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Trends and Developments

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M&A Outlook 2023

Historical context

For the past three years, the challenge has been to predict M&A activity in the face of uncertainty. In 2020, the year began with robust M&A activity, continuing from 2019. In 2021, there was reason to be optimistic about M&A activity due to the strong rebound in transactions toward the end of the third quarter and through the fourth quarter of 2020. It seemed possible that 2021 could see a full recovery in M&A activity and could be a strong year for M&A transactions. Nevertheless, in 2021, concerns were ongoing about both the long-term effect of the COVID-19 pandemic and potential tax policies of the Biden administration (particularly with respect to changes in the capital gains rate). Despite these uncertainties, however, 2021 turned out to be a record-setting year with nearly USD6 trillion in global M&A transaction volume, breaking the previous record set in 2007.

Coming into 2022, the outlook for M&A activity was very positive. Yet, despite the general level of optimism, there were several factors that could adversely impact M&A transactions in 2022. These included:

- unclear timing of macroeconomic cycle turns;
- growing concerns over inflation;
- spikes in COVID-19 outbreaks and/or new variants of COVID-19 causing economic setbacks; and
- the global impact of the war in Ukraine.

These concerns for 2022 turned out to be well-founded as 2022 was a tale of two halves. The record-breaking M&A activity in 2021 continued for the first five months of 2022. Then, in June 2022, the US Federal Reserve Bank (the "Fed") raised interest rates. This move by the Fed, in response to rising inflation, happened more quickly than most experts expected, and the impact was felt almost immediately, as other international central banks followed suit. Combined with the heightened economic uncertainty, M&A activity suffered in the second half of 2022. Uncertainty about the economic outlook, exacerbated by the Fed's interest rate hike, led to a downturn in M&A value and activity in the second half of 2022. Global M&A transactions fell by 36% in deal volume in 2022 compared to 2021.

2023 outlook

In early 2023, the economic outlook remains volatile as a result of global recession fears and rising interest rates. The Fed and other central banks continue to deploy available tools to gain control of inflation. In addition, 2022's steep decline in global stock market valuations, capital availability, industrial policy, national security concerns, geopolitical tensions caused largely by the war in Ukraine, supply chain disruptions, and tightening regulatory scrutiny make predicting M&A activity in 2023 as difficult as it has been since the global financial crisis in 2007-09.

Cyclical M&A activity is nothing new, and experienced deal-makers can still find financial value and strategic additions through M&A transactions. Bold corporate strategists do not cease activity during periods of economic uncertainty and downturns. These companies take advantage of opportunities to reshape their business, and in some cases to reshape entire industries.

As companies look to M&A solutions to address strategic needs and create new opportunities for growth, some of the factors that could drive M&A activity in 2023 include:

- well-capitalised companies with a strong market position, cash on hand, and borrowing capacity should be able to make strategic

acquisitions in their core businesses and have the ability to execute transactions;
- financial sponsors hold a record amount of capital and will be looking for opportunities to deploy some of it in M&A transactions in 2023;
- shareholder activism will continue to be a catalyst for M&A activity as companies attempt to meet the challenge of uneven performance;
- the rebound of cross-border M&A transactions; and
- continued prevalence of small to mid-size deals, which typically involve lower risk, lower levels of equity and debt financing, and less regulatory oversight.

Historically, during periods of a high interest rates and a weak economy, M&A deal-makers put a premium on target assets with cash flow and short-term synergies to bring rapid financial results to the acquirer. As we saw in the second half of 2022, uncertainty regarding cost and availability of capital, as well as the overall uncertain economic outlook, will likely cause buyers to be more cautious in target valuations. In addition, down cycles and economic uncertainty often cause companies to re-evaluate their assets under these new circumstances, and this can lead to an increased level of divestiture activity in certain industries.

Over the past several years, private equity has deployed a record amount of capital in M&A transactions, accounting for more than 40% of deal value in 2022 alone according to one source. Strong fundraising continues among private equity funds, which means that they will continue to be looking for new M&A transactions in 2023 to create value in their portfolio companies. As venture capital investors hesitate to pull the trigger on riskier deals and push for lower valuations, we could see some early-stage companies struggle to obtain necessary financing rounds, which could present some acquisition opportunities for companies and private equity funds.

Some experts believe that 2023 will be a very interesting and exciting time for M&A transactions and believe that when the Fed signals an end to interest rate hikes, it will create greater stability in the corporate markets and act as a catalyst for increased M&A activity. We are in a period of mercurial economic conditions, with interest rates, inflation and wages on the rise. Further, macroeconomic factors like the trade wars and the war in Ukraine add complexity to the underlying economic uncertainty. However, this M&A environment is not unprecedented. It seems that except for the brief window of calm in 2021, the recent past has been defined by shaky and uncertain economic conditions. Despite this context, companies pursuing M&A transactions have navigated these unsettled waters with substantial success.

Challenges in the Banking Industry

At the time of the writing of this article (March 2023), Silicon Valley Bank (SVB), in Santa Clara, California was closed by the California Department of Financial Protection and Innovation, followed shortly thereafter by closure of Signature Bank (SB) in New York City by New York State Department of Financial Services. These were the largest bank closings since the financial crisis in 2008. Since then, other banks have signalled problems. The problems in the world's financial system have resulted in US, European and Japanese banks losing approximately USD460 billion in market value in March alone. As of early April, the KBW bank index, which tracks the performance of 24 major US banks, was trading near a 30-month low after the collapse of SVB. Higher rates and losses on securities have significantly weakened the global banking system. The immediate cause is the rapid increase in official interest rates in the US and other major global economies. These financial weaknesses could impact the general economy. If these recent challenges in the banking industry are just the first of many dominos to fall, we could be looking at a totally different M&A picture for the balance of 2023.

Industries with Significant M&A Activity

Assuming there is no catastrophic fallout from these bank closures, industries in which a significant amount of M&A activity is expected in 2023 include the following.

Technology

Technology has been one of the most active sectors for M&A deals over the past several years. After years of relatively easy expansion, technology companies struggled to find growth in 2022. As sales declined, overall valuations also declined, with technology stocks losing almost 30% of their value in 2022. As they experienced concerns over a recession, rising interest rates, and much higher valuations, many technology companies elected to slow or put on hold their M&A activity in 2022. Deal value was down 45%, and deal volumes dropped by about 4% for the first 10 months of the year compared with the same period in 2021 (excluding gaming companies). Nevertheless, the desire for digital assets and capabilities remains high. Because of the difficult year for technology stock performance in 2022, some technology companies are considering going private.

Although M&A activity in technology companies dropped sharply in late 2022, many observers believe that technology M&A will increase in 2023. The information security sector is expected to be the busiest segment of the technology industry in M&A deals. Even amid a weak 2023 forecast for tech companies overall, a significant majority of technology companies expect to spend more on information security in 2023 than in 2022.

Automotive

The automotive and mobility industry continues to experience one of the most disruptive periods in its history. In 2023, companies in this sector will continue to seek to acquire leadership, innovation, talent, new technology, and development capabilities, especially in the electric and autonomous vehicle sectors, through M&A transactions. Leading companies in this industry are expected to pursue solutions to these problems through traditional M&A transactions, as well as a mixture of alternative deals. In 2022, original equipment manufacturers (OEMs), suppliers, technology companies, and mobility companies forged alliances and partnerships, and invested in venture capital opportunities in an effort to make progress on technology development. This trend is expected to continue in 2023. We also note that some companies pursued divestitures of electric vehicle assets to benefit from share price appreciation and access to capital.

The number of automotive industry M&A transactions in 2023 are expected to continue to increase but with a smaller average deal size. Because the access to debt financing has tightened with the increase in interest rates, well-capitalised OEMs, suppliers, and technology companies with cash reserves are expected to account for the largest number of these acquisitions. These companies will pursue opportunities to strengthen themselves strategically, and there will be affordable targets in the form of companies looking to divest assets in order to focus on a core business or to strengthen their capital structures.

Aerospace and Defence

For many years, aerospace and defence was a relatively stable industry with long-term increases in defence budgets and long-term contracts. Primarily due to the impact of the COVID-19 pandemic, macroeconomic and geopolitical uncertainties, and technological and regulatory disruptions, aerospace and defence executives and investors face unprecedented strategic questions as the industry undergoes profound changes. Companies now must deal with disruption and attempt to create growth in the face of lower volumes and margin pressure. Conversely, the defence industry has been relatively stable throughout COVID-19, and changes in the geopolitical environment along with lower levels of fiscal constraint have led to volume and budget tailwinds.

The CHIPS and Science Act, enacted in mid-2022, is expected to make approximately USD280 billion available over the next ten years to boost domestic semiconductor manufacturing and research.

Given these trends, M&A transactions can be expected to be the primary means to achieve these objectives in 2023 and beyond. However, large horizontal M&A deal-making in the defence sector is likely to be less robust in comparison to the past few decades, partly because of enhanced regulatory scrutiny on major business combinations. Because margins are more attractive further down the aerospace and defence supply chain, M&A transactions may be more attractive at the smaller end of the industry and in industry vertical supply chains.

Healthcare

In 2022, the number of strategic healthcare M&A deals declined by more than 30% and the average deal size declined by approximately 15% in comparison to 2022. Coming out of the COVID-19 pandemic, some healthcare companies are seeking to grow through M&A transactions. Pharmaceutical companies with patents set to expire in the next few years are expected to seek M&A targets to replace those products. Likely targets for these companies are biotechnology companies.

The long-term financial fundamentals underlying M&A transactions in the healthcare industry remain strong. Across all of the industry's sectors, one percentage point of growth has an average of four times as much impact on total shareholder return as one percentage point of EBITDA margin expansion. Cash reserves in many healthcare companies are high. Although the Inflation Reduction Act is not expected to create serious headwinds for deal-making in 2023, buyers could experience greater scrutiny on price. There is some evidence of both a lengthening of the approval process and a more stringent regulatory review process for US transactions. If both continue, it could add to the cost of transactions and the time to close.

Pharmaceutical companies may also seek increased M&A activity to acquire targeted therapeutic areas that can generate future growth. Targets that combine a company's strategic capabilities and existing or acquired talent can warrant a higher multiple and result in higher growth value through M&A transactions.

Banking

Similar to most of the other industries, banking saw M&A activity stall in mid-2022 amid rising interest rates and mounting macroeconomic concerns. More banks will turn to M&A activity in 2023 to help them navigate a rapidly changing industry in an economic downturn. The banks that emerge as leaders will be those that thoroughly prepare for the challenges that are unique to the types of transactions they pursue.

Energy and natural resources
With substantial capital on hand from increased energy prices in 2022, energy companies can be expected to seek to deploy it in 2023 through M&A transactions. Mid-sized energy companies need to grow in scale in order to compete and may seek consolidation opportunities. The Inflation Reduction Act is a big step toward boosting the growth of clean energy, and the sheer scale of the incentives involved will propel M&A deals in this industry. Oil and gas companies and private equity funds are actively seeking ways to capitalise on this opportunity.

One recent survey of M&A practitioners found that 80% of energy industry respondents have proactively evaluated separating or divesting parts of the business. In the first nine months of 2022, divestitures activity totalled USD250 billion – more than in any other industry.

Telecommunications
Just as the serious economic challenges caused by the COVID-19 pandemic lessened, a whole new set of global challenges arose in the form of the war in Ukraine, geopolitical realignments, inflation, interest rate hikes and mounting energy concerns. The resulting macroeconomic uncertainty and rising cost of debt was reflected in the level of telecoms M&A transactions. Transaction value declined by almost 40% and transaction volume fell by nearly 15% during the first three quarters of 2022, following strong growth for both in 2021.

Digital infrastructure deals are expected to continue in 2023 despite the rising cost of debt because of strong underlying demand, government support, and the many high-quality tower and fiber assets that are expected to come to market. Tower deals performed particularly well during the last half of 2022 despite the higher cost of debt. High digital infrastructure investor demand will create a wave of particular interest in data centres.

Wealth management
Wealth management and asset management companies are facing such significant disruption that by 2030 – with new customers, new delivery models, new offerings, new ways of working, and new economics – both financial services sectors will be virtually unrecognisable. Experts expect that scale M&A transactions will play a critical role as the largest players will outpace the market and be able to invest in the digital and analytical capabilities to offer differentiated services. Asset managers are also expected to seek scale deals for distribution/client coverage models and cost leadership.

Looking into the short to medium-term future, M&A activity is expected to persist, but it will likely look different given the market downturn. Fewer large deals for scale are anticipated, both in wealth and asset management – consistent with the events of the 2009 recession and observed trends during the second half of 2022. As an exception to this general trend, the strongest companies are expected to capitalise on attractive scale investment opportunities as the downturn further increases the gap between winners and losers.

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