Corporate Finance Advisory Trending Topics
A 2H 2018 Compendium

CAPITAL STRUCTURE AND CAPITAL ALLOCATION .................. 5–8
CAPITAL MARKETS ................................................................. 9–15
STRATEGY/M&A ................................................................. 16–20
MARKET INTELLIGENCE ....................................................... 21–23
REGULATORY/ACCOUNTING/OTHER ................................... 24–27
Stay one step ahead with content from J.P. Morgan’s Corporate Finance Advisory team

TRENDING TOPICS

Every two weeks, Corporate Finance Advisory (CFA) writes on four themes or trends to serve as a source of thought-leadership for management teams.

WHITE PAPERS AND REPORTS

THE GREAT SHAREHOLDER SHIFT: DEVELOPING FINANCIAL POLICIES FOR AN EVOLVING SHAREHOLDER BASE

The level and manner in which firms engage with their shareholders has changed in the last few years. What are the trends in shareholder composition, how has this shift impacted investor behavior, and in turn, how should the decisions of management teams change?

BLOCKCHAIN AND THE DECENTRALIZATION REVOLUTION: A CFO’S GUIDE TO THE POTENTIAL IMPLICATIONS OF DISTRIBUTED LEDGER TECHNOLOGY

With the advent of blockchain and increased adoption, J.P. Morgan’s Corporate Finance Advisory team, in conjunction with J.P. Morgan’s Digital Investment Banking team and Blockchain Center of Excellence, provides an informed view on the corporate implications of the rapidly changing interplay between finance and blockchain technology.

DISRUPT, OR BE DISTRUPTED: CORPORATE STRATEGIES FOR AN INCREASINGLY DISRUPTIVE WORLD

With the pace of technology development - artificial intelligence, machine learning, cloud and blockchain - continuing to increase, how can firms prepare to disrupt first before they are disrupted?

Get added to our distribution lists
Reach out to your banker or email CFA.Trending.Topics@jpmorgan.com

Check out our website
www.jpmorgan.com/CFA

Access our content at the Corporate Finance Advisory tab in the J.P. Morgan Corporate Finance dashboard
Reach out to your banker to gain dashboard access
# Table of Contents

## CAPITAL STRUCTURE AND CAPITAL ALLOCATION

- #Ratings #Credit #CycleRisk
  Ratings relativity and the great migration to BBB
  ................................................................................................................... 5

- #TaxReform #DistributionPolicy #Repatriation
  How have firms allocated capital since tax-reform in the first half of 2018?
  ................................................................................................................... 6

- #TaxReform #Repatriation #Global
  Repatriation: Separating fact from fiction
  .............................................................................................................................. 7

- #Leverage #Ratings #CycleRisk
  What keeps us up at night? Corporate debt levels
  ................................................................................................................... 7

- #Pensions #MarketIntelligence
  U.S. pension buyout market activity is gaining momentum
  ................................................................................................................... 8

## CAPITAL MARKETS

- #Financing #Structuring
  Solutions to help firms with limited stock borrow to issue a new convert
  ................................................................................................................... 9

- #Financing #InterestRates
  SOFR: Almost ready for prime time
  ................................................................................................................... 10

- #Structuring #Financing #Monetization
  Novel solutions for firms with cross-holdings to maximize value
  ................................................................................................................... 11

- #Leverage #Ratings #Global
  Global leveraged transactions: A shift to three credit rating agencies
  ................................................................................................................... 12

- #Leverage #Credit #CycleRisk
  Borrower-friendly terms indicative of a frothy market?
  ................................................................................................................... 13

- #MarketIntelligence #Structuring
  For multi-class shares, MSCI is in a class of its own
  ................................................................................................................... 14

- #Monetization #Financing #TaxReform
  Increased investor interest in tax receivable agreements (TRAs)
  ................................................................................................................... 15

## STRATEGY/M&A

- #M&A #Global #Regulation
  FIRMA and CFIUS could change global deals as we know them
  ................................................................................................................... 16

- #M&A #Strategy #Regulation
  Regulatory scrutiny continues for U.S. M&A deals too
  ................................................................................................................... 17

- #Blockchain #Strategy
  Blockchain: From words to action
  ................................................................................................................... 18

- #M&A #CorporateClarity #Strategy
  With equity markets continuing to reward corporate clarity, M&A has increasingly trended towards industry consolidation
  ................................................................................................................... 19

- #M&A #CorporateClarity
  Less is more: Divestitures remain a prominent theme as the market continues to value corporate clarity
  ................................................................................................................... 19

- #M&A #Global #Regulation
  The foreign investment environment and shifting responses
  ................................................................................................................... 20
# Table of Contents

## MARKET INTELLIGENCE

- **#Strategy #Global**
  - Global activism in focus: Are you prepared? ................................................................. 21
- **#Credit #M&A #TaxReform**
  - Market primed for LBOs .................................................................................................. 21
- **#Disruption #MarketIntelligence**
  - Is technology disruption helping maintain low inflation? ........................................... 22
- **#Global #MarketIntelligence**
  - GICS sector shuffle ....................................................................................................... 23
- **#MarketIntelligence**
  - What are the betting markets telling us about U.S. midterm elections and what are the market implications? .......................................................... 23

## REGULATORY/ACCOUNTING/OTHER

- **#Accounting #Regulation**
  - Quarterly versus semi-annual reporting ....................................................................... 24
- **#Accounting #Regulation**
  - Upcoming changes in lease and accounting treatments ................................................... 25
- **#Regulation #Disruption**
  - Private companies seek to “disrupt” equity compensation structure .............................. 25
- **#Regulation #M&A**
  - New IRS guidance indicates additional flexibility for tax-free spinoffs ....................... 26
- **#TaxReform #M&A #MarketIntelligence**
  - In the zone: A tax-efficient opportunity to preserve capital gains ................................... 26
- **#Financing #TaxReform #Repatriation**
  - U.S. borrowers to benefit from relaxed tax rules for “deemed dividends” ...................... 27

For further reading, see our 1H 2018 and 2017 Compendia, for which the full text can be found in the reports section of [http://www.jpmorgan.com/CFA](http://www.jpmorgan.com/CFA)
SEPTEMBER 5, 2018

#Ratings #Credit #CycleRisk

Ratings relativity and the great migration to BBB
Firms have been willing to migrate to the BBB ratings category, with the deep and attractive BBB debt market continuing to provide a low cost of capital since the financial crisis. However, the inherent nature of a rating is to capture the long-term credit risk of an issuer, and this ultimately leads to a “stickiness” in the assigned ratings. Further, ratings analysis should reflect relative risk, and hence, in this sense, not all firms can have the same ratings. If all BBBS are not created equal, which direction might a potential “ratings correction” swing, especially given the differing ratings between Moody’s and S&P?

Further questions worth evaluating in the context of capital structure decision-making: what happens to the BBB segment of issuers if we encounter a recession? Can the HY market absorb “all” BBB debt if “angels” start “falling” into this category (recall the turmoil of energy sector downgrades after the 2014 collapse of oil prices)? How should different sectors approach the optimal capital structure decision in light of these market and ratings related implications? These factors need to be taken into greater consideration as firms contemplate shifts down the credit ratings spectrum.

KEY TAKEAWAYS

- In 2017, 52% of rated issuers in the S&P 500 were BBB, compared to 43% in 2008 and 29% in 1998
- Of the ~400 companies in the S&P 500 that are currently rated by both S&P and Moody’s, 50% have the same rating while 40% have lower Moody’s ratings
  - Of the 40% that are more conservatively rated at Moody’s, many are in the healthcare and industrial sectors
- With more firms than ever rated BBB, a “ratings correction” could have broad market consequences
SEPTEMBER 18, 2018
#TaxReform #DistributionPolicy #Repatriation

How have firms allocated capital since tax reform in the first half of 2018?

M&A: Overall Global M&A deal value increased by 58% in the first half of 2018 compared to the same period in the previous year.

- A significant portion of this growth was driven by mega-deals (> $10 billion); when such deals are excluded, M&A deal value increased by 22%.
- Telecommunications and utilities sectors saw the greatest relative increases of 225% and 210% during this period, respectively, while activity in the energy sector slowed, declining 11%.

Capex: Capex spending increased 16% overall year-over-year with tech leading the way.

- Growth in tech far surpassed other industries at 69% year-over-year growth, more than twice the next sector (energy at 33%).

Dividends: Across all industries, dividends increased by 12% and 10% in Q2 and Q1 2018, respectively, compared to 9% and 7% in the same periods for the previous year.

- The energy sector had the strongest dividend growth at 14%; however, this was due in large part from starting from a lower base than other sectors.

Buybacks: The increase across all sectors in executed buybacks was 46% as all but one sector (consumer staples) saw payouts increase year-over-year.

The consumer staples sector has seen margin pressure across all staples sub-sectors (in part due to rising commodity costs) which illustrates that capital allocation trends are not immune to other broader macro factors.

KEY TAKEAWAYS

- The first and second quarter of 2018 saw an increase across capital allocation metrics including capex, M&A, dividends and share buybacks across the board, led by a 46% increase in buybacks from H1 2017 to H1 2018.
- As partially discussed in a prior CFA Trending Topic detailing buyback activity in H1 2018, firms continue to evaluate how to best strike a balance between growth, balance sheet strength and shareholder-friendly actions.
### OCTOBER 16, 2018

#TaxReform #Repatriation #Global

**Repatriation: Separating fact from fiction**

U.S. companies repatriated $170 billion in foreign profits as per their disclosures in Q2, marking a decline from the $295 billion repatriated in Q1. These transfers represent a combination of newly earned foreign profits and previously “permanently reinvested” profits accumulated by foreign subsidiaries. While these amounts were significantly higher than historical norms, they still only represented ~10-15% of accumulated foreign earnings and profits in Q1 and ~5-10% in Q2. This suggests a significant amount of cash repatriation is yet to take place, even if one considers about half of the offshore assets subject to the repatriation tax were non-cash.

Further, U.S. firms have generally signaled the intent to repatriate capital only when faced with a specific capital need, such as an acquisition or announced shareholder distribution strategy. Many firms in the technology and healthcare sectors are repatriating cash as debt maturities come due, effectively reversing the past trend of raising debt in the U.S. to offset the cash buildup offshore. These trends mean that the consequences of tax reform are likely to play out more gradually and may offer some cushion to any future economic uncertainty.

---

**What keeps us up at night? Corporate debt levels**

Central bank stimulus and record low interest rates following the financial crisis have fueled a pick-up in corporate borrowing over the last decade. U.S. corporations have increased on-balance-sheet debt by over $2.5 trillion during this time period. Aggregate investment grade leverage increased from 1.9x to 2.9x debt/EBITDA over the last 10 years, with net leverage similarly increasing from 1.5x to 2.2x. Share buybacks are expected to top $800 billion this year while the vast majority of the last 50 largest acquisitions over the last five years – valued at $1.9 trillion – used debt as a source of financing. A simultaneous complication to this trend has been the patience exhibited by credit rating agencies in maintaining investment grade ratings on these institutions. With about 50% of S&P 500 firms now BBB, versus 30% 20 years ago, fallen angel risk is one to keep an eye on.

---

**KEY TAKEAWAYS**

- Despite expectations of “trillions” in foreign earnings being rapidly repatriated back to the U.S., the trend observed during the first two quarters of 2018 suggests firms are taking a more measured approach
- U.S. companies have generally signaled a plan to repatriate when faced with a specific need, such as an acquisition or shareholder distribution
- The potential for a more extended repatriation of offshore capital means tax reform may provide modest economic tailwinds for years to come

---

**KEY TAKEAWAYS**

- Corporate debt levels have climbed at a rapid pace over the last decade, increasing by over 40% since the last peak in 2008
- Market leverage metrics have increased ~50% and U.S. corporate debt is now at an all-time high at over 45% of GDP
- Continued economic strength makes leverage manageable in the near-term, but firms may find themselves with significantly less financial flexibility in the case of a downturn
NOVEMBER 27, 2018
#Pensions #MarketIntelligence

U.S. pension buyout market activity is gaining momentum

Many firms have accelerated their pension contributions in order to lock in deductions at 35% corporate tax rate.¹ Record levels of pension contributions, coupled with the recent rise in interest rates, has led to an improvement in funded status, with the top 100 largest plans reaching 93% funding as of October 2018, up from 88% as of December 2017.² As funded status improves, pension plans will continue to be exposed to downside in the equity or debt markets, while likely not being able to monetize any overfunding from an upside in the markets. This asymmetric risk reward profile has led many firms to pro-actively focus on de-risking their pension plans and pursue pension buyouts.

U.S. pension buyout market activity has increased significantly over the last few years, with estimated volume of ~$25 billion for 2018 and significant pipeline expected for 2019.³ Notable recent large transactions include FedEx’s $6 billion risk transfer in May 2018 and International Paper’s $1.6 billion in October 2018. International Paper’s buyout represents the company’s second large risk transfer transaction, following the $1.3 billion executed in 2017. Firms with well-funded plans are now positioned to take advantage of the attractiveness of the pension buyout market and defease a portion of their pension liabilities at minimal cost. Proactive de-risking can help plan sponsors improve performance during a downturn and enhance competitive positioning.

KEY TAKEAWAYS
• Funded status has improved significantly for many pension plans in 2018, driven by voluntary contributions ahead of tax reform and recent rising rate environment
• Firms are increasingly focused on de-risking their pension plans, leading to significant activity in the U.S. pension buyout market in 2018
• Firms with well-funded plans are now well positioned to defease a portion of their pension liabilities at minimal cost through a pension buyout

¹ Firms with December 2017 fiscal year end could make contributions up to September 15, 2018 and receive 35% tax deduction.
² Based on Milliman’s 100 Pension Funding Index.
³ Based on Mercer estimates.
Solutions to help firms with limited stock borrow to issue a new convert

Convertible arbitrageurs are approximately half of the convertible market investor base. They buy convertibles and concurrently sell short some of the underlying stock, which needs to be borrowed. For firms with high levels of short interest, the lack of stock borrow may make it difficult or expensive to place a convertible ... hence, a bank can help firms to create stock borrow for these investors to facilitate the convert sale.

For example, an issuer can pay a bank cash now for the agreement that the bank delivers shares in five years (e.g., prepaid forward, which retires shares). Then, a bank enters into a total return swap with convertible investors, where the investors achieve short exposure, without technically having borrowed the stock. Alternatively, there are other structural ways to create borrow, such as a bank borrowing shares from the company itself and selling them short in a registered transaction.

KEY TAKEAWAYS

- There are strategies for companies with limited float/stock borrow to do converts efficiently
- A bank can help create additional stock borrow for convertible investors
SOFR: Almost ready for prime time

SOFR is an overnight rate based on transactions conducted in the Treasury repo market, which is poised to join the list of benchmarks used with financial instruments. Recommended language to replace LIBOR with SOFR, should LIBOR be discontinued, is expected to be proposed by a special committee by the end of 2018.

After Fannie Mae issued the first SOFR-linked note ($6 billion floating rate note), the World Bank was first to hedge a bond issuance linked to SOFR ($1 billion 2Y note using a SOFR to 3-month LIBOR swap). Expansion into other capital markets products like CDs by Credit Suisse ($100 million 6-month CD), commercial paper by Barclays ($525 million floating rate commercial paper), and GIC notes by MetLife ($1 billion 2Y guaranteed floating rate note) highlight the continued progress, so a logical next step could be traditional corporates. Pricing of recent SOFR offerings appears to be roughly flat to ‘LIBOR equivalent’ offerings.

SOFR still remains an overnight rate, however, and its full potential will only be seen once term rates and derivative products develop around the new benchmark, and broader market infrastructure gets upgraded to accommodate both primary and secondary markets for SOFR-linked products.

KEY TAKEAWAYS

• SOFR (Secured Overnight Financing Rate) is widely expected to replace LIBOR and the transition appears to be accelerating
• SOFR implementation is starting to be seen across multiple areas of the debt capital markets
• The market may swing from LIBOR to SOFR more quickly than anticipated but the development of SOFR term rates and related derivatives products will be key
Novel solutions for firms with cross-holdings to maximize value

Altaba (formerly known as Yahoo! Inc) is an NASDAQ-listed firm that consisted of two primary investments: a large Alibaba stake (one of the world’s largest online retailers) and a smaller Yahoo! Japan stake. Between its first transaction in 2017 and its recent September 2018 sell down of $4.3 billion Yahoo! Japan shares, Altaba both leveraged non-traditional financing techniques and efficiently retired large portions of its outstanding shares via structured buybacks and exchange offers. In particular, key lessons through Altaba’s multi-faceted journey include:

- Evaluate all financing options: Raised $3 billion via margin loan against its Alibaba stake, while in other executions, pursued traditional monetization in a $6 billion Alibaba sell down and $4.3 billion Yahoo! Japan sell down
  - Among many potential financing alternatives, the margin loan resulted in an asset backed form of financing that resulted in attractive depth and financing rates
  - Execution of equity market sell down was balanced with expected tax liabilities and complex registration rights agreements
- Structure large buybacks strategically: Executed a $3.4 billion Dutch Auction tender versus separate $13.9 billion Exchange Offer to retire Altaba shares efficiently
  - In the Dutch Auction, encouraged investor participation by using a Dutch Auction to target natural index sellers
    - Also included a novel pricing mechanism to increase pricing transparency/capitalize on correlation between Altaba stock and the underlying cross-holdings
  - In the Exchange Offer, participating investors could tender their Altaba shares for Alibaba shares (held by Altaba) and cash
    - In effect, Altaba used shares held in another public company as a currency to repurchase its own shares a novel structure to achieve two steps simultaneously (monetization of underlying stake and repurchase of shares)

J.P. Morgan’s global team played a lead role across all aspects of the transaction, including structuring, tax, accounting, and capital markets executions.

KEY TAKEAWAYS

- Strategic buyback structuring and evaluation of non-traditional financing options can be key differentiators in unlocking value for firms with minority stakes of other public companies (“cross-holdings”)
- Firms with cross-holdings trading should explore strategies to optimize for sum-of-the-parts discounts, while remaining mindful of complex issues around structuring, risk-management, and tax

OCTOBER 2, 2018

#Structuring #Financing #Monetization
OCTOBER 30, 2018
#Leverage #Ratings #Global

Global leveraged transactions: A shift to three credit rating agencies

Refinitiv and Akzo Nobel Specialty Chemicals – two of the largest post-crisis LBOs – obtained ratings from each of S&P, Moody’s and Fitch. A clear benefit of holding three ratings in both transactions was demonstrated by achieving ‘B range’ ratings on the junior notes from each of S&P and Fitch – this compares to Moody's providing ‘Caa range’ ratings on the notes. Crucially, having two out of three ‘B range’ instrument ratings made the notes eligible for ‘B’ indices and baskets for many investors. This would not have been possible if the same notes had only been rated with one ‘B range’ and one ‘Caa range’ rating. Allowing the junior debt to qualify as a ‘B’ instrument with investors helped create meaningful cost saving for the issuers.

In Europe, one third of €500 million+ Term Loan B issuers in 2018 have published three ratings, a 9x increase from 2017. The value of obtaining three corporate ratings is partially driven by changes in CLO rating requirements. 80% of new 2018 European CLOs are Fitch + Moody’s rated vehicles and therefore require the Term Loans in which they invest to be assessed by both of these agencies. This has resulted in Fitch loan ratings becoming more relevant for new CLO investors. By comparison, pre-2018 CLOs still typically require a combination of S&P + Moody’s ratings before they can invest in a loan. Therefore, although it is not a necessity to obtain three ratings, larger Term Loan transactions can maximize market access by providing the investor base with three ratings.

The increasing presence and acceptance of Fitch across debt products is a positive development for issuers and investors. The trend of obtaining three ratings (or two of any three agencies) is likely to continue through 2019.

KEY TAKEAWAYS
• There is an increasing trend of obtaining credit ratings from all three major agencies (Moody’s, S&P, and Fitch), particularly for large leverage finance transactions
• The benefits of three ratings can be meaningful for bond and loan issuers, allowing broader access within the high yield index and CLO investor universe
OCTOBER 30, 2018

#Leverage #Credit #CycleRisk

Borrower-friendly terms indicative of a frothy market?

An S&P Global review of a sample of transactions originating during 2015 shows that on an aggregate level, “add-backs” to EBITDA have inflated projections by an average of 45%. This study has also revealed that management projections are almost universally overstated, as 56% and 69% of issuers included in this analysis missed their EBITDA projections by greater than 25% in 2016 and 2017, respectively. To a lesser degree, issuers have also under-delivered on debt repayment projections, as 16% and 31% of these issuers missed their debt projections by greater than 25% in 2016 and 2017, respectively. As a result, actual reported net leverage was 2.9x higher for 2016 and 3.6x higher for 2017. While the concept of EBITDA add-backs is not new, robust credit markets in recent years have increased the acceptance of management forecasted numbers and borrower-friendly credit documentation. That does not mean, however, that agencies or lenders take marketing material at face value without forming their own view on leverage and management forecasts.

While this practice exists across the credit spectrum, a recent S&P Global study across single B issuers shows that over 50% of management reported EBITDA is comprised of add-backs. To this end, future event risk may be understated as loan documentation that relies on EBITDA likely provides additional flexibility that would not otherwise exist. However, this concept has enabled borrowers of this size and scale to access robust leveraged loan markets that have supported both organic and inorganic growth opportunities. Issuers have the ability to maneuver under negative covenants and restricted payments such as dividends and future leveraging events that will continue to drive opportunity, notwithstanding potential incremental risk to credit markets. In a stress scenario, investors and markets may deconstruct add-backs and forecasts across highly leveraged transactions and conclude that additional flexibility creates additional opportunity, albeit at a cost.
For multi-class shares, MSCI is in a class of its own
On October 30, MSCI concluded an 18-month consultation process with the investment community regarding unequal voting structures. MSCI had temporarily excluded companies with multi-class shares from its investable universe during the consultation period. After the decision to retain multi-class shares, all companies with such structures will be eligible for inclusion as part of MSCI’s February 2019 quarterly review and May 2019 semi-annual review.

As we observed in our October 2017 note, “To multi-class, or not to multi-class,” institutional investors have campaigned for years against multi-class shares that concentrate founder/management control. Spurred by the March 2017 IPO of Snap, Inc. with non-voting shares, S&P opted to explicitly exclude multi-class shares structures and Russell added the requirement to have a minimum of 5% public voting rights. MSCI defended its decision with the argument that global market benchmarks should reflect the broadest investment opportunity set available, without the constraint of specific investor preferences. Acknowledging the importance of voting rights to many investors, MSCI will also develop a new index series in Q1 2019 with voting rights as part of the eligibility criteria.

KEY TAKEAWAYS

• After extensive consultation, MSCI announced that its Global Investable Market Index (GIMI) series will retain companies with multi-class shares at their free float market capitalization weight
• MSCI’s decision marks a departure from other major indices that have decided to exclude multi-class shares, including S&P Dow Jones and FTSE Russell
• Given this divergence in index eligibility, will we see a shift in fund flows towards index-tracked products that reflect investor preferences for voting structures?
Increased investor interest in tax receivable agreements (TRAs)

In late 2015, J.P. Morgan brokered a transfer of a TRA held by a financial sponsor to an investment fund buyer, breaking new ground for sales of TRAs. Tax reform has since further heightened investor interest in acquiring TRA payment rights. TRA payment obligations have decreased as a direct consequence of lower corporate tax rates, thus lowering the present-value of remaining TRA payments and removing some uncertainty related to future tax rates. These factors combined have created a viable buyer universe for these assets at a 13-17% discount rate. Holders are frequently protected from event risk by clauses that accelerate payments in the event of an early termination. Recently, more investors have been willing to absorb risks associated with company operating performance and the creation of any new future tax attributes senior to those covered by the TRA.

Sellers, on the other hand, can transfer these risks for immediate cash monetization, thereby offloading portfolio company earnings risk and tax rate change risk. As the universe of buyers expands, sellers may be able to achieve more competitive pricing and increased returns. Companies with public trading history and audited financials achieve a more attractive pricing; however, modest management participation is required. Ultimately, the entire process can be strictly confidential, with no public or SEC disclosures required, making it a sophisticated, yet seamless, transfer of assets.

KEY TAKEAWAYS

- TRA monetization, which took a hiatus in 2017, has recently seen renewed investor interest as U.S. tax reform and tax rate changes have been implemented
- Specialized investment funds, family offices, insurance companies, and certain banks are forming a viable buyer universe for TRAs due to their willingness to undertake illiquidity and duration risk
- In the future, bid-ask spreads on TRA pricing due to differences in valuation sought by buyers and sellers could be bridged with back-end financing by investment banks and/or retention of upfront cash flows
JULY 23, 2018
#M&A #Global #Regulation

**FIRRMA and CFIUS could change global deals as we know them**

CFIUS serves as an inter-agency committee, reviewing foreign investments in U.S. companies or operations that could result in a breach of, or compromise to, national security. On July 19, in an attempt to modernize the committee, Congress passed FIRRMA.

- FIRRMA expands the scope of CFIUS by allowing or requiring review of any non-passive investment by a non-U.S. person in any U.S. critical technology business
  - However, it simultaneously exempts from review foreign investors from “friendly countries” and other passive investments
  - In addition, the definition of passive investment will be clarified so that joint ventures and limited partnerships will no longer be viewed as passive if the foreign investor (often the minority investor in a JV or the limited partner in an LLC) has participating or possibly even protective veto rights
- The White House had previously issued an official statement expressing intent to rely on FIRRMA — rather than impose separate investment restrictions — to address investment-related technology-theft issues

---

**KEY TAKEAWAYS**

- The Foreign Investment Risk Review Modernization Act (“FIRRMA”) is generally expected to target investments from China in particular, and hence impacts the technology sector the most
- Expect more scrutiny for transactions in targeted industries and those related to national security
- Historically, the Committee on Foreign Investment in the United States (“CFIUS”) has responded positively to deal announcements with implied positive U.S. economic outcomes
Regulatory scrutiny continues for U.S. M&A deals too

Earlier this month, two high-profile government challenges on regulatory approval for M&A transactions were brought against M&A acquirers:

- On July 12, the U.S. Department of Justice filed an appeal to the AT&T-Time Warner merger approval, despite its loss at the first level of federal courts
  - This appeal was filed even though the presiding federal judge at the trial warned against further appeals to the approval, whose related decision emphatically stated that the government had failed to meet the minimum burden of establishing that the merger would decrease competition
  - Additionally, this appeal came after the AT&T-Time Warner merger closed in mid-June, such that a government victory would result in the challenging task of unwinding a consummated merger
- In a separate decision involving a separate federal agency, on July 16, FCC Chairman Ajit Pai issued a statement indicating “serious concerns” about the proposed Sinclair/Tribune merger

A FCC vote for further judicial review caused additional delay to closing, despite Sinclair’s willingness to alter its proposal and satisfy FCC conditions.

---

**KEY TAKEAWAYS**

- Recent gestures by governmental agencies indicate a continued willingness on the part of the government to challenge high-profile M&A transactions
- This ongoing scrutiny may signal the government’s plan to continue to challenge vertical consolidation (and not concede these mergers, as the previous administration did), which could change the landscape of U.S. M&A activity
#Blockchain #Strategy

**Blockchain: From words to action**

Blockchain continues to penetrate the mainstream lexicon. Though citations over the last few years have mainly been limited to discussion of initiatives, blue-chip companies are starting to spring to action, including those outside the Tech and Financial sectors.

On August 3, 2018, ICE (Intercontinental Exchange) announced the formation of a company, Bakkt, in partnership with Microsoft, BCG, Starbucks, among others. Aimed at developing an open source platform for access and trading of digital assets backed by the world’s largest owner of exchanges, Bakkt would “help unlock the transformative potential of digital assets across global markets and commerce,” according to its CEO. It will be launching in November pending regulatory approval.

IBM’s Food Trust project aimed at streamlining the tracing of the food supply chain has also hit milestones in recent months. Food Trust partners include Walmart, Dole Food Co., Nestle, Driscoll’s Inc., Golden State Foods, Kroger Co., McCormick and Co., McLane Co., Tyson Foods Inc. and Unilever NV. For potential food recalls, the technology allowed data to be processed within seconds, compared to a seven-day period when blockchain is not employed, according to IBM.

Finally, the interest level in security issuance on the blockchain continues to increase, with the latest announcement from World Bank on a $50 million, two-year debt deal to be issued on the blockchain in a domestic Australian market transaction.

---

**KEY TAKEAWAYS**

- “Blockchain” has become a favorite buzzword across industries, showing up twice as often in financial firm earnings calls and four times as often in tech industry calls versus 2016
- Recent announcements by large industry incumbents like Intercontinental Exchange, Walmart, Microsoft, Nestle, and Starbucks demonstrate how blockchain technology is moving from hype to implementation
SEPTEMBER 4, 2018
#M&A #CorporateClarity #Strategy

With equity markets continuing to reward corporate clarity, M&A has increasingly trended towards industry consolidation

An analysis of a broad swath of large U.S. firms over the past three years reveals that firms with more than three reporting segments typically trade at PE- and EBITDA-multiple discounts to their industry peers, highlighting the persistence of the “conglomerate discount.” This focus on corporate clarity has not only spurred trends in divestitures and spin-offs, but contributed to a shift in the complexion of M&A more generally, as well. Publicly traded U.S. strategic buyers are purchasing more public targets within their own industries when compared to five years ago. So far in 2018, 78% of all U.S. public-to-public deals were in the same sector, compared to 64% in 2013. This trend suggests firms are seeking to achieve both growth and clarity objectives by not stepping outside of their industry to acquire targets.

DECEMBER 12, 2018
#M&A #CorporateClarity

Less is more: Divestitures remain a prominent theme as the market continues to value corporate clarity

As the market continues to attribute value to corporate clarity and scale, firms and investors alike recognize that separation and acquisition activity aren’t necessarily at odds. An increasingly high proportion of acquisitions have been intra-sector, aimed at achieving scale: 78% within the same industry in 2018 versus 64% in 2013. At the same time, there has been an increase in divestitures versus this time last year: 21% more spins, 26% more sales.

The high divestment rate is unlikely explained by regulatory pressures - diverging from historical norms, regulatory attention has recently focused on high-growth “mega-cap” technology and service companies rather than old guard multi-industry conglomerates. Activism, high equity valuations, and investor concern regarding economic cycle uncertainty are the more likely drivers. Regardless of cause, firms should carefully consider how to best demonstrate a commitment to achieving both corporate clarity and growth objectives within the current paradigm.

KEY TAKEAWAYS

- Equity markets continue to apply a “conglomerate discount” to firms with numerous reporting segments
- M&A continues at a record pace and firms are increasingly acquiring firms in their own industries versus just five years ago
- By concentrating operations on a few core segments (through strategic divestitures and sector-focused M&A), firms are building scale while preserving focused business strategies

KEY TAKEAWAYS

- The first nine months of 2018 showed dollar global divestiture volume up 26% relative to the first nine months of 2017, as firms continue to rationalize their segments and business lines through separation
- Large deals are prominent, both U.S. and internationally, with 19 deals larger than $10 billion in 2018 year to date
- U.S. and non-U.S. firms alike should continue to execute on corporate clarity objectives to proactively address shareholder concerns and reinforce management focus

1 Sectors defined by SIC classification.
The foreign investment environment and shifting responses

Chinese acquisitions and investments in the U.S. announced in the first half of 2018 fell by over 60% year over year, according to Dealogic. Global investment oversight and review alongside trade tensions are fundamentally changing the environment, with fears about the ability to achieve regulatory approval from multiple jurisdictions reshaping M&A and investment decisions. Some high-profile cases of M&A failures due to regulatory hold-ups, such as NXP/Qualcomm are discouraging others from pursuing any M&A.

At the same time, some investors are pursuing deal structures that have adapted to the August 2018 enhancements to the CIFIUS laws (Committee on Foreign Investment in the United States). For example, acquiring a voting stake in companies just below a 10% threshold, while making the rest an investment in non-voting stock, may not subject an international purchaser to U.S. regulatory review. Japanese conglomerate SoftBank has employed this strategy in several recent venture capital investments.

Investors should remain vigilant in this space. The U.S. government is now in the process of developing regulations for enhanced review of foreign investment under the Foreign Investment Risk Review Modernization Act (FIRRMA), which will extend the scope of CFIUS authority.

KEY TAKEAWAYS

• Global trade and political tensions are impacting the cross-border M&A environment
  – The U.S. is continuing to enhance regulations for foreign investments (e.g., CFIUS/FIRRMA)
• Increased regulatory scrutiny has caused corporates and investors to modify behavior and investment structures
JULY 23, 2018
#Strategy #Global

Global activism in focus: Are you prepared?

Management teams can pre-empt activist attacks first by focusing on governance and corporate clarity; then by asset sales and spin-offs to reduce or even eliminate the diversification discount, with the result often being a “focus premium.” UK/EU managers should be especially vigilant as Nelson Peltz’s Trian Partners is raising a £1 billion war chest to launch campaigns against leading British and European conglomerates.

In other global examples, the Lee Family, who is Samsung’s largest shareholder, is under pressure from activist hedge fund Elliott Management, the South Korean Government, and the global markets, to reduce its control of the electronics giant and simplify its corporate ownership. BHP, under pressure by Elliott, is selling its non-core U.S. shale assets and may collapse its dual list structure to become a unified company, hence potentially simplifying its corporate structure.

AUGUST 14, 2018
#Credit #M&A #TaxReform

Market primed for LBOs

Tax reform limitations on deductibility of interest expense might have initially been expected to have a chilling effect on the Leveraged Buyout (LBO) market. Subsequent analysis has shown the impact on returns to be marginal thanks to increased cash flows from lower headline tax rates.

At the same time, continued strength in the U.S. economy has bolstered free cash flow (FCF) generation: Q2 ’18 S&P 500 FCF was 35% higher than three years prior while EBITDA multiples increased by only ~1x (or about 10%) over the same time period. Couple this with a high yield debt market that remains issuer-friendly and underpinned by low interest rates and all signs point to continued strength in LBO activity.

KEY TAKEAWAYS
• Global conglomerates are under scrutiny as activist funds are focusing their resources and targeting the following weak points:
  – Convoluted and complicated cross-holding ownership structures
  – Disparate business segments, that result in a discount consolidated valuation
• As global conglomerates shed assets, opportunities may become abundant for companies who may be better owners of the “disposal assets”

KEY TAKEAWAYS
• Market dynamics are primed for a pick-up in LBO activity as valuation multiples (EV/EBITDA) begin to plateau, continued economic strength drives strong cash flow generation, and tax reform offers greater access to global cash piles
• Global LBO dollar volumes are up 35% year-over-year and are on pace to be the highest since 2007

1 Based on first half 2018 versus first half of 2017 data.
Is technology disruption helping maintain low inflation?

Last year, inflation hovered persistently below the U.S. Fed’s target of 2% and economists’ forecast models even as the macro-economy strengthened. Janet Yellen described this as a “mystery,” and some economists and forecasters have argued that the traditional relationships between the unemployment rate and wage growth no longer apply, or that prevailing theories on the mechanisms of monetary policy are due for major revisions.

Technology-driven disruption is among the factors that may have shaped inflation results alongside the inflation target-setting expectations of the Federal Reserve and other central banks. Underneath the headline inflation of 2.7%, there is a wide range of inflationary and deflationary components. Technology advancements have long contributed to decline in the prices of goods; for example, TVs were down 18% year-over-year in the latest August reading, which continues a long trend. Cross-industry disruption using technology, such as internet comparison shopping or the growth of the sharing economy (e.g., lodging and travel) have spread technology’s deflationary properties across more of the consumer basket. Dishes and toys got 12.8% and 9.3% cheaper, respectively, in the last year. August’s 1.6% seasonally adjusted m/m decline in apparel prices was the largest drop since 1949. Some commentators link the competitive effects of things like price comparison to sluggish wage growth, with deflationary pressure in retail also compressing companies’ margins.

However, not all segments have seen price declines. Gardening and lawn care services rose 8.9%, elementary and high school tuition 4.8% and hospital services 4.2% in the last year. Do the offsetting pockets that contribute to modest inflation in the whole basket identify top candidates for future disruption?

---

KEY TAKEAWAYS

- U.S. inflation has climbed above 2% this year and wage growth reached 2.9% in August. August’s year-over-year growth in hourly earnings was a nine-year high, but both CPI and core inflation returned to May levels in August (2.7% and 2.2%, respectively).
- Will business cycle strength and global macro factors push inflation higher, or will deflationary factors such as widespread technology-driven disruption contribute to keeping inflation contained?
GICS sector shuffle

Over the past week, the Global Industry Classification Standard (GICS) implemented its largest sector reclassification since 1999. The Telecommunications Services sector was replaced by a new Communications Services sector. Heavy-weight technology stocks such as Google, Facebook and Netflix were added to the Communications Services sector, increasing its weight in the S&P 500 to 10% compared to the previous 2% of the Telecommunications Services sector. The Consumer Discretionary and Information Technology sector both decreased in weight within the S&P 500, with the former dropping -3% to 10% and the latter, -5% to 21%. The last time a sector was amended, in 2016, Real Estate was broken out from Financials largely due to a difference in investor fundamentals between the two industries. This most recent change reflects recognition that firms like Netflix, Disney, and Twitter are no longer best described as simply “Consumer Discretionary” or “Information Technology” firms and deserve a sector more befitting of their evolving businesses, a reminder of how different industries have increasingly overlapped with technology. For firms in the Information Technology or Consumer Discretionary sector, this change may also alter the comparable company landscape for valuation or benchmarking purposes.

What are the betting markets telling us about U.S. midterm elections and what are the market implications?

Betting markets currently imply a ~70% chance of Democrats gaining control of the House and an 85% chance of Republicans retaining control of the Senate in the 2018 November federal midterm elections. Historically, equity market performance under a split Congress has been strong during periods with a Democratic president and Republican-controlled Congress, the S&P has delivered an 18.3% average annual S&P gain (since 1950). A Republican president and split Congress is close behind with an average annual gain of 15.7%. In a world of Twitter feeds and cable news cycles, could the likely inaction of divided government offer more policy certainty rather than less?

KEY TAKEAWAYS

- The Global Industry Classification Standard (GICS) system finally acknowledges the evolution of media and content in the age of the internet by undertaking a massive reclassification, its most extensive since 1999, of companies involved in communication, as broadly defined either via the internet or from legacy platforms
- This reclassification impacts the Telecommunications Services, Information Technology, and Consumer Discretionary sectors, and companies such as Google, Facebook, and Netflix. The reshuffling acknowledges that core aspects of communication, media, and content cannot today be separated from the internet, now the most essential way that information and entertainment is consumed globally

- Betting markets are currently suggesting U.S. midterm elections result in a Democratic House (~70%) and Republican Senate (~85%)
- A divided government isn’t necessarily bad for equity markets: the S&P has seen an average gain of 15.7% since 1950 under this type of split political leadership (with a Republican president)

Source: Betting market info from PredictIt as of 09/27/2018 and market performance data from LPL Research as of 09/15/2018.
Quarterly versus semi-annual reporting

In August, President Trump tweeted that he would ask the SEC to explore moving to semi-annual earnings reporting. The topic is not a new area of analysis for the SEC and Corporations’ voluntary quarterly earnings guidance has also recently garnered attention (with some criticizing this practice while still supporting quarterly earnings reports).

Critics and proponents of quarterly reporting both claim their positions enhance shareholder value. Critics say a semi-annual system allows managers to focus more on long-term results and reduces reporting costs. Proponents say a quarterly system enables investors to better oversee managers, reduces scope for insider trading, and lowers the cost of capital for reporting firms (thereby promoting investment) through more regular disclosure and more accurate stock prices.

In the OECD, nine countries require quarterly reporting while the rest (26 countries, including the 23 members of the European Commission, which fully eliminated mandatory quarterly reporting in 2013) do not. The world’s three largest economies, the U.S., China, and Japan, all require quarterly reporting, with Japan having adopted quarterly reporting in 2008.

The academic evidence on costs and benefits is mixed:

- Research looking at non-U.S. firms with semi-annual reporting found that their stock price overreacted to information in U.S. peers’ quarterly reporting in the absence of information from the non-U.S. firm in the first and third quarters.
- Research on the impact of shifts from mandatory annual, to semi-annual, to quarterly reporting for U.S. public companies from 1950-1970 found a 1.5-1.9% reduction in investment in fixed assets attributable to more frequent reporting, with more pronounced impacts in industries where investments took longer to pay off.
- However, research on the U.K. requirement of qualitative quarterly reports from 2007-2014 found no significant impact on investment, but did find 7% of affected firms had an increase in analyst coverage associated with the more frequent mandatory reporting.

The SEC will have their task cut out for them as they re-evaluate the merits of quarterly versus semi-annual reporting.

1 Arif and DeGeorge, January 2018.
2 Kraft, Vashishtha and Venkatachalam, April 2017.
3 Nallaredy Pozen Rajgopal, October 2016.
SEPTEMBER 18, 2018
#Accounting #Regulation

Upcoming changes in lease and accounting treatments
Please reach out to the Corporate Finance Advisory team should you have specific questions as it relates to the new leasing standards.

#Regulation #Disruption

Private companies seek to “disrupt” equity compensation structure
Airbnb is petitioning the SEC for revisions to Rule 701 that would allow the company to grant stock to Airbnb hosts. Last year Uber met with the SEC regarding the possibility of giving drivers equity in the company. Under current rules, private companies are limited to a total of either 2,000 shareholders or 500 non-accredited U.S. investors before having to register with the SEC. Current exceptions for equity holdings by employees recognize the importance of “sweat equity” as an essential part of building a new venture. Limitations on the extent to which equity in private enterprises is distributed to nonemployees may prevent abuses and misleading practices – people are protected from providing goods and services in exchange for equity that lacks a readily knowable market value supported by public disclosure. However, these limitations may also restrict the extent to which needy segments of the U.S. and global population can participate in private sector wealth creation. Already, 4.5% of U.S. families participate in the “gig economy” through online platforms.

The SEC has not turned a deaf ear to evolving capital markets: in 2016 the SEC adopted “Regulation Crowdfunding” to enable small businesses and startups to leverage the advertising power of the internet to raise capital from large numbers of people in a cost-effective way. However, the changes to Rule 701 to permit awards of equity to nonemployees prior to an IPO could be possible, but would not be without complications if the spirit of securities laws are to hold: any change in the Rule will still need to set limits on the scope, number, and type of individuals/entities that may be given equity.

KEY TAKEAWAYS

- New U.S. GAAP and IFRS leasing standards will soon put most operating leases on the balance sheet
- For most U.S. GAAP companies, the new U.S. standard (ASC 842) will not change the income statement, but will involve additional work, beginning with establishing the discount rates at which to capitalize operating leases
- For IFRS companies, the new standard (IFRS 16) will change the income statement and could affect important metrics

- The last several years have seen companies such as Uber and Airbnb challenge the bounds of equity compensation structures for private companies
- Current SEC Rule 701 limits companies’ ability to grant equity to non-employees, but Uber and Airbnb are taking steps to make it easier to compensate drivers and hosts with private shares
New IRS guidance indicates additional flexibility for tax-free spin-offs

Over the last several weeks, the IRS has released two pieces of public guidance that indicate additional flexibility for corporate taxpayers to pursue tax-free spin-offs. The two pieces of guidance – a revenue procedure and an IRS statement – suggest a potentially expanded definition of “active trade or business” that would facilitate tax-free spin-offs for early stage businesses, such as in healthcare and technology, as well as willingness to provide tax rulings to corporations seeking to monetize spin-offs through debt exchanges. Corporate taxpayers can thus now obtain more definitive guidance on key structuring areas of tax-free spin-offs that were called into question in recent years by IRS pronouncements. Clarity surrounding monetization can also enhance the value of spin-offs for parent companies that seek to obtain greater cash proceeds from a spin-off divestiture.

In the zone: A tax-efficient opportunity to preserve capital gains

As part of the Tax Cuts and Jobs Act, Congress established the Opportunity Zones program aimed at spurring investment in low-income communities. In essence, a taxpayer can elect to defer recognition of an unlimited amount of capital gain if that capital gain is reinvested in a Qualified Opportunity Fund (“QOF,” which in turn invests in Qualified Opportunity Zones) within 180 days. The Opportunity Zone provision rewards long-term investment – the longer a QOF is held, the bigger the tax savings. The benefits range from deferral of payment of capital gains tax until the investment in the QOF is sold, to a 10-15% step-up in tax basis (effectively resulting in forgiveness of a portion of the original gain), to an election to have the tax basis equal the fair market value of the investment if the QOF is held for at least 10 years (effectively resulting in forgiveness of all new gain in the QOF). Despite significant investor interest and public attention given to the Opportunity Zones program, practical questions remain and investors should consult with legal counsel and investment advisors before investing in QOFs to minimize risk of a technical misstep.
U.S. borrowers to benefit from relaxed tax rules for “deemed dividends”

Historically, under Section 956 of the U.S. tax code, U.S. multinationals were deemed to receive a taxable dividend — “deemed dividend” — when controlled foreign subsidiaries lend to, or support a borrowing by a related U.S. borrower (e.g., through a guarantee, asset pledge or certain stock pledges). The 2017 tax reform legislation resulted in tax relief for cash dividends from 10% owned foreign subsidiaries, but neglected to exempt “deemed dividends” that were not actually paid. The proposed regulations released on October 31st are intended to correct this technical inconsistency by providing the same exemption to “deemed dividends” arising from credit support.

While the regulations are yet to be finalized, U.S. corporates may generally elect (but are not obligated to do so) to rely on them for foreign subsidiaries with tax years that start after December 31, 2017. U.S. borrowers may elect to continue to exclude foreign collateral for other legal or economic reasons. Nonetheless, the new regulations are expected to vastly simplify financing arrangement going forward, because collateral packages should, over time, eliminate this market standard, tax-driven carve-out.

**KEY TAKEAWAYS**

- Under proposed regulations, U.S. multinationals would be relieved from “deemed dividend” rules that have previously limited credit support (e.g., asset pledges, guarantees) from foreign subsidiaries
- As a result, to support borrowings, U.S. corporate borrowers can more readily pledge the stock or assets of foreign subsidiaries
- In general, beginning in 2018, credit packages can include upstream guarantees from foreign subsidiaries and the amount of first-tier foreign subsidiaries stock pledged as collateral can exceed the previous cap of 65%