CORPORATE
M&A

M&A expected to dampen for remainder of 2022

Kenneth Baronoff of Solomon Partners explains the factors contributing to a slowdown in M&A activity in the US

Although the future is always difficult to predict, a number of factors indicate that there will likely be a continued slowdown in M&A activity in the second half of the year and potentially beyond.

It is important to look at future M&A activity in historical context. 2021 was the most active year for M&A in the history of recorded M&A transactions. Even an impactful decrease for all of 2022 would still result in one of the more active M&A markets in recent memory.

Closed US M&A transactions from January 1 through June 30 2022 were down 13% versus the same period in 2021, but were 17% above the pre-Covid period of 2019. Much of this year's activity is a function of closing out the 2021 pipeline. Newly announced transactions for 2022 are down 31% versus 2021. Since announced transactions and pipeline have the most direct correlation to M&A closings, there will almost certainly be a slowdown for closed transactions for the second half of the year and potentially a continued downward trend into 2023.

There are a number of reasons why transactions are being delayed or even put to rest for the time being. One key driver is a more hesitant and risk averse mindset of directors and other key decision makers. M&A transactions are bold initiatives for both the buyer and the seller. Decisions are made based on well-vetted business plans supported by detailed analyses. M&A is also catalysed by less measurable but equally important factors including the faith and confidence by leadership that a target (and the acquiror itself) can perform to plan. When uncertainties in the economy undermine the stability of that plan, buyers can get second thoughts and become wary of making expensive and metamorphising "bets". Sellers, understandably so, may also get cold feet about selling into less stable markets based on recessionary concerns, inflation, higher interest rates and more difficult capital markets.

Last year, the mindset of leadership was "can I go now"? This year we're finding the thought processes of leaders have shifted more to "is this the right time"? To help understand this metamorphosis, we take a look at some of the key factors creating these headwinds.

Headwinds ahead

Higher interest rates / stock market volatility / differing value expectations

The Federal Reserve has increased interest rates by 150 basis points since the beginning of the year and it's highly likely we'll see a number of additional interest rate bumps to help combat rampant inflation. Higher rates cause the repricing of assets due to the recalculation of present values and their dampening effect on the economy.

As of the market close on July 8, the S&P 500 has declined 18.2% from the beginning of the year, with a corresponding decrease in multiples. Historically, sellers take longer to adjust their value expectations to a new normal, despite the current market conditions. This discrepancy in valuation expectations inhibits deal activity. Until valuation spreads normalise and volatility diminishes, it will be hard to reach consensus on appropriate pricing.

It's worth noting that not all types of M&A transactions will be mitigated. Acquirors, for example, may be willing to use their pressured stock as a currency in stock-for-stock transactions where relative values have stayed consistent. Additionally, structural transactions where stock prices are less relevant, such as Kellogg's split into three separate companies should proceed uninterrupted.

Potential recession

There is concern that the economy may enter a recession. Higher interest rates will take a greater share of consumer wallets to the extent they have outstanding indebtedness. Inflation is near a four-decade high and is diminishing purchasing power and re-allocating consumer dollars to the most affected areas such as gasoline, electricity and certain food items.

With less dollars to be spent on other consumables, many sectors are already feeling the pinch and are under pressure to maintain historical performance. Since sellers, unless forced by circumstance, do not like to sell when sales and profits are under duress, many companies are waiting for inflation to slow, interest rates to stabilise and an economy without the cloud of recession before testing the M&A markets.

Cooling of capital markets

The public markets for equity and debt capital have been virtually closed over the last several months and may not reopen for some time. The financings that are getting done are often at lower leverage multiples and at higher interest costs which, over time, will suppress valuations. This drought in the public markets has shifted capital sourcing to direct private lenders such as GSO, Fortress and Ares. These lenders are less able than money center banks to bankroll larger leveraged buyouts which is putting pressure on big transactions. Interestingly, many of the largest private equity firms such as Apollo and KKR seem to be focused on gathering assets under management (including for direct lending) versus leveraged buyouts.

Regulatory constraints

In addition to all these factors, heightened and less predictable regulation is also dampening M&A activity. For example, the US Securities and Exchange Commission (SEC) recently issued numerous new regulatory proposals regarding the scrutiny of special purpose acquisition company (SPAC)-related transactions. The uncertainty of these proposals has stalled the issuance of new SPACs, almost to a halt, and a number of bulge bracket banks have recently announced restricting their involvement in SPAC IPOs and de-SPAC transactions. Although SPACs have a home in certain situations and may evolve and return at some point, the SPAC "bubble" of recent times appears to be gone for the foreseeable future.

Other regulatory concerns revolve around the increased unpredictability of the SEC's and Justice Department's actions regarding enforcement of merger regulations. Historically, companies and their advisers were comfortable relying on precedent with respect to analysing the risk that a merger achieves regulatory approval. However, current regulators seem to be making decisions that are not based on traditional precedents related to pricing and concentration, making it harder for merger partners to analyse risk and negotiate terms. Many transactions have been stifled or put on internal pause as constituents try and figure out the decision-making landscape.

Optimism going forward

Due to economic headwinds and an increasingly uncertain regulatory environment, M&A activity will likely continue to slow in the second half of this year. Despite these conditions the long-term fundamentals underlying the M&A markets are favourable, this year notwithstanding.

The pandemic informed us that increasing size and capability via acquisition helped the strong get stronger. Companies are still well capitalised and ready to make deals when the headwinds lessen, which they eventually will. The markets, as always, reward smart strategic transactions and will continue to do so when opportunities arise, though patience will be required.

Consumers overall maintain strong balance sheets and should continue to spend, although the allocation of their dollars may shift due to rising energy costs and inflation. Sponsors have tremendous amounts of capital to put to work and will do so opportunistically, capitalising on lower valuations where sellers cannot hold out until a better pricing environment or wait for the reopening of the public equity markets.

M&A, like most other elements of the economy, is cyclical and an occasional downturn is healthy for the system as it allows the environment to adjust and grow back stronger. Some respite in the recent torrid activity should build up demand for the market to return to higher levels of activity when the environment stabilises and reverts to more fertile conditions.

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