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Outlook 2016

WHAT TO EXPECT IN:
The Economy • Tax •
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Financial Reporting

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FROM THE EDITOR

Looking Back

The month of January is named after Janus, the Roman god of beginnings and endings, who is typically depicted with two faces—one looking forward, the other looking back. In the spirit of Janus, we offer our annual CFO Outlook feature on page 8 and, here, a look back at some of the stories we covered in 2015.

In February, our 30th anniversary issue, we examined the choices and cost-benefit issues involved with cloud computing in **"Covering the Cloud."** In March, we weighed the arguments for and against a territorial tax system in **"Territorial Imperative."**

April's cover story, **"Euro Pain,"** reported on the damage inflicted on corporate revenues by the falling euro and rising dollar. In May, CFO Charles Holley explained how the world's largest retailer is integrating e-commerce with its brick-and-mortar stores in **"Walmart's Next Move."**

An executive with a baby in a Snugli appeared on June's cover, illustrating our story on CFOs and work-life balance, **"Balancing Acts."** July's cover story, **"Diebold Grows Bold,"** focused on the ATM maker's transition to a services-led company. And September's cover story, **"CFOs to Watch,"** profiled 20 finance chiefs worth keeping an eye on in the coming year.

Finally, **"401(k)s: Eye on Providers"** offered practical advice for plan sponsors in October; **"From Finance to Fintech"** covered the exodus of Wall Street executives to fintech startups in November; and **"The Road Ahead"** presented CFO Chuck Stevens' account of major changes afoot at General Motors in December.

I hope you read and enjoyed these articles and others in 2015. (If you missed one or two, you can find them at www.cfo.com.) We promise to deliver equally timely, forward-looking stories in the year ahead. CFO

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Trendline

FINANCE

Access to Capital High, But Demand Is Wavering

Small and midsize businesses successfully secured capital in Q4 2015, but their demand for funding fell. BY KATIE KUEHNER-HEBERT

U.S. small businesses' access to capital is at its highest level since 2012, but demand for funding is down, according to the latest results from Dun & Bradstreet and Pepperdine University's Private Capital Access quarterly report.

Small businesses surveyed were able to access more capital, with a 5% increase in successful bank loan financing (35% success rate for Q4 2015). In addition, there was an increase in access from alternative business financing options, including business credit cards (60% success rate), merchant cash advances (31% success rate), and business online marketplace lenders (26% success rate).

However, the segment's demand for funding fell 5.2% from the third quarter, according to the survey.

Dun & Bradstreet and Pepperdine define small businesses as those with less than $5 million in revenue and midsize businesses as those with $5 million to $100 million in revenue.

Midsize businesses, too, are seeing decreases in demand for capital (-3.8% change since Q3 2015). This segment also had a decline in bank loan access in the fourth quarter (73% success rate, a 17% decrease from Q3).

"Midsize businesses struggled with demand more than their small counterparts for the first time in quite a while, which is concerning" for the overall economy, said Craig R. Everett, director of the Pepperdine Private Capital Markets Project, in a press release.

"Since a growing small business quickly becomes a medium-sized business, I consider medium-sized businesses the true bellwether of growth in our economy," said Everett. "With demand for capital taking a hit for these midsized businesses, the overall business growth outlook seems very soft. These businesses are saying that they are optimistic about growth, but they do not appear to be making actual plans to grow."

Other findings from the report:

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• 80% of small and midsize businesses expect 2016 to be better than the previous year, with 87% confident of growth in 2016.

• 72% of small and midsize businesses expect to increase revenue in 2016 by an average of 10%.

• 56% of small businesses believe the current economic environment is restricting their businesses' growth opportunities, compared with just 25% of midsize businesses.

• 49% of small businesses indicated the current business environment is restricting their ability to hire, compared with 22% of midsize businesses.

The report was derived from 2,773 survey responses collected in November 2015. CFO

COMMODITIES

MOODY'S SLASHES 2016 FORECAST FOR OIL PRICES

The rating agency lowers its price assumptions for crude oil benchmarks. BY KATIE KUEHNER-HEBERT

In December, Moody's Investors Service slashed its 2016 forecast for oil prices, as the Organization of the Petroleum Exporting Countries (OPEC) continues to exacerbate oversupply by pumping oil.

Moody's lowered its price assumptions in 2016 for Brent crude oil, the international benchmark, to $43 from $53 per barrel; and for West Texas Intermediate (WTI) crude, the North American benchmark, to $40 from $48 per barrel. The rating agency expects both prices to rise $5 per barrel in 2017 and 2018, according to its report "Oil and Natural Gas Industry Global: Threat of Prolonged Oversupply Drives Prices Lower."

"OPEC oil producers continue to produce without restraint as they compete for market share, exacerbating the currently saturated markets," Moody's senior vice president Terry Marshall said in a press release. "Russia has also greatly increased production, and the possibility that sanctions will be lifted on Iran in 2016 could flood the market with even more supply."

The rating agency has also significantly reduced its medium-term price assumptions for Brent and WTI crude oil, to $63 per barrel and $60 per barrel, respectively.

Moody's forecasts that global oil demand will rise by roughly 1.3 million barrels per day in 2016, an increase from its previous assumptions, as oil consumption picks up in countries such as the United States, China, India, and Russia.

In a separate report, Moody's said that it was maintaining its negative outlook on the integrated oil and gas, exploration and production, and drilling and oilfield services sectors, due to the prolonged period of oversupply keeping oil prices lower for longer.

"Low commodities prices and un-

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certainty about the pace of their recovery will continue to limit exploration and production activity in 2016, leading to spending cuts, stalled production growth, and volume declines," said Steve Wood, Moody's managing director of the oil and gas team. "And these cuts will in turn lead to lower revenue for drilling and oilfield services companies, which will face persistent equipment overcapacity and need to minimize capital expenditures just to operate near break-even cost levels."

The integrated oil and gas sector will also need to further cut capital expenditures in 2016 despite a 20% cut in 2015, as the sector will have negative free cash flow through the next year, according to "Oil and Gas—Global: 2016 Outlook—All Regions and Sectors Facing Lower-for-Longer Environment." CFO

ECONOMY

Economic 'Perfect Storm' Brewing?

The World Bank cites a slowdown in the BRICS economies.

THE CURRENT SLOWDOWN IN four of the five largest emerging economies could combine with turmoil in the financial markets to create a "perfect storm" for the global economy in 2016, the World Bank has warned.

Launching its annual Global Economic Prospects report this month, the bank said growth had slowed to 2.4% in 2015, from 2.6% in 2014, but a stronger performance in developed countries should lead to 2.9% growth this year.

That pickup in growth, however, could be in jeopardy because of a synchronous slowdown in the economies of Brazil, Russia, South Africa, and China, which, with India, form the so-called BRICS economies, the report said.

"Downside risks dominate and have become increasingly centered on emerging and developing countries," the report said.

Noting the Federal Reserve's decision in December to hike interest rates for the first time since the financial crisis, the bank said this tightening cycle would likely have "only a modest impact on emerging and frontier markets."

But in the event that growth in the BRICS economies fell one percentage point short of expectations, the bank said this would knock eight-tenths of a point off growth in other emerging markets and reduce growth in the global economy by 0.4%.

"Spillovers could be considerably larger if the BRICS growth slowdown were combined with financial market stress," the report warned. "If, in 2016, BRICS growth slows further, by as much as the average growth disappointment over 2010–14, growth in other emerging markets could fall short of expectations by about one percentage point and global growth by [seven-tenths of a] point."

The bank is predicting that recessions in Brazil and Russia will bottom out in 2016, that China will experience only a modest growth slowdown from 6.9% to 6.7%, and that India will continue to expand at a robust pace.

Growth challenges in China and other emerging markets are expected to force the International Monetary Fund to downgrade its global economic forecast for 2016 when the fund posts its latest outlook this month. CFO

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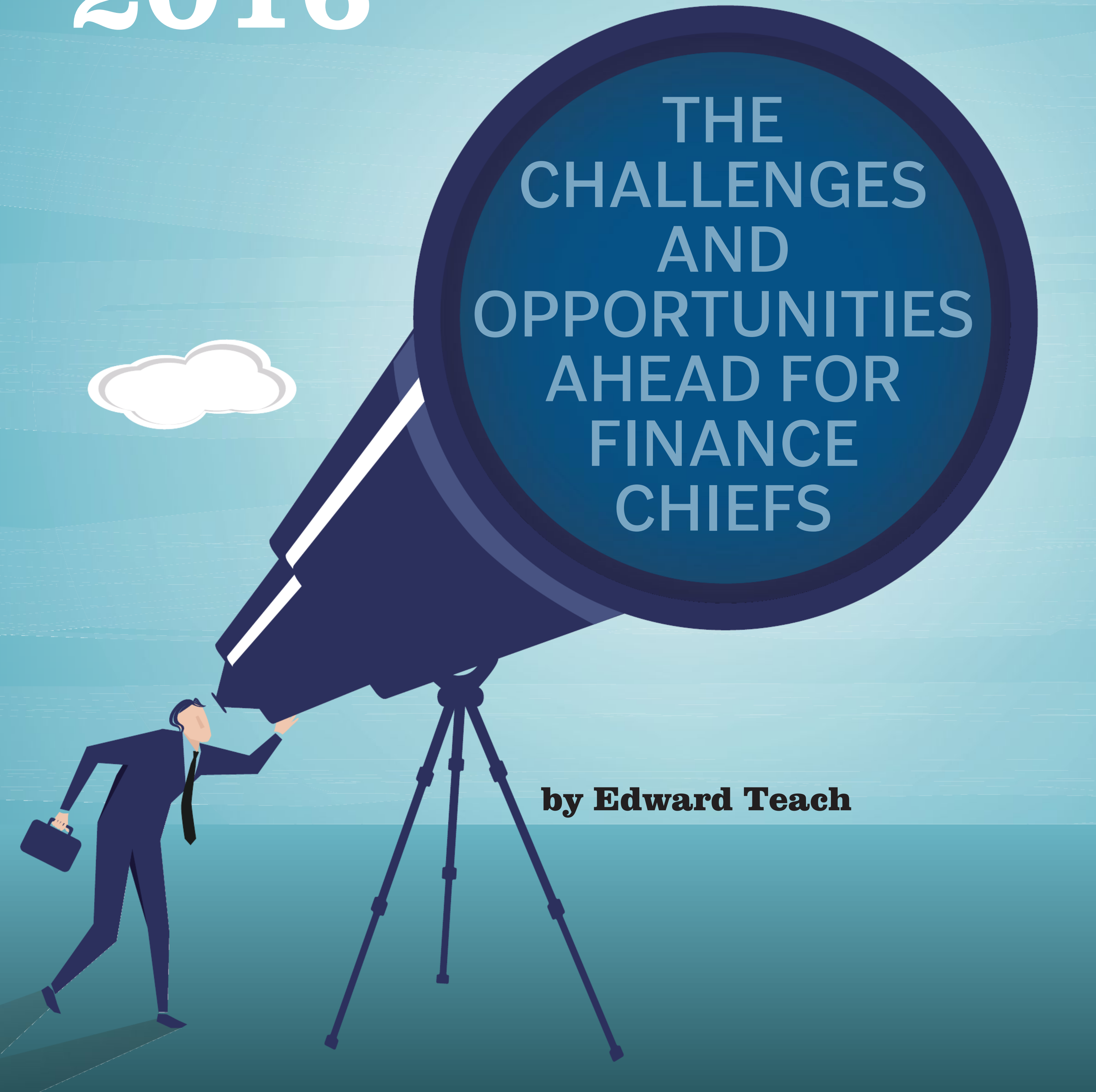
CFO OUTLOOK 2016

THE CHALLENGES AND OPPORTUNITIES AHEAD FOR FINANCE CHIEFS



by Edward Teach

The 2016 edition of our annual CFO Outlook feature draws on the judgment of four experts. In **The Economy,** Patrick O'Keefe of CohnReznick predicts how the U.S. economy will fare in 2016, and analyzes factors that could dampen its performance in the years ahead. Next, in **Tax,** Jeffrey LeSage of KPMG discusses some of the issues that are high on the agendas of chief tax officers and CFOs. In **Accounting and Financial Reporting,** Neri Bukspan of EY offers an insightful overview of coming rule changes from the Financial Accounting Standards Board. Finally, in **Deals,** EY's Sharath Sharma reviews the record year for mergers and acquisitions that just ended, and explains why the deal momentum should continue in 2016.

THE ECONOMY

LOW GROWTH, HIGH DEBT

The year 2015 will go into the books as "a moderately positive one" for the U.S. economy, but expectations for 2016 are somewhat less encouraging, according to Patrick O'Keefe, director of economic research at CohnReznick. Longer term, a combination of low growth and high debt could spell trouble ahead.

Growth had its ups and downs last year. Real (inflation-adjusted) gross domestic product barely budged in the first quarter, grew by 3.9% in Q2, then fell to 2% in Q3. Economists recently surveyed by the *Wall Street Journal* predicted 2.5% growth for the fourth quarter.

Job creation was a brighter story, however, with 2.7 million jobs added to the economy in 2015. Since 1999, only 2014 has been a stronger year for jobs, with 3.1 million created. With December's addition of 292,000 jobs, private-sector employment has grown for 70 consecutive months, the longest such streak in history.

The unemployment rate continued to fall, from 5.7% in January to 5% over the last three months of the year. The labor force participation rate, however, remained stagnant, at just 62.6% in December. "The labor force participation rate has been at an extraordinarily low level, the lowest in decades," comments O'Keefe. If the rate were the same as the average for the five years prior to the recession, unemployment would be over 10%, he notes.

While jobs are up, wages are still down. Nominal wage growth, which plummeted from over 3% to less than 1.5% during the Great Recession, has been slow to recover, reaching 2.5% in December.

Overall, the recovery from the recession has been the third-longest since World War II, but "the pace of the recovery has been subpar," says O'Keefe. Still, the pace was strong enough in December for the Federal Reserve to raise the federal funds rate, which had been effectively zero for the past seven years.

Deceleration

O'Keefe's detailed forecast for 2016, which uses arrows to indicate trends, is shown below. He believes real GDP growth in the first half of 2016 will average around 2.5%, and then slow in the second half to around 2%, perhaps less. (His forecast assumed continued weakness in China and further strengthening of the dollar.)

By 2017, the deceleration in the economy will be apparent, O'Keefe says. At that point, he warns, "if we don't have monetary policy where it has the flexibility to respond to a slowing economy, we could well be in a situation where the new administration is confronted with a potential recession and doesn't have the wherewithal to intervene as quickly as would be ideal." (Fed officials have projected that the federal funds rate will rise about one percentage point per year for the next three years, to about 1.5% in late 2016, 2.5% in late 2017, and 3.25% by the end of 2018.)

How will rising interest rates play out in the economy? Near term, most of the impact will be felt in the financial sector, says O'Keefe, as investors and traders rearrange their positions and try to anticipate the timing of the next rate increase. With banks raising their prime rates, consumers are likely to pull the trigger on purchases of cars or houses while the rate is still relatively low. "That's why we anticipate that growth continues" in the first half of 2016, says O'Keefe.

Longer term, rising rates will be felt in the general economy, he says. Decisions about things like inventory and investment "will be more guarded, as people intuitively understand that activity won't be as robust when rates do go up."

In normal times, the Fed raises interest rates when inflation threatens to become uncomfortably high. But as Federal Reserve chair Janet Yellen noted in December, inflation rose by a mere 0.25% over the 12 months ending in October, well below the Fed's target rate of 2%. "We have been in a near-deflationary condition for a very long time now," comments O'Keefe. Yellen said that the slump in oil prices and the strength of the dollar have dampened inflation, but predicted that as these conditions change and the labor market strengthens, inflation will rise to 2%.

"Unfortunately, low inflation has proven to be stubborn, because it involves expectations," says O'Keefe. "If we think the price of something is going up, we'll buy it this month, not next month. And if we think it's going down, we'll save." According to the University of Michigan's monthly surveys of consumers for December, households not only expect inflation to remain low, their confidence largely depends on it.

THE ECONOMY AHEAD

Change relative to prior period, 2016–2017

*Real (inflation adjusted)
Based on data through Dec. 15, 2015
Source: CohnReznick

It's About the Debt

Over the long run, the economy faces thorny challenges, says O'Keefe, thanks to a combination of lower growth and higher debt. The projected growth for 2016 "is very much in line with what the future trend growth of the U.S. economy will look like—somewhere around 2.5% a year," O'Keefe says. By comparison, GDP growth during the 60 years from the end of the post-World War II demobilization through 2007 averaged 3.5% per year, he says.

Meanwhile, outstanding debt—household, business, and government—has risen steadily over the past 20 years, to $44.2 trillion, or nearly 2.5 times GDP. Thanks to the Fed's zero-interest-rate policy, servicing that debt hasn't been a strain on the economy, says O'Keefe. But when interest rates do rise, so will debt service as a share of income. "That means less income available for investment, for spending on consumption of goods and services, for financing the debts that we already have, including the government's debts."

The household sector has been diligently deleveraging, he says, to the point where household net worth has more than recovered from its near-20% drop during the recession. The business sector "has rationally refinanced or increased debt, to record highs," O'Keefe says. "With interest rates at rock bottom, if you don't use your balance sheet now, when will you?"

In the government sector, the Fed used its balance sheet to combat the financial crisis, creating nearly $3.6 trillion in new liquidity. "The amount of monetary expansion we undertook was justified in battling the twin meltdowns of the housing and financial sectors," says O'Keefe.

"But what we failed to do next is to start paying down the mountain of debt," he adds, "by means of increased saving and less spending in both the public and private sectors." (Total federal debt currently amounts to $14.5 trillion.) As a result, when the U.S. can no longer postpone reducing its debt, "the debt mountain will be harder to climb."

Corporate America will have to start rolling over its debt toward the end of the decade, at a time when the government will need to borrow more to fund its responsibilities (defense spending, income transfers, and so on) and finance its own debt service—which is going to rise, says O'Keefe, because debt continues to accumulate and interest rates are going up.

You can see where he's going. Combine one-third slower trend economic growth with rising interest rates and a huge amount of debt—throw in the retirement of the baby boomers for good measure—and you have a recipe for stagnation or worse.

Didn't the postcrisis growth of the U.S. economy, and slump of Europe's, demonstrate the wisdom of postponing deleveraging? "The history of economics says that when it would be prudent to take an action that would not be comfortable, we're typically imprudent," replies O'Keefe. "To increase savings and/or reduce consumption, whether in the public or the private sector, is almost always an uncomfortable thing to do in the short run. But eventually, the chickens will come home to roost." CFO

Projected growth for 2016 "is in line with the future trend growth of the U.S. economy—somewhere around 2.5% a year."

›››› **Patrick O'Keefe,** director of economic research at CohnReznick

TAX

REFORM HERE AND ABROAD

As U.S. vice chairman of tax at KPMG LLP, Jeffrey LeSage makes about 300 client visits a year, talking to both chief tax officers and CFOs. Based on what he's been hearing from them, the following tax issues will be top of mind for companies in 2016.

Business Tax Reform. Given that 2016 is an election year, most observers expect that comprehensive tax reform will be off the table until 2017. Nevertheless, LeSage advises finance chiefs to monitor reform proposals from various parties, each with its own interests in mind, as the year progresses. Such proposals "are potential chips in play in a give-and-take reform scenario," he says, with Congress attempting to lower taxes in a revenue-neutral way, cutting one tax here while closing a loophole there.

One popular cause is lowering the federal corporate tax rate from its current 35% to a level more in line with the rates of other developed nations. Both Republicans and Democrats in Congress championed the issue in 2015, with 25% a commonly cited rate, while President Obama called for lowering the rate to 28% in his budget for the 2016 fiscal year.

Courtesy CohnReznick

But not all companies are necessarily pushing for a lower rate. Many small firms are pass-through entities and pay no corporate income tax. They do, however, benefit from tax breaks like bonus depreciation—the kind of item that might be eliminated in a tax-rate deal. As for multinational companies, the issue is less urgent for them, since they have other means of managing their global effective tax rate, points out LeSage.

Higher on multinationals' wish lists is the ability to repatriate cash held overseas (currently around $2 trillion) at a lower rate than the statutory 35%. A temporary solution would be a repatriation tax holiday. Last year, for example, Senators Barbara Boxer (D–Calif.) and Rand Paul (R–Ky.) proposed a 6.5% holiday, with the revenues to be earmarked for the federal Highway Trust Fund.

"Countries are becoming very aggressive in trying to extract what they believe is their fair share of revenue from organizations."

››››› **Jeffrey LeSage,**
U.S. vice chairman of tax at KPMG

A way to permanently relieve the potential tax burden on overseas cash would be to switch from the current worldwide tax system to a territorial system, in which income is taxed just once, by the country it is generated in. The territorial system, which is used by most countries, has powerful advocates in Congress, including House Speaker Paul Ryan (R–Wis.) and Senate Finance Committee chairman Orrin Hatch (R–Utah). But the system also has its detractors, and many believe that it could be adopted only as part of a comprehensive overhaul of the tax code.

Base Erosion and Profit Shifting. The days of tax arbitrage could be numbered, thanks to the Organisation for Economic Co-operation and Development. Last year the OECD, in cooperation with the G20, finished the guidelines phase of its base erosion and profit shifting (BEPS) project. The purpose of the BEPS initiative is to prod countries to rewrite and harmonize their tax laws so that multinationals can no longer avoid taxation by shifting profits to low- or no-tax locations where little or no economic activity occurs.

"Countries are becoming very aggressive in trying to extract what they believe is their fair share of revenue from organizations," comments LeSage. Many European countries, as well as the European Union, have already introduced or proposed BEPS-inspired reforms.

As the 15 action items of BEPS move into the implementation stage, some countries may deviate from the script. "My personal view is that although the member countries have the guidelines, they are going to do what is in their best interest," LeSage says. "It's going to be interesting to see what individual countries are going to do on their own."

A particular headache will be Action 13, which addresses transfer pricing documentation and country-by-country reporting. It recommends that multinationals submit a global master file and a local file for each jurisdiction they operate in, as well as a country-by-country report disclosing where their revenue is earned, what their profits are before tax, how much tax they pay, where their assets and employees are located, and so on. LeSage says KPMG and other firms are helping companies gear up to comply with country-by-country reporting.

"You can imagine how tax authorities may react when they get all this information they've never had before," he says. "They may ask, 'How come XYZ Co. has a significant amount of people and assets and income in our country, and we aren't seeing significant tax revenue?' "

Finance chiefs, says LeSage, should be sensitive to the increased visibility of this information and the potential reputational risk accompanying it. Even tax planning that is permitted in the post-BEPS world may be seen as inappropriate in the public eye, he says. "CFOs need to understand both the legal view and the public impression of how they are managing their effective tax rates."

The Common Reporting Standard. For financial institutions, the OECD's Common Reporting Standard begins where the U.S. provisions commonly known as the Foreign Account Tax Compliance Act leave off. Like FATCA, the CRS is aimed at curbing tax evasion by individuals, through the exchange of financial-account information between tax authorities. While the CRS is based on FATCA, multinationals need to prepare for some significant differences. In particular, many exemptions that apply under FATCA do not apply under the CRS, so many more institutions will be affected under the CRS. "It's almost like FATCA on steroids," says LeSage.

The standard took effect on January 1, 2016, in more than 50 early-adopter jurisdictions. Although the United States hasn't adopted the CRS, U.S. banks' foreign operations will have to comply with the standard in those countries that have adopted it.

With country-by-country reporting and the CRS, "countries are going to have a lot more information on individuals and companies than ever," says LeSage. And also more than ever, he adds, "CFOs should have a single framework for managing their global tax positions." CFO

ACCOUNTING & FINANCIAL REPORTING

NEW RULES IN FASB'S PIPELINE

Finance chiefs will be preoccupied with implementing two major accounting standards from the Financial Accounting Standards Board in 2016, but they should also be aware of a host of other projects on FASB's drawing board, says Neri Bukspan, a partner in EY's financial accounting advisory services practice.

FASB issued one of the standards, on revenue recognition, in 2014, but last April the board pushed back the effective date for calendar-year public companies to January 1, 2018, and to a year later for nonpublic companies. The postponement was a nod to the complexity of the new rules and the difficulty of implementing them, says Bukspan, as companies will have to adjust their systems and managerial processes for compiling the necessary information on customer contracts. Many companies have already

FASB's project on hedge accounting "is an interesting one—and one that some CFOs will like."

››››› **Neri Bukspan,** partner in EY's financial accounting advisory services practice

learned that the impact of the standard may not be immediately apparent, he adds, in areas such as sales and marketing, internal processes and controls, and key performance metrics.

But finance chiefs shouldn't postpone their preparation for adopting the standard any longer. Three out of four executives responding to a 2015 survey by PwC and the Financial Executives Research Foundation reported that their companies had yet to gain a complete understanding of the standard's impact on their organizations, while 78% said their companies had not quantified the effect of the standard on their financial statements.

FASB is expected to issue the other major standard, on lease accounting, early this year. Compared with revenue recognition, the new leasing rules "are more streamlined, much more 'cookie-cutter' in nature," says Bukspan. Still, adopting the rules will involve plenty of process adjustments and data gathering from lease portfolios, says Bukspan.

U.S.-based multinationals, meanwhile, are moving to comply with the International Accounting Standards Board's separate standard on lease accounting, issued on January 12 and effective on January 1, 2019. Those with subsidiaries that report according to international financial reporting standards will eventually have to maintain two sets of books on leasing, one according to U.S. GAAP and the other according to IFRS.

Making It Simpler

FASB also has a number of short-term projects under way as part of its simplification initiative. The purpose of these projects is to improve the usefulness of information reported to investors while reducing the cost and complexity of doing so. Completed projects to date include simplifying the

Courtesy the companies

measurement of inventory, eliminating the concept of extraordinary items from generally accepted accounting principles, and revising the criteria for reporting discontinued operations, among other items.

Here are some of the simplification projects currently in progress, all intended broadly to reduce cost and complexity:

- Balance sheet classification of debt
- Accounting for income taxes, intra-entity asset transfers
- Stock-based compensation
- Equity method of accounting

Of course, adopting such changes "is not immediately simple," Bukspan says. "All of these projects warrant initial work by CFOs, controllers, and heads of reporting in evaluating the change, revisiting and adapting policies and processes, and communicating the change both internally and to the Street."

Financial Instruments

FASB is also making changes regarding the accounting for financial instruments. The changes address classification and measurement, impairment, and hedging.

An Accounting Standards Update (ASU) for the classification and measurement of financial instruments was issued in the first week of January. "There are no major differences from existing guidance," says Bukspan, "except for the accounting for investments in equity securities, which will now be at fair value with changes through net income." Both the cost method of accounting and the available-for-sale classification for equity securities have been eliminated.

FASB's second project, on impairment, is "more interesting and more controversial," says Bukspan. Under the current incurred-loss model, credit losses on loans and other financial instruments are recognized only when the losses have occurred or are probable—a scenario that was too slow for many investors during the financial crisis. FASB wants to replace that model with a more forward-looking expected-loss model, says Bukspan. The new approach will require banks and nonfinancial companies that have financial assets (such as loans, trade receivables, and debt securities) to introduce the concept of lifetime expected losses within a portfolio for a particular lending arrangement, he says.

"You're effectively writing down the assets on day one," says Bukspan. "The rule will introduce much greater assumptions and estimates into the financial reporting process, including supportable economic forecasts." That, in turn, "will call for greater management oversight, greater audit committee oversight, more internal controls." The ASU for impairment is expected to be issued in the first half of 2016.

The third project, on hedging, which has not yet been exposed for comments, "is another interesting one—and one that some CFOs will actually like," says Bukspan. The project seeks to make hedge accounting simpler and less restrictive for companies, and more useful for investors, he says.

For example, FASB is expected to widen the definition of a "benchmark interest rate" to allow a company to hedge any contractually specified component of a variable-rate hedged item, such as a bank's prime rate. Also, companies would be permitted to hedge components of nonfinancial items, such as a particular commodity in a food product. Hedges would still be required to be highly effective, but "once a hedge is established, the periodic measurement of hedge ineffectiveness, which many users did not understand, would be eliminated," says Bukspan. "It's a better depiction of a company's risk profile." CFO

DEALS

A TOUGH YEAR TO FOLLOW

"It was an extraordinary year for mergers and acquisitions," says Sharath Sharma of 2015. U.S. deal values rose 55% to a record $2.3 trillion, compared with $1.5 trillion in 2014, says Sharma, the global and Americas sectors leader at EY Transaction Advisory Services. It was the year of the megadeal: 47 deals were valued at $10 billion or more, compared with 20 in 2014, and another 252 deals were valued between $1 billion and $10 billion.

It might be unreasonable to expect 2016 to be a comparably active year for M&A, but there are signs that it will be. As of September, according to EY, more than half (57%) of U.S. companies had three or more deals in their pipelines, up from 10% six months earlier. Also, nearly three out of four (74%) U.S. executives said they expected to do deals in the coming year.

And why not? The market has been rewarding acquirers, especially the risk-takers, says Sharma. Shares of U.S public companies recently announcing deals worth more than $1 billion have increased an average of 2% the day after the announcement, according to EY.

"Companies are thinking about what is core to the value of the company they are acquiring."

›››››**Sharath Sharma,** global and Americas sector leader, EY Transaction Advisory Services

Beyond Synergies

The market is also rewarding companies that take a more thoughtful approach to deals, says Sharma. "Acquirers are thinking beyond synergies in the first year, thinking beyond R&D pipelines," he says. Transactions such as Teva Pharmaceuticals' acquisition of Allergan's generic-drug business in July and the $160 billion merger of Pfizer and Allergan in November "are founded in strong strategic logic, and aligned toward emerging trends in the sector or future value in the sector," says Sharma.

In a number of transactions, divestitures have been part of the acquisition rationale. "Companies are thinking about what is core to the value of the company they are acquiring," says Sharma.

In some instances, dealmakers are thinking about the dynamics of entire sectors. Industry experts cite the December announcement of a $68.6 billion merger of equals between DuPont and Dow Chemical, which will result in the creation of three focused businesses in agriculture, materials science, and specialty products. The dealmakers subsequently plan to spin off the businesses into three independent, publicly traded companies.

"Clear strategy on the front end suggests a strong strategic rationale behind the dealmaking, and the market is rewarding this thoughtful approach," Sharma says.

Busy Sectors

Other factors will drive deals in 2016. Changes in customer buying patterns will drive cross-sector deals, says Sharma, as companies seek to adapt to those changes by acquiring new technologies and intellectual capital. In some sectors, such as consumer goods, health care, and automotive, disruptive technologies will spur transactions, says Sharma.

Sectors where M&A will be particularly active in 2016, according to EY, include:

• **Technology.** Mobile technologies, the cloud, Big Data, and the Internet of Things will be prominent catalysts of M&A in technology.

• **Life Sciences.** Consumer buying patterns and the expense and speed of innovation will continue to drive pharmaceutical deals, says Sharma.

• **Health care.** The consolidation of providers in 2015, impelled by consumer-driven health care, economies of scale, and cost reduction, will continue in 2016.

• **Oil and Gas.** The plummeting of oil prices will drive distressed firms into the hands of companies with deeper pockets.

Private Equity's Part

The expected rise in interest rates following the Federal Reserve's rate increase will affect private equity firms more than corporate buyers, says Sharma. Private equity "is a leveraged business," he says. "The cost of capital is an important driver of their appetite for deals."

Still, he expects 2016 will be a good year for private equity M&A. On the buy side, U.S. PE firms have more dry powder than ever ($275 billion at recent count) and will continue to do bolt-on deals, which reached record highs last year. On the sell side, "we are seeing an uptick in exits," says Sharma. "I think we will see more in the year ahead."

Finally, what about the market for initial public offerings? "We're not worried about IPO conditions," says Sharma. Although IPO activity in 2015 was dramatically lower than in 2014, it was only marginally lower (5%) than the median activity in recent years, he says. "We think 2016 will look a lot like 2015." CFO

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