A activity in diagnostics and medical device makers in 2020 and will continue to affect these sectors in at least the first half of 2021. In contrast, the biopharma and pharmaceutical services sectors ranked valuation and competition as more important factors in 2020. Biopharma experienced the most active M&A deal market in history in 2020. In 2021, early-stage cell and gene therapy companies and antibody-drug companies are expected to be key targets for M&A activity in 2021. In addition, telehealth companies are expected to attract significant attention for M&A activity over the next 12-18 months.

Technology

Companies significantly reduced or eliminated expenses in response to the COVID-19 pandemic, which reduced M&A deal value in the first half of 2020 to the lowest it had been since 2016. However, M&A activity dramatically increased in the second half of 2020 due to optimism that a potential vaccine was in sight coupled with continued low interest rates. In the second half of 2020 alone, there were 14 mega deals (USD5 billion) with total value of USD192 billion, compared to just four mega deals in the first half of 2020.

Overall, the technology sector has been impacted less by the COVID-19 pandemic than other sectors because consumers and businesses have sought technology solutions to the new ways of working and living. The COVID-19 pandemic has acted as a catalyst to accelerate technology and digital trends, which has caused many companies to seek solutions for remote work for the long-term and to pivot to software-as-a-service (SaaS) offerings. Technology companies have become attractive M&A targets to

supplement companies' existing capabilities, which is expected to fuel deals in 2021.

Automotive

The automotive industry experienced a rollercoaster of activity in 2020. The COVID-19 pandemic dampened M&A activity in the second quarter of 2020 to a degree similar to that experienced during the Great Recession in 2008-09. As in other industries, however, activity rebounded in the third quarter of 2020 with an unexpected recovery led chiefly by the advent of new capital in the form of special purpose acquisition companies. Unfortunately, the fourth quarter regressed as fears of another wave of COVID-19 cases took hold. The automotive industry continues to face a challenging year because of COVID-19 concerns.

The deal value and volume of M&A activity in 2021 is expected to increase over 2020, but volatility is expected to exist, at least in the first half of 2021. Investments in computer-aided software engineering ("CASE technologies") may continue to drive M&A activity in 2021. In addition, companies focusing on lithium ion battery technologies may be attractive acquisition targets as the industry transitions to battery-powered vehicles.

Aerospace and Defence

Both deal volume and value were down significantly in 2020 from a high of USD65 billion in the second quarter of 2019 to USD7 billion in the second quarter of 2020 and only USD6 billion in the fourth quarter of 2020. Many analysts believe that the outlook for M&A in this sector in 2021 is mixed. The commercial air travel sector suffered extremely adverse financial results because of the COVID-19 pandemic, with passenger traffic down significantly in 2020 versus 2019. Most industry analysts believe the recovery in this sector will be measured in years rather than months. As a result, these companies will likely

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be focused on day-to-day operations rather than M&A activity in 2021.

M&A activity involving defence contractors did not suffer to the extent it did on the commercial side. While defence budgets during the Biden administration likely stagnate or even shrink, certain sub-sectors, including cyber, unmanned, space, hypersonic and IT modernization will drive M&A transaction activity.

Consumer Products

The COVID-19 pandemic disrupted consumer markets and changed consumer behaviour. In response, consumer companies have altered their operational strategies and accelerated digital transformation. Strong consumer companies will be seeking opportunities to execute on their growth strategies by taking advantage of disruptions in the disrupted consumer markets landscape. Consumer products companies are expected to be focused on building supply chain resiliency and capitalising on e-commerce growth.

Consumer retail companies are expected to continue to invest in technology to promote safer in-store experiences for customers and associates and boost operational efficiencies. Increased consumer awareness of social distancing and public-health concerns will likely incentivise cross-sector investments in contactless payments and checkout technologies to create a safer in-store environment. These priorities are likely to promote M&A activities to achieve these goals.

Real Estate

The real estate industry experienced a significant decline in M&A transaction volume and value through the first half of 2020, but the industry rebounded significantly in the second half of the year – a trend that has continued in the first quarter of 2021. While certain sub-sectors have struggled with the changes to the economy as the result of the pandemic and, as a result, experienced waning interest in investments, others have seen a substantial uptick in investor activity and interest. Real estate is at the centre of changes across all industries whether it's the acceleration of technological changes, compliance with social distancing requirements, or short- and long-term changes in the way people live and interact with each other.

However, some real estate sectors may not fare as well in the post-pandemic world, such as certain areas of office space, retail stores, and luxury high rises. Accordingly, the industry will need to re-evaluate market demands and historic fundamentals. Despite the disruptions in 2020, investor demand still exists, which will likely trigger M&A transactions in the real estate industry in 2021.

Dentons Sirote PC has an M&A team comprised of 27 attorneys, 19 of whom hold an LLM in taxation. Sirote's M&A team has extensive experience in all stages of public and private company mergers, acquisitions, and divestitures, as well as private offerings across a broad spectrum of industries, including insurance brokerage, healthcare, manufacturing,

food and beverage, retail, and real estate. The team's depth of experience and location allows it to provide clients with highly sophisticated yet cost-effective M&A counsel. With particular expertise in tax law, it is capable of anticipating and addressing federal and state income tax issues, allowing clients to achieve their business objectives in a tax-efficient manner.

AUTHORS



W. Todd Carlisle is president, board member, and shareholder of the firm, where his practice focuses on mergers and acquisitions and general corporate representation with an

emphasis in the financial services industry. Todd represents private equity firms, national property/casualty and life insurance distribution platforms, broker-dealers, national and regional banks, wealth management firms, and family offices. Todd is actively engaged in the representation of clients in the consumer products, forest products, healthcare, insurance and financial services, manufacturing, and technology industries.



John H. Cooper is a shareholder and former president, whose practice spans corporate, securities and tax law, with an emphasis on M&A, private equity and venture

capital, securities, business and succession planning, corporate finance, corporate tax, directors and officers, executive compensation and general counsel services. He is a member of the tax section of the ABA, Alabama State Tax Section, and the Alabama State Bar and was an adjunct faculty member of the University of Alabama School of Law for Advanced Corporate Tax (1982-2008). John's recent work includes the formation of a real estate investment fund and two opportunity zone program funds.

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R. Michael Murphy is a shareholder whose work covers corporate and securities law, in particular, M&A, financial services, private equity and venture capital, regulatory,

compliance and risk management, and securities. He is a member of the Alabama State Bar Association and a speaker on matters relating to M&A. Representative matters include serving as outside counsel to national insurance, banking, and financial services businesses in connection with insurance-related matters; buyer's counsel in connection with the acquisition of 14 financial service firms over five years by national insurance brokerage; and counsel to institutional and angel investors in connection with investments in numerous start-up companies.



David W. Drum is a shareholder practising in the areas of corporate and securities as well as tax law, with an emphasis on M&A, private equity and venture capital, and general counsel

services. Since 2016, he has served as lead counsel or assisted in more than 35 transactions involving private and public companies in a variety of industries, ranging in size from USD500,000-1 billion. He also has experience with transaction tax analysis and premerger notification filings under the Hart-Scott-Rodino Antitrust Improvements Act. David holds an LLM in taxation from the University of Florida and is a member of the Alabama, Florida, and Georgia State Bar Associations.

Dentons Sirote PC

2311 Highland Avenue South
Birmingham
AL 35205

Tel: (205) 930 5100
Fax: (205) 930 5101
Email: marketing.us.dsp@dentons.com
Web: www.dentons.com/sirote.com

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