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ACROSS BORDERS

RISK & RESILIENCE

M&A in 2023

The emerging picture

Content

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M&A IN 2023

2023 has begun with a challenging environment for deal making with buyers and sellers needing to navigate difficult macro-economic conditions, geopolitical instability, increased regulation, accelerating ESG pressure and the post-COVID reset. Predictably, the volatility and outlook have resulted in the softening of M&A globally and increased caution from those buyers who are in the market.

As we near the end of Q1, we reflect on the direction of travel and share our thoughts on the practicalities of doing deals in this more challenging environment, looking at four key areas:

1. **Financing** – We summarise the shifting bank and acquiror dynamics, and highlight some alternative structures.
2. **Private Equity** – We look at the opportunities for financial sponsors in the current environment.
3. **Deal terms and structuring** – We consider ways of bridging valuation or funding gaps through more bespoke pricing structures or the creative use of vendor finance, joint ventures and minority stakes.
4. **Regulatory intervention** – We look at the latest patterns of increased regulatory intervention and how to manage them.

We expect some of these challenges to lift as we get further into 2023, particularly when debt markets find a new normal. However, in the short to medium term, there will be good opportunities for strategic buyers and financial sponsors who are able to navigate the more volatile landscape.

We hope this short summary will be of interest. Please get in touch if you would like to discuss any of our observations or suggestions in more detail.

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FINANCING TRENDS

2022 saw the end of the era of cheap money and a shift in the ready availability of bank credit. This more challenging environment has continued into 2023, impacting both strategic buyers and sponsors.

We are seeing three areas in which the availability of acquisition financing is changing.

1 Bank dynamics

Clearing books – Cautious lenders nervous about having to hold the credit position on their own balance sheets will be focused on clearing their own loan books. An emphasis on syndication and refinancing bridge and other interim debt is going to be at the forefront of any discussions.

Rates and terms – In the wake of higher interest rates and macroeconomic pressures, we are seeing higher pricing and tighter terms shifting the dynamics of acquisition financing. 2022 saw a very significant reduction in bank lending activity, particularly sub-investment grade, and several major cases of banks stranded in hung positions, with underwritten exposures that they were unable to syndicate without incurring material losses. Private credit funds took up much of the slack in the LBO markets in 2022, but at higher rates.

Longer bridging – The regulatory environment, particularly international merger control policy, is having a knock-on effect on the pricing and availability of acquisition debt. Investigative agencies taking a more interventionist stance has led, in some cases, to a longer period between signing and closing of acquisitions, which has pushed up the cost of bridge debt as commitments are held for an extended period.

Greater caution – As we move into 2023, bank lenders are returning to the market but with significantly increased caution, and with a focus on syndication and routes to takeout for bridge financings.

Alternative funding sources – We expect investment grade credits to continue to be able to access debt finance, albeit at a higher cost of capital. However, corporate acquirors lower down the credit spectrum may find they need to turn to alternative sources of debt, such as private credit funds, who will also continue to be a major participant in PE deals.

2 Acquiror dynamics

Acquiror identity – Private equity sponsors may find their returns impacted by the higher cost of capital, potentially reducing their appetite for acquisitions. With lenders taking a more aggressive position on terms and a reluctance to lend at high leverage multiples, we expect fewer transactions led by funds, particularly on the larger deals where private equity has been a key player in recent years. We may also see more consortium or co-investor bids to support a successful financing package.

Deployment of cash – Strong corporates with healthy balance sheets looking for strategic acquisitions and opportunities will deploy their cash in the immediate term.

3 Alternative structures

Alternative funding structures – Alternative funding structures, for example, borrowing at the target level, or deferred or contingent payment mechanics, may also be part of financing discussions.

Across all three areas, tax remains a critical consideration and in a climate of rising interest rates, getting effective tax relief for interest costs will be important. But groups may increasingly find relief capped under interest restriction rules introduced during the last five years, which operate by reference to a percentage of EBITDA. Matching deductions to operating income has also become less straightforward. In particular, where debt funding flows through a number of newly incorporated group companies in an acquisition structure, deductions could be challenged under anti-avoidance rules unless they have a clear commercial rationale.

Use of alternative consideration – We still expect acquirors to fund via the debt markets. However, to mitigate the increased costs, we may see a greater proportion of the consideration package comprising equity or coming from cash reserves.

PRIVATE EQUITY IN THE CURRENT MARKET

A COMPLEX LANDSCAPE

2023 presents an interesting landscape. The scale of committed capital continues to drive the ascent of private capital; financial sponsors start the year with more than US$1 trillion of dry powder to fund dealmaking. Despite some recent hardening in fundraising markets, investor demand for private capital products – and the growing significance of private capital investment – looks set to continue.

The conventional model of private equity investing is heavily reliant on debt to fund buyouts and deliver target returns. As noted previously, leveraged loan and high yield bond markets were all but frozen during the second half of last year, which led to a dramatic slowdown in large (US$1 billion+) sponsor-backed transactions. This position looks set to continue for a good part of 2023, as lenders seek to clear hung syndication positions and get a clearer view of the longer-term interest rate environment. If deteriorating economic conditions trigger significant restructurings and insolvencies, it could take longer for the traditional sources of debt – and the large-cap buyout markets that rely on them – to thaw.

Sponsors are also facing increasing scrutiny from global regulators:

1 **Competition regulators** are applying greater scrutiny and regulatory hurdles to private equity transactions (particularly in the US). The regulators are also adopting a more sceptical position when other merging parties offer to divest a business to private equity purchasers as a condition of securing clearances for their deals. Concerns around attempts to 'hollow out or roll up an industry' are cited as support for these new policies. This could present real challenges to tried and tested 'buy-and-build' strategies reliant on accretive M&A in the form of bolt-on or tuck-in acquisitions.

2 **Securities regulators** are also increasingly concerned about the issues posed by so-called 'GP led' transactions, involving the transfer of assets from one managed fund to another (whether that is just the sponsor's most recently raised fund or one established specifically for the purposes of the transaction). These deals have, in recent times, provided sponsors with an alternative means to provide investors with liquidity, whilst still retaining control of high-quality assets with potential. They also give rise to actual and potential conflicts of interest that must be carefully identified and managed.

OPPORTUNITIES FOR MANY

Activity by venture, growth and mid-cap funds remains buoyant, typically involving deals that are funded either exclusively with equity or with debt raised from debt funds. Private capital investment in some sectors – particularly infrastructure, healthcare and some technology verticals – has been hugely resilient despite the broader challenges faced by sponsors, with a number of record-breaking transactions completed in 2022. We expect this to continue throughout the first half of the year, and anticipate that quality assets will be in fierce demand and face considerably less of the valuation pressure that is likely to apply elsewhere.

Fundamentally, the weight of committed capital behind sponsors must and will drive deals. The pressure to deploy is considerable, both to maintain current assets under management (and associated management fee income, perhaps increasingly more so than performance-related returns) but also to demonstrate the track record necessary to support fundraising. We expect a number of themes to emerge in private capital dealmaking in 2023:

1 Treasure hunting

The most successful investors are likely to be those that find hidden gems, arbitrage opportunities or sources of value. Debt is now significantly more expensive than during the last two investment cycles, both as a result of rising base rates and a widening of credit spreads. This will put significant pressure on valuations and is likely to move power back into the hands of buyers for whom due diligence – particularly to verify the fundamental performance of an asset – will become critical to support tighter modelling assumptions, to demonstrate lending capacity and to answer the questions of increasingly cautious and demanding investment committees.

A weak pound relative to the dollar and comparatively depressed valuations of UK equity markets provide fertile ground for public-to-private takeovers. Assuming current conditions continue, we expect to see bid announcements increase once the debt markets reopen later in the year.

2 Door knocking

The pace of deals in 2021 and part of 2022 was frenetic, and investment teams became fatigued with the sheer number of processes in which they were forced to participate to have any chance of securing assets. Dead deal costs quickly mounted and appetite for hotly contested auctions dwindled.

Sourcing bilateral deals through novel channels will be an invaluable means of securing assets at an attractive valuation with time and space to undertake thorough due diligence. Far easier said than done, however.

3 Focus on 'capital solutions'

Increasingly, private capital investors are looking at alternative structures to invest in good-quality assets, including minority equity positions or hybrid capital instruments such as preferred equity. These typically involve smaller, non-control positions that are funded with equity and leave control in the hands of existing shareholders (subject to guardrails, but crucially avoiding change of control refinancing triggers and often limiting the extent of regulatory approvals needed).

Whilst debt markets remain challenging, there is a real opportunity for tactical and strategic opportunities investors to bridge a gap – whether to fund expansion through bolt-on or tuck-in acquisitions, to defer the need for a refinancing until market conditions are more favourable, or to fund a business through to an intended full sale or IPO.

As the all-in cost of unitranche debt approaches that more typically associated with preferred equity, private capital investment may present a compelling alternative to borrowing. Significant upsides include more flexibility and reduced debt service burden on the underlying business.

4 Profit taking

Whilst the height of the seller's market may be over, considerable opportunities will remain for sponsors to sell high-quality assets, whether to other sponsors or to strategic investors now better-positioned to use strong balance sheets to fund M&A.

Ultimately, scarcity value may prove a potent antidote to broader macro pressures on valuations.

We expect some will find it difficult to deploy capital effectively in 2023. For others, as in the years following the global financial crisis, dislocation in markets may support record-breaking vintages. However, as the year unfolds, it is sure to be one of the most interesting and challenging faced by private capital investors for some time.

DEAL TERMS AND STRUCTURING

Well-capitalised companies will continue to seek strategic transactions or bolt-on acquisitions, whilst more highly leveraged companies may focus instead on liquidity, looking to carve out and monetise non-core capabilities or sell off high-value assets. We also expect to see some all-share merger transactions focused on combining complementary businesses and achieving substantial synergies - improving balance sheets and also optimising business portfolios. These are natural dynamics in the current market.

Alongside them, we believe there will also be a recalibration of structures and deal terms, with buyers looking to steer deals through the volatility and sellers keeping a keen eye on preserving value.

We see three clear trends emerging:

1 A focus on risk-sharing

Joint ventures or partial purchases – Rather than acquiring 100%, buyers could initially commit to purchase part of the business, without taking on the entire valuation risk and financing burden at the outset. This might include, for instance, a put and call option structure to transfer the remaining business over time, potentially enabling the seller to share in future upside. It can, if carefully structured to avoid tripping change of control, also enable debt already in place to continue, avoiding a refinancing.

Consortium bids – Buyers may share the risk and exposure of a particular acquisition with other investors, potentially with a view to breaking up the business on completion or leveraging the lower cost of capital of some non-traditional investors.

2 Mechanics to bridge valuation gaps

Deferred consideration – More buyers may look to defer elements of the consideration post-completion. Vendor financing or loan notes can fulfil the same function, with the additional potential for the seller to receive interest and/or security. The tax implications of such structures need to be considered as reliefs available on the initial disposal may not extend to deferred consideration.

Earn-outs - The classic way of deferring the valuation debate and bridging the gap. Where management sellers remain in the business, earn-outs may be particularly attractive, but the risk that they could be regarded (and taxed) as employment income has to be managed.

Paper consideration – By offering shares as consideration, buyers can preserve cash, avoid the high cost of borrowing and shift price discussions with the seller to relative value. Sellers may be more receptive to share for share combinations in the current environment, but will want to ensure that any gains are not immediately taxable.

3 Softening of seller-friendly terms

We expect a shift back to more evenly balanced transaction terms in private M&A relative to the seller-friendly M&A environment of recent years, which was underpinned by high levels of private equity involvement in competitive auction situations.

Pre-completion conduct – With parties increasingly alert to business risks in the pre-completion period and longer timeframes to accommodate the greater range of regulatory and FDI conditions, there may be heavier negotiation around conduct of business in this period, as well as walk-away rights. However, parties should always be mindful of gun-jumping risks.

Warranty cover – Moving away from the more recent 'no recourse' seller terms, there may be more scope for debate on warranty protection and the timing for bring-down of the warranties. Whilst the trend for W&I insurance is likely to continue, in distressed situations there may be higher premiums and more limited coverage. That could also see the rise of retentions and escrow arrangements.

REGULATORY INTERVENTION

Recent years have seen regulatory authorities around the world become increasingly interventionist in M&A. This has been driven by a range of factors, including: scepticism about the benefits of M&A, concerns around previous under-enforcement, geo-political factors, and uncertainty no longer being seen as a reason not to intervene.

1 Merger control

Increasing intervention – US regulators' increasingly interventionist approach is part of a global trend. The UK Competition and Markets Authority (CMA), for example, is now intervening in three times as many deals as it did ten years ago. In the current financial year, the CMA has intervened in over half of the mergers it has reviewed (i.e., the transaction was prohibited, abandoned, or required remedies to secure clearance). Around one third of the cases were referred for an in-depth investigation, typically adding several months to the transaction timetable. Similarly, although its intervention rate has been significantly lower, the European Commission (EC) continues to pursue a rigorous approach to merger control.

Greater jurisdictional reach – Regulators are adopting increasingly broad approaches to claim jurisdiction over global transactions, and the fact that the target does not generate turnover in a country may no longer be sufficient to rule out a regulator's involvement. In Sabre/Farelogix, for example, the CMA relied on services indirectly supplied to a single UK airline via an alliance partner in the US in the absence of the target having UK turnover. The EC has also introduced a new policy which allows it to examine deals where the jurisdictional thresholds are not satisfied in Brussels or the Member States.

Greater uncertainty on timing – Some regulators are also extending the period within which they may intervene in transactions. For example, the EC's new approach to below threshold deals envisages reviewing both prospective and completed deals. Although the EC has noted that it would "generally" not review a deal under this policy more than six months after completion, this poses significant challenges to legal certainty. The US agencies also now routinely send letters to merging parties informing them that, although the relevant waiting period may have expired, the investigation remains open and that the parties close "at their own risk".

Competing interpretations – Additional complexity is created because the appetite or ability to intervene is not uniform everywhere, meaning that there is now considerable scope for divergence between different authorities. That is also true in relation to the outcomes reached by authorities when they do intervene. For example, there were some high-profile instances in 2022 where major authorities came to opposite decisions on the necessity and viability of remedies.

2 Foreign investment

Strengthening regimes – There has been a significant strengthening of investment screening regimes around the world. In the European Union, for example, 25 out of 27 EU Member States have recently taken measures to develop their screening regimes.

Security concerns – The UK National Security and Investment (NS&I) regime, which came into force in 2022, created a formal notification process for mergers which may raise national security concerns. The regime is expansive and includes review of minority investments in both UK and non-UK companies, provided that they carry out activities in the UK or otherwise supply goods or services to people in the UK. National security is not defined in the regime, meaning that the government can choose to apply the concept broadly.

Conditions for subsidised companies – New legislation for dealing with the distortive effects caused by foreign subsidies in the EU's single market will come into force in 2023. Once in force, companies in receipt of subsidies from non-EU governments may have to file another notification in Brussels when seeking to acquire EU companies (on top of merger control and FDI notifications). The EC will have powers to impose conditions on or block relevant transactions where the subsidies distort the internal market.

PRACTICAL STEPS

1 Careful planning

These developments mean that M&A transactions can now expect greater scrutiny and regulatory hurdles than in the past. The careful planning and execution of an appropriate regulatory strategy should therefore be adopted to avoid unforeseen delays and uncertainty.

2 Additional analysis

It will be even more important for counterparties to analyse their position under all applicable merger control and investment regimes at the early stages of transaction planning. This exercise should be carried out for acquisitions of minority holdings, as well as acquisitions of control. Careful attention should also be given to the relevant gun jumping rules which apply to a wide range of transaction structures.

3 Consideration of partners

Dealmakers will also need to consider the position of any investment partners. Various factors can have an impact on the likelihood of intervention, including the structure of transactions, the identity of consortium partners, the relative proposed stakes, and the prevailing political context.

4 Contingency planning

We will increasingly see hell or high water provisions in sale agreements, break fees, and an earlier focus on what the parties may be willing to divest to get the deal approved by the authorities.

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