2023 M&A OUTLOOK

ANSARADA

COVER IMAGE
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Q&A with twelve top Global M&A Dealmakers

Overall, 2022 has seen total M&A figures fall short of the heights achieved in 2021, but this was always to be expected – after a strikingly hectic year for global M&A, activity was bound to cool down.

Persistent inflation, slowing growth and rising geopolitical tension were already at the forefront of dealmakers' minds this time last year. Russia's invasion of the Ukraine at the start of this year, and the subsequent dislocation this caused in energy prices, along with a continuation of strict COVID measures in China have continued to exert challenges for the global macroeconomic picture.

To curb inflation, central banks the world over have hiked up interest rates – meaning that the era of abundant, cheap deal financing has come to an end.

Yet, the dealmakers we spoke to were far from pessimistic. While there is a consensus that the deal environment is more challenging, our experts were clear that there are tremendous opportunities to explore in the current climate.

Although technology firms have seen falling valuations, the digitization trend is as relevant today as it has ever been. And although in the short term the disruption in energy supply in Europe has led some governments to re-embrace carbon-intensive energy sources, long-term the solution to energy security lies in renewables. Climate change and rising ESG regulations will only prompt further investment into green energy.

As businesses assess the current economic landscape, they may shift their priorities from growth-at-any-cost to a more cautious approach. M&A practitioners will also adapt, looking to creative deal structures to bridge any gaps in seller and buyer expectations, and using equity, rather than debt, to finance deals.

For dealmakers to prosper, they must seek order amid the chaos. It's time for a new kind of order; one achieved through collaboration, based on transparency, and one that powers social responsibility.

Amid this backdrop, we turn to the experts for their predictions of global dealmaking in the year ahead.

Sam Riley

CEO
Ansarada

Four key takeaways for dealmaking in 2023

Investors' nerves were tested in 2022 and they will need to keep their wits about them over the next 12 months. The effects of monetary tightening in capital markets are immediate, however these more stringent conditions can take time to fully manifest in the real economy in the form of higher unemployment and weakening demand.

Central banks around the world will continue to closely monitor inflation metrics to decide for how long they need to stay on their current course. Operational performance will be under pressure and financing will remain harder to access amid higher interest rates and lower growth. This should see deals stabilize at lower levels.

In what remains a challenging environment, acquirers are assessing risks more intently than ever and stress testing their investment theses. At the same time, authorities are paying closer attention to deals and increasing their enforcement scope. Corporates, financial sponsors and deal targets alike should keep the following in mind and be prepared for deal timelines to be more drawn out:

01

Comprehensive and incisive due diligence

Dealmakers are running the rule over companies with renewed intensity. Operations are being scrutinized for potential fragilities and weak supply chain links. Buyers are looking for resilient financial performance and businesses that have pricing power and a firm handle on elevated input costs. IT due diligence is also becoming more critical, from both a performance and a security perspective. Companies that can proactively demonstrate these strengths with transparency will be in high demand and benefit from smoother sale processes.

02

Sanctions exposure

Geopolitics were thrust to the fore in 2022 thanks to Russia's invasion of Ukraine. Cross-border transactions have been complicated by potential sanctions exposure and investors have had to unwind and review ownership structures for any risks. Indirect ownership may not always be immediately obvious and adds to the depth and complexity of due diligence reviews. Investors will need to continue assessing the scope and nature of target group operations and their shareholder structures, while staying on top of the changing reach of sanctions regulations and guidance.

03

Emergent merger enforcement

Geopolitics are also playing into merger controls. Governments have been strengthening their powers to scrutinize investments on national security grounds to protect their interests, some jurisdictions implementing new regimes and others strengthening existing ones. Most EU countries have now embedded active foreign direct investment screening mechanisms. In the US, CFIUS remains as hawkish as ever towards inbound Chinese investments.

It is not just foreign investment that is under the microscope. The European Commission and national authorities continue to intensely scrutinize deals on competition grounds, while in the US the Department of Justice and Federal Trade Commission have been demonstrating aggressive enforcement. There are also discussions and consultations in some Asian jurisdictions about introducing merger regimes, as certain countries consider bringing their competition law in line with international best practice.

04

ESG as a value driver

ESG has become a core ingredient in the due diligence mix. Investors are not only risk assessing basic compliance, but looking to identify material progress and a willingness to engage in areas including energy efficiency, emissions, supply chain sustainability and social aspects such as diversity and inclusive career progression. High-profile blow-ups in 2022 have also brought basic governance back into the spotlight. Without the foundations of rigorous board oversight, as well as basic financial and other risk controls, unseen malfeasance can take root. Any governance deficit or lack of senior management integrity will also mean that ESG reporting is more likely to be unreliable. Investors now see ESG as a point of differentiation between companies and a means of driving equity value from their investment.

Anna Mello

Partner
Trench Rossi

Anna Mello, partner at Brazilian law firm Trench Rossi, discusses the LatAm dealmaking environment, along with regulatory and macroeconomic challenges

We have seen a softening of deal activity in 2022 compared to 2021. Do you expect deal activity to continue to trend down in 2023? What about in your region specifically?

M&A activity has shown resilience in the first half of 2022 despite major geopolitical and financial headwinds. Multiple factors, including the Russia-Ukraine conflict and the relationship between the United States and China, are putting additional strain on a global dealmaking environment already facing inflationary pressures, high interest rates, and supply chain disruption.

While these challenging market conditions point to a slowdown in activity for the remainder of 2022, long-term M&A prospects remain promising. Major deal drivers such as digital transformation, healthcare, and ESG considerations will continue to encourage cash-rich companies to pursue deals.

Interestingly, we are seeing renewed dealmaking in the Latin America region, despite these political and economic headwinds. The regional trend suggests a relative comeback following the pandemic, which has its corresponding challenges – ranging from local government policies concerning economic rescue or reactivation packages, corporations' capacity to access additional capital to navigate or even capitalize on existing business opportunities, and global macroeconomic challenges, to name a few. We are witnessing a certain optimism in the investment community about their prospects in Latin America, since 2021 was a record year for M&A transactions despite the challenges being faced.

What do you see as the primary drivers of M&A activity in 2023?

Deal drivers that underpinned the record-breaking M&A market in late 2021 and beginning of 2022 – such as digital transformation, supply chain disruption, portfolio optimization, and ESG considerations – have not gone away, and will remain influential in the second half of 2022 and into 2023.

There are still cash-rich companies that will continue to turn to dealmaking to expand or add new capabilities, and this will be most prominent in sectors such as healthcare and tech. Healthcare looks set to be driven by strategic transactions and high demand for biotechs, while digital transformation remains a key driver of revenue and growth in the tech sector.

Despite mounting public scrutiny due to both inflation and ESG-related concerns, energy companies are benefiting enormously from the current shortage in global supply. The energy transition and the need for supply chain security are expected to support M&A activity over the near to medium term.

We have seen macroeconomic conditions become more challenging over the past 12 months, but have not yet seen an increase in insolvencies and bankruptcies – do you expect this to change in 2023?

There is some expectation that general insolvency levels will begin to return to a normal level in the second half of 2022 or at the start of 2023. This is expected following the withdrawal of fiscal or governmental support post-pandemic, as without support, zombie companies will default. The earlier the withdrawal of fiscal support, the earlier we expect to see an increase in insolvency numbers.

We are already seeing examples of this trend in action. The highest insolvency rates to date for 2022 are in Portugal, the Netherlands, Singapore, Belgium, and the US. These countries had low insolvency levels in 2021 and withdrew fiscal support in either late 2021 or early 2022.

New Zealand and Hong Kong are bucking the trend, both seeing decreases in the number of insolvencies throughout 2022. This is attributed in some instances of support being extended until the end of 2022 – effectively concentrating the adjustment in 2023. Other countries where the 2023 insolvency growth rates are projected to be high include South Korea, France, Poland, Norway, and Australia, reflecting relatively low insolvency levels in 2021 and a later withdrawal of government fiscal support in mid-2022.

While insolvency levels are likely to be high at the start of 2023, we expect them to progressively normalize throughout the year.

Do you expect financing conditions to tighten further in 2023 compared to 2022? Will it lead to fewer transactions?

We are seeing banks starting to pull back on lending for big-ticket transactions, choking off financing for private equity firms that fueled the pre-pandemic boom in dealmaking. An increasing number of deals are stalling altogether.

While bankers are keen to point out that activity remains comfortably above historical averages, M&A tends to trail capital markets by a few months – and major equity indexes have been flashing red for a while, with share sales now at a near two-decade low. The hype around special purpose acquisition companies, or SPACs, has also disappeared, blocking another avenue for mergers.

Do you expect greater levels of protectionism and FDI scrutiny globally in 2023? If so, how do you see this affecting dealmaking?

In short, yes – we see merger theories of harm continue to broaden which means further deal scrutiny and complexity even where traditional threshold filing requirements haven't been met. FDI scrutiny is definitely a big topic, and rising geopolitical tensions have also made governments, intelligence agencies, and regulators look much harder at how a country's national interest will be protected.

We are seeing an increase in the number of foreign investment regimes, in particular of mandatory filing regimes, with expanded jurisdictional scope and increased scrutiny and penalties in existing jurisdictions, including an expanding list of "sensitive" industries. As a result, multi-jurisdictional foreign investment reviews are increasingly important to the success of a transaction.

How has the war in Ukraine and sanctions against Russia affected M&A? And how are dealmakers approaching transactions that involve sanctions risk?

Russia's invasion of Ukraine has introduced new risks when carrying out cross-border transactions. Even purely US-centered potential deals aren't completely sheltered from the effects of the current crisis, with unstable energy prices injecting even more volatility into the mix. There is a trend for expanding the scope of due diligence, especially regarding sanctions. Deal terms may also need to be reviewed in order to address potential issues associated with sanctions.

Brian Fahrney, Co-Head of Sidley Austin's Global M&A and Private Equity Practice, discusses the global dealmaking market, including financing challenges and regulatory hurdles on the horizon

Brian Fahrney

Co-Head
Sidley Austin's Global M&A and Private Equity Practice

In your opinion, what is the general outlook for the global M&A market? Do you expect to see a drop in activity following a record year?

It's choppy right now. While activity in the first two quarters of the year was pretty strong, the third quarter experienced slowness and we expect the fourth quarter to be similarly soft. There are certainly challenges on the horizon – the financing markets are difficult, and there are concerns about a general economic downturn.

The IPO market has effectively shut down and the debt markets are soft, which will create a difficult environment for dealmakers heading into the end of the year and 2023.

What effect is this softness in the capital markets having on M&A? Do you think it will push dealmakers to get deals over the line, or will they adopt a wait-and-see approach?

Some dealmakers are adopting a wait and see approach to see whether conditions improve. People are very nervous about making a mistake in difficult economic times. And there is a lot of uncertainty around access to financing and the regulatory front – and uncertainty is not a friend of M&A. When these uncertainties exist, people are very cautious. They tend to move more slowly and take a pass on certain opportunities. On the other hand, quality businesses are always going to sell, even in difficult times, so long as agreement on valuation can be reached between buyer and seller. Often, that requires creative pricing structures.

Do you think these conditions are leading to a more defensive style of M&A, where dealmakers are favoring steady returns over high growth?

Clearly, where there's concern around interest rates and general economic conditions, some of the more speculative investments don't get made. That's why we've seen venture capital activity effectively cut in half in terms of fundraising and early-stage investments. Technology deals in particular are more difficult to get done, as future returns and cash flow can be more speculative.

Businesses that have very stable cash flows will be easier to sell. Those are the sorts of deals that people are more likely looking at under the current conditions. If there is uncertainty around a target businesses' cash flows, it is now more difficult to get it over the line as accessing finance has become more of a challenge – there's a greater deal nervousness among financing sources and obviously pricing has moved up dramatically with the overall increase in interest rates.

You mentioned that financing conditions are becoming more challenging under the current climate. Do you think that this will result in ongoing or future deals being structured differently?

It may be more difficult, for instance, to secure high yield financing. The high yield markets are challenged. This would impact larger deals in particular, as those are the ones that tend to require more high yield debt. Acquirers may need to look at less traditional sources of financing as a result.

On the private equity side, investors may need to provide more equity and consider putting in an equity backstop if there's real concern around the ability to access financing. But that of course has its own risks and has a negative impact on returns for PE sponsors.

On the strategic side, using debt to finance an acquisition program will become more challenging, though probably not as challenging as for PE. Additionally, with the stock market having corrected downward and being as volatile as it's been, companies may be less willing to use their own stock as an acquisition currency. So, there are some challenges on the strategic side as well.

Do you think the challenging deal environment you describe will lead to a greater number of distressed deals and turnaround situations within the M&A market?

Likely – we're starting to see indicators that this will be the case. It's something that's on the horizon – if not in the last quarter of 2022 certainly as we move into 2023.

You definitely can see two sides to the market: On the one hand, there are the high-quality assets, where it is easier to get deals done and less execution risk. At the other end of the spectrum, there are distressed assets where acquirers can secure good valuations if they are willing to take on more risk and deal complexity. This is a trend I see happening to a much greater extent in 2023 – we are definitely beginning to see indications of it.

You have mentioned an increase in regulation and its impact on M&A. Over recent years, we have seen a more interventionist approach from antitrust or merger control authorities across a number of jurisdictions. Is this something that in your opinion could discourage deals moving forward?

There is no doubt that the antitrust environment in the US and Europe is particularly challenging right now. Regulators have become quite active and aggressive, discouraging dealmakers from attempting certain deals.

And certainly, as more deals are being reviewed, we're seeing a greater delay on deals than in previous years. Having said that, if a deal is compelling, there are ways to get it over the line.

Other than antitrust, protectionist regulation surrounding foreign direct investment – in the US, but also in many other countries – is one of the biggest challenges to deals. In many cases this is delaying if not killing deals, and I don't see any sign of this abating. If anything, the trend is getting stronger.

One topic that we are seeing repeatedly mentioned in dealmaker conversations is ESG. How do you see this affecting M&A?

There's been a ton of regulatory and activist activity which is influencing public companies' ESG strategy. I don't see that slowing down. How much it affects M&A depends on the industry you operate in. If you're working in the fossil fuels industry, for example, this absolutely will affect M&A activity, in part positively as companies invest more in renewables. But no matter what industry you're in, you have to conduct due diligence – legal, regulatory and reputation – on ESG-related aspects of the target company.

Daniel Yong

Partner
AIGF Advisors

Daniel Yong, partner at AIGF Advisors in Singapore, discusses the current state of M&A in Southeast Asia, along with how tightening financing conditions will affect PE firms' strategies going forward

Southeast Asia has become an interesting region to watch in terms of dealmaking activity. How would you describe the current state of the M&A market?

Southeast Asian dealmaking, within the wider regional context, is being fueled by a growing middle class, which in turn is driving demand for certain goods and services. This trend cuts across numerous sectors and is a section of the market that will continue to see a significant amount of regional investment moving forward.

At AIGF, our focus is on the mid-market segment, which means a lot of the companies that we work with are family-run or founder-led businesses. Some of these companies have managed to grow to an impressive scale but sometimes find it difficult to break out of their current mold, adapt to the rapidly changing environment and reach the next stage. This is where investors such as ourselves can help, by connecting them to new networks and bringing knowledge on best practices.

In the current market, businesses are facing challenges on multiple fronts – from inflationary pressures to the tightening of capital markets. Against this backdrop, there are also significant opportunities to do things differently, from rationalizing their operations and cost structures to making innovations in their business models. Hence, it is even more important for these companies to find the right partners who can value-add in the relevant areas, in order to continue growing.

Over the last few years, the digital transformation of businesses, even in brick and mortar industries, is changing the way that businesses operate today. I think this trend will continue with a lot of companies in the region.

Are there specific sectors that are particularly active in the region?

An important part of our approach at AIGF is to take a step back and deep dive into a particular industry, to get a sense of what the entire value chain looks like. That way, we are able to identify bottlenecks within the industry, and identify areas that are currently underserved and zoom into the right players that are operating within the space.

Broadly speaking, there are several themes that we believe will continue to drive business growth within Southeast Asia. For example, logistics has always been a major trend, driven by a growing middle class fueling demand. The food industry is another, given the importance of both food security and safety.

The COVID-19 pandemic has accelerated both technological adoption and innovation, and that change is something that we are seeing cut across all industries. It has meant that even the more traditional industries have adopted new technologies to improve efficiencies: Industries such as consumer retail, healthcare and education, for example, are leveraging new technologies to deliver more targeted products to consumers. As a result, technology-enabled businesses will remain very sought after going forward.

For example, marrying two of the themes, we recently invested in a specialized logistics company called BHS Kinetic, based in Singapore. They move mission-critical equipment for their clients, and semiconductors is one of the key industries that they serve. The company is working on leveraging automation, among others, to enhance the efficiency and mitigate manpower constraints.

Looking forward over the coming year, what do you see as the biggest challenges to completing deals?

Acquisition financing looks set to be a significant hurdle for deals, with rising interest rates. I definitely see this impacting regional dealmaking going forward.

When investing in Southeast Asia, foreign exchange risk is increasingly becoming a significant risk in several jurisdictions. When a deal is transacted in a local currency and you're looking at exiting during a time when the exchange rate is not favorable, investors may want to hold back until conditions improve.

Inflationary pressure will continue to be a huge issue in the region. We have seen many companies being hit, with costs going up as much as 50% for some. As an investor, we've embarked on in-depth scenario planning and stress-tested the target companies' projections against these scenarios to assess the risks and rewards of the investment opportunities. This will continue to be an essential part of our investment process going forward. We will also have to expand the scope of our due diligence to get comfortable with our investment thesis and the growth potential in light of the current climate.

Then, of course, we have been hearing a lot of discussions surrounding merger controls across several Asian countries. Earlier this year, Malaysia initiated a public consultation process to see how increased merger controls will impact deals. I don't think it's a major issue just yet, but something we will need to keep in the back of our minds as we look ahead.

You mentioned tightening financing conditions across the region. How will this impact private equity firms more generally, and how do you expect them to work around the challenge?

In the past, when interest rates were low, it was easier to pursue a strategy of growth at all costs. In today's investment climate, we are seeing funds moving back to more value-oriented investment strategies. Value creation is key, as funds need to be very careful as to how they get the best bang for their buck.

From a dealmaking perspective, PE firms will want to be more prudent in the way that they seek growth opportunities. There needs to be a very deliberate approach to this. In today's climate, we are seeing companies rationalizing their cost structures and divesting certain non-core businesses. If a company's growth is fueled by high levels of leverage in a high-interest rate environment like now, it can potentially get into a challenging situation very quickly,

Emilio Zito

Head of M&A and investor relations
EDF

Against a backdrop of rising energy commodity prices, Emilio Zito, the head of M&A and investor relations at French utility firm EDF, talks about the dealmaking environment in Europe and beyond

The M&A market is in a very different place compared to where it was when we were working on this report last year. Do you think that we will see a significant drop in deal activity next year, or is it still going to be fairly high by historical standards?

I think M&A activity will continue to be quite sustained. Not the same as last year, of course. When I say last year, I mean pre-October. From October/November, the inflation situation created by energy commodity prices started to have an impact on the outlook and on people's ability to make strategic decisions. And of course, everything got completely out of hand when the war in Ukraine started in February, which created the situation we know today with regards to inflation and interest rates.

This environment is clearly not ideal for M&A, because it is not easy to firm up valuations. For buyers, it is a good environment, and probably for funds, because valuations are coming down a little across most industries. But for sellers, in general it's not a great time to sell – though some strategic asset classes and long-term value platforms will likely continue to attract good and competitive valuations.

So why did I say that M&A activity will continue to be sustained? Precisely because of this situation. When you are in this crisis mode, you get fewer deals – but a good number of high-profile or big deals will happen in order to rescue companies or projects, and to inject new capital into distressed situations. Some companies in our industry have projects that are experiencing issues with cash, valuations, pricing or commodity exposures, and so on.

You mentioned that funds might be in a better position than corporates for M&A. It has been interesting so far this year, because we have seen PE activity fall quite significantly – do you think this is a period of adjustment for funds, but that they should be better positioned than corporates to take advantage of the current market dynamics?

Yes, because we are seeing a huge amount of capital being raised by some of the mega funds and some of the biggest infrastructure funds in Europe and the US. There is a lot of liquidity in their hands. But there are fewer opportunities today, again, because of the current macroeconomic and geopolitical situation.

Balance sheets of companies and developers in the energy sector, for example, will generally be more stretched than before, and it will be more challenging to keep the "growth, yield and investment grade" equation valid. In my view, funds should be able to play a more impactful role in M&A in the next two to five years, by partnering with and, in some cases, even replacing the incumbents.

You mentioned lower valuations. We have seen an increase in earn-outs and other deferred structures in recent years. Is this something that we will continue to see? Is it challenging to agree on how to structure these considerations?

For sure: price adjustment, earn-outs, deferred payments, this sort of share purchase agreement continue to be used even more than before, because when you're facing huge volatility in terms of valuation, pricing and the environment, the best way to protect the seller – but also the buyer, because ultimately we want this to be win-win – is to create this sort of mechanism. In most of these cases this allows you to not lose value due to externalities. For the assets we are talking about in the energy space, so much depends on externalities, like volatility in commodity prices and in terms of geopolitics.

The topic of ESG has come a long way in the past few years. Talking to dealmakers around the world, it seems that Europe and the US are leading on imposing a higher standard. Will companies based in other jurisdictions end up defaulting to the tougher regulations set by the EC and the US?

Look, it's not easy to answer. ESG is of course embedded in our corporate governance, in our strategy and I would even say in our society. My view is that it will not go away and it will continue to grow. Of course, we have many differences between regions and countries. But, to focus on Europe, a year ago I would have said that ESG is having a strong impact on M&A, that companies are using M&A to achieve their ESG goals – this will continue and will eventually get stronger.

In the next few months though, we might see some flexibility on this. There will be some tension between ESG objectives and the crisis reality we are facing in the energy space. It is inevitable that some concessions will have to be made at least in the very short term. Mid-/longer-term strategies will still be based on it, I have no doubt.

To stick to the topic of regulation, in recent years we have seen increased scrutiny around foreign investments in many jurisdictions, as well as greater intervention by anti-trust and merger control authorities. Have you noticed an increase in these types of regulatory scrutiny?

The short answer is yes, we will continue to see state intervention. Our industry has always been of strategic interest, but now it's becoming more visible and critical. Governments, authorities, regulators and even companies are talking about it publicly. An example: in Europe, we are going to see governments try to limit the increase in energy bills. If there was no intervention by companies and governments or the EU at all, it would be tough for the economy and society to stay healthy.

This example is in front of us now and there is debate happening at government and EU levels about, among other things, the possibility to adjust the energy market structure in Europe.

Considering all of these challenges, I think energy and utilities companies are showing a lot of resilience. Energy is clearly vital to human activity and, you know, I think people in this industry should be very proud at the moment of how they are reacting to try to fix issues that in most cases are completely out of their control, in most cases external to business issues.

Jacqueline Chan

Partner
Milbank

Jacqueline Chan, a partner at Milbank's Singapore office, discusses the challenges facing dealmaking in 2022 and how the energy transition is fueling M&A in Asia

There has been a downswing of activity in 2022 compared to the historic highs of the previous year. Do you expect deal activity to continue to trend down in 2023? What about in APAC specifically?

It has been interesting. I think 2021 was a bit of a standout year for everyone in terms of M&A. Anecdotally, in 2022 many are talking about a slowdown due to various pressures. The war in Ukraine has affected European M&A a little more than some other regions, but has led to geopolitical risks for all. Another factor has been inflationary pressure and the need for central banks to start raising rates to counter inflation – this started during the COVID period but was exacerbated by the war in Ukraine. All of this has essentially put a halt to capital markets, which has knock-on effects on acquisition finance as rates tend to go up. And, because IPOs are not a viable exit route at the moment, this has led to a slowdown in the decision-making around buyouts and investment.

Most markets have witnessed a slowdown in deals being announced. As an M&A practitioner, I recognize that there are still many deals in the pipeline. It remains to be seen how many deals come to fruition this year.

Have you noticed any change in the type of acquirers this year?

We have noticed a change in the participants in M&A, particularly in Asia. Private equity folks are slightly less active at this moment. Due to the softening on valuations and the increase in the cost of debt, they are being more cautious. Meanwhile, strategic buyers can access longer-term capital, have more synergies and face less competition. Strategic buyers are getting more active in the marketplace. That's everyone from SK in Korea to Mitsui in Japan, as well as conglomerates all across the spectrum, like Ratch Group or PTT Group in Thailand and Adaro in Indonesia.

Are there any sectors that you think will be especially active in terms of M&A in 2023?

There has been a shift towards energy transition and renewables for sure. Infrastructure also has been much more active. We're observing PE firms, strategic buyers and infrastructure funds all focusing much more on the energy transition. Three or four years ago, there were significantly fewer deals of that type; we now see joint ventures, as well as M&A and investments into existing platforms.

Infrastructure is very active, whether it's logistics, water, transport, and especially digital. But there are only so many data centers and tower companies left to buy in Asia. It seems that the idea is to acquire what you can to execute platform deals and capture the aggregator multiple.

On the other hand, tech has taken a bit of a downturn this year. There is a lot of discussion as to whether this is affecting early-stage tech as much as it is affecting late-stage companies. I think this may be true – pre-IPO rounds are definitely down – but we also are seeing less early-stage activity in the market. And there are no exits at the moment for tech. Many appear to be waiting to see how that goes, I think.

Other sectors that have been attractive for investors thus far, like health and education, continue to be so, however Asia has a limited range of targets available in those sectors.

Is the shift to industrials and renewables a result of long-term shifts towards the energy transition, or is it fueled by a shorter-term turn towards stable, reliable returns due to slowing growth?

I think that it's twofold. Firstly, Asia used to be active for traditional PE sectors like consumer, healthcare, education and digital. I think many still hold as attractive platforms, but they're harder to do in Asia, especially because of COVID.

The consumer sector is more volatile, education is kind of tapped out right now, as is healthcare – there aren't many of these assets up for grabs. Industrials are more of a challenge for private equity than for strategic buyers; they need to determine if they really want to do that and what their exit opportunities will be.

Secondly, I think that looking at a 10- to 15-year timeframe, the energy transition is the way to go. That means metals and mining, nickel or precious metals integral to the energy transition story. It can be the production space, involving specific materials for the energy foundation, as well as battery manufacturers. It's a variety of different sectors, but all of the stories for growth lead toward decarbonization and energy transition. This seems to be the longer-term play for almost everybody. The focus is on trying to figure out where those opportunities are, where the technology is going and identifying who is likely to be participating.

Europe and the US seem to be leading on ESG standards. What effect is this having on Asia-Pacific?

Much of what is happening is being led by policies crafted in the United States and in Europe and being fed through to Asia through two channels. One is investments. Funds that are themselves subject to ESG reporting will impose the same level of ESG reporting on their portfolio companies. As a result, many companies that have taken PE funding will incorporate the same policies and standards. The second is financing. There is a lot of financing available for sustainability and green bonds. That in itself is likely to encourage many companies to voluntarily start complying and raising their standards.

To the extent that legislation in Asia-Pacific has not yet caught up to the same requirements as the US and Europe, the flow of money will actually precipitate change and adoption, which in many ways is more powerful.

Continuing on the theme of regulation, we have seen increased protectionism around the world, as well as more interventionist merger control actions. What is the situation in Asia?

While there is evidence that the United States and Europe are stepping up protectionism and merger control, we see Asia trying to make itself more open to investment. During COVID, some countries, the Philippines for example, suspended their merger control regime. Indonesia reduced its negative investment list, meaning fewer industries are now subject to foreign investment rules. Vietnam also has been exploring ways to make foreign investment rules a little less restrictive, particularly in the renewables sector, even though there is a requirement for merger control review. Still, it may be too early to say. However, we do note that governments in Asia, such as Vietnam and Indonesia, are actively looking to encourage foreign investment, particularly in the areas of decarbonization and energy transition.

Keely Woodley, Head of UK Corporate Finance Advisory at Grant Thornton, discusses the current M&A market, along with the current regulatory and ESG compliance environment

Keely Woodley

Head of UK Corporate Finance Advisory
Grant Thornton

Can you describe the general mood, or atmosphere, surrounding the M&A market within the current macroeconomic climate?

Volatile is the word I would use. There are clearly a lot of factors at work – the market is still recovering from the COVID pandemic, interest rates are on the rise, and inflationary pressures are increasing due to the Russia-Ukraine crisis. This is all playing out at the moment.

What's really interesting, from my perspective and considering my focus on the human capital and talent solutions sector, is the fact that the demand for skilled talent across the globe is driving record employment, despite these challenges.

We're in a really unique situation where employment's actually at a healthy level – despite the macroeconomic factors I've outlined, which historically have created high unemployment – leading to further wage inflation.

Against this backdrop of employment growth, it's actually very difficult to ascertain how deep a potential recession could be. The economic data is very volatile as well in terms of growth, so from an advisory perspective, we're seeing that businesses who are clear what their purpose is, and understand how to navigate the markets quickly, are the ones who will prosper in volatile times.

It's really about the individual leaders within businesses, and how they navigate through the various challenges successfully.

Against this volatile backdrop are you seeing an increasing difficulty agreeing on price? How is this affecting the ability to carry out deals?

I believe it's always possible to come to an agreement on deal pricing. You might need to put in place some creative structures, such as a deferred payments and earn-outs, but there are ways to work around any disagreement or gap in expectations between valuations.

What you typically see in times of uncertainty is vendors taking a view as to what their businesses are worth, and buyers will have their own view as to what those businesses are worth. When you get shocks in the market such as Brexit and the COVID pandemic, it takes probably 6 to 12, sometimes 18 months for those expectations to realign.

Now that the initial impact of these challenges has subsided, we are seeing pricing expectations realigning far more quickly due to pent-up demand. Firms that perhaps saw their business models fail during the pandemic are not taking anything for granted, even though they have since recovered.

What we're seeing today is a realignment of expectations, and the ability for businesses to adapt to change. The time this takes has shortened quite considerably, and we're seeing a lot more flexibility, with businesses more willing to come to the table more quickly. From a dealmaking perspective, there hasn't been as large a drop off as was perhaps experienced in the upper end of the market. There's still appetite to make strategic changes through M&A, and activity isn't as slow as perhaps some commentators have been describing.

When the pandemic began, we didn't see the increase in levels of distressed M&A activities and turnaround situations as was perhaps expected. Do you expect an increase in these types of deals coming down the pipeline over the next year or so?

We're definitely seeing some of that activity pick up among smaller businesses, yet a lot remains uncertain. I think consumer and hospitality-focused businesses are particularly vulnerable, but even for more resilient businesses, rising energy costs are a real concern. In the UK, we now have an energy price cap put in place by the government, but whether that will help to stave off restructuring activity remains to be seen.

We've seen examples in the UK of regulators becoming more interventionist and placing greater scrutiny on foreign investments. How do you expect the regulatory environment to develop over the next few years?

We're witnessing an increased level of government scrutiny on deals in the UK, which is creating a shift in the likelihood of certain jurisdictions being able to transact in the region.

Countering this trend is the strength of the dollar and euro. At the moment, the strength of these currencies compared to the pound still makes the UK a very attractive market to invest in. We are seeing a lot of inward investment, as UK assets are comparatively cheap and represent good value. We've actually seen a lot of UK businesses taken private by overseas PE firms because of this trend.

Yet the UK government hasn't acted on that many of those transactions. Whilst they're being referred, they're still being allowed to continue. There is legislation, but it's not being implemented in any meaningful way.

The other area driving behavior within the regulatory environment is the topic of diversity and inclusion, and the way that this is impacting company boards. On a daily level, there is more scrutiny around how progressive organizations are, based on the leadership team they have put in place. There is legislation coming down the track that reflects how boards are constituted, so this issue is really becoming more prevalent – either through legislation or through social activism.

How are you seeing the need to comply with ESG issues affecting cross-border deals – is there a general consensus around how to approach these issues?

Different economies are moving at different speeds. The US, for example, has gone further in producing concrete legislation. Yet Europe is catching up, and this is driving a change in behavior among organizations as to how they approach M&A transactions.

More broadly in terms of ESG, there is now a financial incentive to be able to prove positive policies on climate change within the debt markets. This can make the difference between whether a pension fund will invest in a private equity house or not. We are seeing more social impact funds being created at all levels. There's clearly an investing agenda in terms of being able to attract capital by proving that you are investing with intent.

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Neil Pathak

Co-Head
Gilbert + Tobin's M&A/Corporate team

Neil Pathak, the Co-Head of Gilbert + Tobin's M&A/Corporate team, talks to us about trends in Australian M&A and how ESG and the energy transition are changing the dealmaking game

So far this year, we have seen a year-on-year decrease in M&A activity, although this is compared to 2021, which was a huge year for M&A. What is the current state of the M&A market?

Absolutely, 2021 was crazy in terms of workloads. I've been doing this nearly 30 years and it was the busiest year by far. Coming into 2022, we're still quite busy. In the first half, we were completing on deals from last year and also moving onto new deals.

Certainly, here in Australia, climate change and energy transition has driven, and continues to drive, a lot of M&A, particularly in renewable energy.

Separately, PE firms in Australia are very active – both global and local firms. We often hear about PE firms having lots of "dry powder". That's true generally, but here in Australia, that's supercharged given our compulsory superannuation system, which requires employers to contribute 10.5%, growing to 12%, of a person's salary to pension or superannuation schemes. So, our superannuation funds (i.e., pension funds) are getting incredibly large. They've got to put that money to work – apart from listed equities, it's going into PE funds, property or into infrastructure investments (and we have seen a lot of infrastructure M&A over the last two years). There is plenty of unspent money in our market looking for good homes.

That all said, times are becoming more challenging. With inflation going up, in September, our Reserve Bank increased interest rates for the fifth month in a row. So debt is becoming more expensive, and terms are harder too. Asset prices, and stock markets in particular, are declining. While bidders may have adjusted their valuations and prices downwards, targets and vendors have not. So there is a pricing mismatch now, which makes it harder to get deals done.

However, by overall standards, it has still been a strong year and we expect that to continue to the end of the year. For 2023 – it is maybe harder to say, particularly if inflation and interest rates do not start to flatten out.

At the start of the COVID pandemic, there was an expectation that we would see higher levels of distressed M&A and restructuring situations. Due in large part to government support programs, that hasn't happened – do you expect these types of deals to increase in the next year or two?

My insolvency partners have been really disappointed with the levels of distressed M&A over the past two years, which, to your point, has been a function of strong markets as well as governments providing COVID relief, stimulus funding and other emergency measures.

I think banks have also been pretty good throughout that period in giving borrowers time to recover from periods of COVID-impacted trading.

But now, as we move to a high-inflation, high-interest rate environment, those times are behind us. Banks will give borrowers less time to fix their problems. And, at the same time of course, government relief is falling off. This will inevitably lead to more distressed M&A.

By way of example, just this last week, I have been helping a listed company with a rescue capital raising. The company had not been trading as well as it might have hoped and so their lenders wanted to see some debt repaid. This ultimately led to a capital raising to repay some of that debt – so, maybe not a fully distressed situation but certainly a challenged situation and an example of the banks being harder with borrowers. We will absolutely see more of that as interest rates rise. Companies that don't have their balance sheet in the right place will be pushed into a distressed situation.

We're also seeing credit funds that we work with monitoring a lot more situations, actively looking at opportunities to buy bank debt for less than 100 cents on the dollar.

Talking to dealmakers around the world, it has been interesting to hear about the different regulations around ESG in different jurisdictions. How is ESG affecting M&A in Australia?

ESG is a huge consideration for M&A now.

The starting point, as I see it in Australia, is not so much regulation but rather investors are demanding that companies into which they invest are doing the right thing across a range of ESG-related matters: climate change, emissions reduction, diversity, and how they deal with stakeholders generally including employees, local communities, and Indigenous matters.

Increasingly, investors are holding companies to account. Two examples that come to mind.

Firstly, AGL, Australia's largest electricity generator, recently had its demerger/spin-off plans derailed when the founder and CEO of Atlassian, Mike Cannon-Brookes, bought up a significant shareholding and threatened to vote down the demerger for various reasons including that it would undermine AGL's transition away from fossil fuels.

Another good example is that of Rio Tinto a few years back, when in the course of progressing the development of a mine, destroyed 46,000 year old Aboriginal rock caves containing ancient Indigenous artifacts. This resulted in a range of criticism, sanction, and also senior executives were forced to resign.

These are matters which may not have been a big issue say 5 or 10 years ago but they are now really significant.

I think that this means that life as a public company is increasingly hard when one not only faces all the economic and financial challenges we've discussed in terms of high energy prices, interest rates and inflation, but one is also constantly being critiqued about doing the right thing for all of your stakeholders. It can also be hard to please everyone all of the time. There is an enormous time and cost to manage these matters. I think we are going to see more and more companies moving into private ownership. Not that ESG standards are lower there, but privately owned companies do not have the daily focus of public markets and therefore may have a longer time horizon to progress, and improve on, ESG matters.

Over the last few years, we have seen a greater level of intervention from merger control authorities, as well as greater scrutiny of foreign direct investment, in many jurisdictions. Is this something that has affected your work?

The ACCC, the Australian anti-trust regulator, has a new chair. In fact, my former colleague, Gina Cass-Gottlieb, has become the new chair of the agency. Gina is an excellent appointment for our country in terms of her understanding of economics, markets and the law, and her judgment and considered approach to decision-making. I think she is bringing, and will bring, a more nuanced approach to regulation in this area than her predecessor. Certainly, in terms of enforcement, the ACCC has historically had a poor track record of winning contested cases in the courts. I expect that to change now: it may be that fewer cases are brought but, for those which the ACCC contests, the ACCC success rates may now improve.

On foreign investment – Australia, like in many other places in the world, is becoming increasingly regulated in this space. In the last three or four years, the detail, length and complexity of the legislation in this area has multiplied many times. Not only has the Foreign Acquisitions and Takeovers Act been amended, but there has been a whole range of new regulations and regulatory guidance supplementing the changes to the Act. There is also specific regulation relating to infrastructure assets, as well.

The Foreign Investment Review Board, together with other government departments, is looking very closely at every acquisition now, from a range of angles including national security, cyber risk, use of data, and tax compliance. And if you think of the health sector, issues of privacy for personal data are also important. It means that, in general, review periods are taking longer.

It is also increasingly common for foreign investment approvals of acquisitions to be subject to conditions around compliance including in relation to tax compliance, and, where relevant, use of data. Approvals for acquisitions in some industries, like significant infrastructure assets, are also being made conditional on the company undertaking regular/annual security assessments (and reporting on the results), having Australian directors and ensuring that sensitive data is maintained on-shore.

Of course, few acquisitions in Australia are ever rejected. If they are, they're around sensitive industries and one or two particular countries that other Western countries may also have concerns with.

One last point is that application fees for foreign investment approvals doubled just last month, from amounts that had already been significantly increased in recent years. For very large, billion-dollar transactions, the application fee itself is over a million dollars.

All in all, foreign investment regulation is certainly an area that is going to have more and more focus as time goes on. It is a difficult area and is likely to continue to be subject to increasing regulation.

Pilar Tarry

Managing Director and Global Co-Lead of M&A and Transaction Advisory
AlixPartners

Pilar Tarry, Managing Director and Global Co-Lead of M&A and Transaction Advisory at global consulting firm AlixPartners, discusses current drivers and challenges within the global dealmaking market

"The need to diversify and ensure that businesses have supply chain alternatives through nearshoring is driving a number of transactions, especially in manufacturing."

Can you give a broad overview of where the global M&A market sits at the moment? How do you expect this to develop over the coming year?

It is certainly going to be interesting to watch how global dealmaking unfolds over the coming year. I don't have a crystal ball – I wish I did. But I think people naturally want to compare activity with 2021, when we saw unprecedented levels of dealmaking. While the volume of deals is certainly down compared to that record year, we are still operating in a very strong global deal market.

We have seen in both Europe and the US that the first half of the year was quite active as dealmakers worked through a healthy pipeline of deals. In a lot of ways, activity in the second half of the year is really going to provide the baseline going forward. I do believe that transaction volume will remain stable, but the way in which deal opportunities come to market will look a little different over the course of the next year.

Since the beginning of the COVID-19 pandemic, there's been a general expectation that we will see more distressed and turnaround situations. However, a major uptick in activity has yet to materialize. Do you expect to see an increase in this type of transaction?

The short answer is yes. It's now not a case of "if" we will see more deals connected with restructuring, but "when". People tend to equate restructurings with bankruptcies, and that's not necessarily the same thing. While a bankruptcy is typically a restructuring, there are many restructuring and distressed-type transactions or situations that are only considered part of a complex or distressed universe in retrospect.

In this sense, activity has been happening already, but we are expecting an uptick. In fact, we surveyed about 600 turnaround experts this year, and 76% said they believe M&A transactions involving distressed assets will increase. I expect to see activity in the automotive, manufacturing, and retail industries, which are being particularly disrupted by supply chain vulnerabilities exposed during the pandemic – this will drive a fair amount of deals.

The need to diversify and ensure that businesses have supply chain alternatives through nearshoring is driving a number of transactions, especially in manufacturing, as businesses want to be protected in the event of further disruption.

The other major trend set to affect complex transactions is the financing environment and the state of the capital markets. While deal financing is still available, especially from private lenders, it is much more expensive. This has made the pricing on deals very high, and I think the pressure is going to pile on for companies finding themselves on the borderline of distress. The expense of financing, and the difficulty of sourcing, is going to tip more companies into distress as we move forward.

Do you think the increased expense in financing might affect the way that deals are structured going forward?

I think we will start to see this play out within the private equity market in particular. PE firms clearly have a lot of dry powder and are keen to deploy it – they will still be chasing deals. Yet PE relies heavily on high-yield market financing – large, syndicated deals – and that market has been extremely quiet lately. Capital markets do tend to move at lightning speed, however, so we could see that shift quickly.

What we might see is a focus on deals that are better candidates for private lending, because this market is still active. It's expensive, however, and rising interest rates will make it even more so.

While there is still financing available, its rising cost will start to have an impact on deal structures. I think that we will start to see PE firms trying to fill the gap with equity, meaning that equity as a percentage of overall deal value will increase. That's how they'll try to bridge some of that gap.

You say that PE firms are under pressure to deploy dry powder, yet the financing environment is challenging. What do you see as the main qualities PE firms need to show to prosper in this environment?

I think we're going to see private equity firms become very active, but they're going to be very selective as there are not enough quality assets to go around. I think PE is very adept at navigating those situations.

Firms that do well are going to be the ones who can spot a deal, make a decision, move very quickly, and be smart about how to start extracting value from the deal so they can realize the returns. The ones who move quickly and create more value from synergies are the ones that will really shine. This might mean that the deal timeline gets protracted because they need to spend time figuring out what their game plan is, as well as raising the financing. Good, insightful due diligence is going to be even more important within this context – operational, financial, IT – all of it focused on value capture.

In addition to financing, regulatory reviews are certainly stretching deal timelines. We are seeing clients manage this challenge in different ways. As a partner to PE sponsors, it's been challenging, and very interesting, trying to help them navigate today's uncertain landscape.

And what challenges do you expect corporate buyers to face over the coming year? How do you see these differ from PE firms?

Some of the challenges are the same. But on the corporate side, there's a real distinction between the haves and the have nots. There are a number of companies who are over-leveraged and struggling in this inflationary and interest rate environment – almost running on fumes. Despite the best intentions, they really don't have an ability or the wherewithal to participate in an M&A strategy right now, other than to potentially divest.

There are also corporates that have been able to keep their balance sheets healthy through the pandemic and disruption and are ready to transact. We're going to see these corporates using M&A proactively to shed non-performing parts of their portfolio, and grow strategically.

In an environment where a recession seems highly possible and there's more pressure on cost, I think that, across the board, companies even in high-growth sectors such as tech, are thinking about cost and are worried about the profitability of their revenue stream.

Rick Lacher

Managing Director
Houlihan Lokey

Rick Lacher, Managing Director at Houlihan Lokey, discusses upcoming trends in the US M&A market

2022 has seen a softening of M&A levels compared to the historic highs of 2021. Do you expect deal activity to continue to trend down in 2023?

What a difference a year makes. M&A activity has seen a clear slowdown across the globe – both in terms of value and volume. In the US specifically, concerns over rising inflation, interest rates hikes and, the war in Ukraine are certainly causing both buyers and lenders to become more cautious.

The gap between buyers and sellers is increasing and, as a result, more and more deal processes are being elongated or are not reaching the finish line.

There does appear to be more caution in the market. It has been interesting that the dealmaking market has not been as busy as expected so far this year, despite the huge amount of capital available. Do you expect to see a pick-up in activity over the remainder of the year?

It's important to note that despite a number of factors applying downward pressure on the market, there is still a healthy level of activity based upon historical standards. Having said that, I don't think we're going to see a meaningful pick up in M&A activity for the rest of this year and the first half of '23 will likely be slower than the first half of '22.

In certain cases, there is downward pressure on valuations based on financing availability and potential uncertainty with respect to the future. Ultimately, this is going to create gaps between buyer and seller expectations, which tends to result in a slowdown or pause in deal activity.

Overall, I think that we'll continue to have a healthy level of activity, but due to the downward pressures in the market, it is not going to be anywhere near the historic highs we witnessed in 2021.

While we've seen volumes going down, it seems that large-cap deals with a compelling strategic rationale are still going ahead. Do you expect to see a continuation of this trend?

Large firms, whether corporate or private equity, have substantial capital and available cash to deploy in transactions. On the other hand, volatility in the stock market and a decline in valuations – whether performance or multiple related – are reasons why targets may be hesitant to consider a transaction, which complicates the dealmaking environment.

I think we'll continue to see corporate M&A activity as strategics may take advantage of targets with depressed stock prices, but it will be sector specific. For many potential targets, the timing won't be quite right, and they will be waiting for a bounce back in their stock price. In certain cases these dynamics are creating an increase in the number of potential take-privates where a large shareholder wants to purchase the equity it does not own.

We are also seeing an increasing number of proposed spin-off transactions, where companies are considering splitting up their business due to a lack of synergy or looking to arbitrage a multiple difference that should be realized if their different business units are separated. It's also a way of testing the market – announcing a spin-off is effectively code to say that a business is looking to sell a division which may be dragging down its overall valuation.

The other trend we're seeing is that companies that are pre-revenue or pre-profitability are no longer able to go public by merging with a SPAC. This is causing SPACs to turn their attention to corporate carve outs to determine whether there is an opportunity to merge with a business that is embedded in a public company.

For the public company, it can be a tax-efficient way to exit a business while still retaining part ownership.

So again, we're seeing a range of creative methods to put capital to work.

What challenges are you seeing coming from regulation?

We're clearly seeing regulatory risk being factored into the deal process, both in terms of the willingness to pursue deals, and negotiating the economic allocation of risk if the transaction does not go ahead.

We went through a process recently where we had two different bidders – one carried CFIUS risk and the other did not. Ultimately, we decided to partner with the one which didn't carry the regulatory risk. I think that these types of issues are increasingly front and center in the dealmaking process.

In certain cases, large firms are willing to take the regulatory risk. About ten years ago, ATT tried to buy T-Mobile and effectively bet five billion dollars it could convince the regulators to bless the transaction. I do not believe you will see that type of aggressiveness in today's market.

These regulatory risks are real and may cause smaller businesses to shy away from deals. Announcing a deal can cause havoc to your employees, customer base and vendors. Sellers are generally hesitant to go down that path unless they have a high degree of certainty.

Continuing on the theme of regulation, ESG is a hot topic in the market. Are you seeing tougher regulation in the US, in relation to ESG risk on deals?

We're seeing a lot of focus on ESG, either by those who want to see it, and those who believe it shouldn't be a factor. Florida recently passed a law eliminating ESG from investment decisions and New York is telling firms they need to be more aggressive.

I haven't seen much ESG-related focus in my deals. It is a theme that bankers may use to market a business, but not something that I believe is truly, meaningfully impacting the M&A market.

Are there any trends on the horizon that you think will affect the dealmaking environment in particular?

An important trend to consider is the fact that we've gone through a period of extremely low default rates. We're seeing activity picking up in our restructuring practice, driven by an increase in default rates and debt prices trading down reflecting potential stress in the credit. When there's dislocation in the regular M&A market, we tend to see an increase on the restructuring side of our business. We are working with a handful of companies on a M&A option, which if that option does not pan out, the company will have to be restructured.

When companies are restructured, it's not unusual for the creditors, who are likely controlling the equity, to want to increase scale through acquisitions and industry consolidations. Many times when industries go into decline (for example, offshore drilling) and restructurings increase, you tend to see M&A activity in those industries. I do think we will start to see a pick-up in this type of M&A.

Samson Lo

Co-Head Asia-Pacific M&A
UBS

Samson Lo, Co-Head of Asia-Pacific M&A at UBS, discusses the state of play in the Asian M&A market, as well as the impact of regulation within the region

How would you describe the current dealmaking climate within Asia?

I think there has been a lot of focus on the negatives when assessing global M&A activity this year in the media, with a focus on how activity is significantly down compared to a record 2021. There are certainly some headwinds in the global market, such as the Russia-Ukraine conflict, which has caused many dealmakers to rethink their deal positions. Plus there is rising inflation, various currencies rapidly depreciating and increasing regulatory pressures.

Yet what we are actually seeing regionally is an increase in the diversity of deals being announced, which can sometimes get lost in the overall numbers. Chinese activity remains strong, Southeast Asia has become a hotbed for M&A activity, while Australia and Japan are also seeing plenty of activity.

I would say that, despite global macroeconomic uncertainty, there is still plenty of opportunity for dealmakers within individual Asian markets, which is creating a very diverse dealmaking environment across the region as a whole. It's very different to the picture compared to 2016, which was primarily outbound driven.

Are you expecting to see any sectors being particularly active?

Tech will continue to be very active – with a focus on digital infrastructure as well as data centers and towers. We have seen some big-ticket data center sales and expect this sector to continue to be busy.

Lately, there has been a lot of focus on improving ESG metrics among corporations, and this will remain an important topic for Asian firms. I expect we will see industrial companies increasingly using M&A to add capabilities, such as automation, which will improve their ESG profile in the long-term.

In terms of ESG, we are seeing global regions adopting regulations at different rates. It seems that, in the Asia-Pacific region, there is not much regulation, but companies are actually driving the agenda forward themselves. What do you think is driving this focus on ESG?

We are definitely seeing more deals with an ESG focus, and the pressure for these deals comes from many different directions. This could be from existing institutional shareholders, or it could be through comparison with Western counterparts. Businesses don't want to feel that they are falling behind.

The impact of a good ESG rating on share price is another major consideration, along with the preference of PE firms to invest in companies with a good ESG performance – so there are multiple pressures that dealmakers face.

And what about private equity activity? Some are saying that PE firms are under pressure to invest due to the high amount of capital they have, while others are saying they might take a pause as corporates have more of an incentive. What are you seeing in the Asian market?

The private equity situation is really quite interesting. Due to the large amount of capital being raised, we are seeing a lot of activity – particularly in Japan, as this is a key market for firms to expand into. We are seeing increasing interest in firms located across Southeast Asia, and also China expanding to Southeast Asia.

I think there's a lot of pent-up demand following the regional COVID lockdowns, which can be seen among Chinese investors in particular. Chinese firms who had been cautious in lockdown are now looking for high-quality assets in Southeast Asia and Australia – this will continue to be busy as long as there are good-quality assets to secure.

Given the more challenging macroeconomic environment, a lowering of valuation multiples is more likely, which could create a gap between buy-side and sell-side expectations. Is this a trend that you're seeing within the Asian market?

This gap between buyer and seller expectations can happen in any market, not just the Asian market. It's down to the individual situations surrounding a particular M&A deal. At one end of the spectrum, an ability to agree on price can shut down a deal process completely, whereas, on the other end, businesses will pursue the deal even though it is below their valuation expectation.

You mentioned some global challenges affecting the deal market, such as the Russia-Ukraine crisis. How is this affecting deals in the Asian market, either directly or indirectly?

In terms of the impact on Asian M&A activity, we have been quite fortunate. While there are some cases where our clients do work with the countries affected, this is quite rare.

The exception is when we are working with a global business that operates in many different jurisdictions; it is inevitable that their operations tie into the countries mentioned. Yet the exposure is small – perhaps five percent of the operations. If the business was based in Europe, the impact would be much more direct.

There is an argument to say that while some countries across the globe have adopted a more protectionist stance towards inbound M&A, the Southeast Asian region has become more open to foreign investment. Is this a trend that you are witnessing in the market?

Where we are right now, the Southeast Asia region is more open to inbound investment from Japan, Korea and China. Korea has always been open to foreign investment, while the China-European situation remains challenging. But, overall, I would say that the interest level in Europe and in particular in the UK remains strong.

And what about the anti-trust side? Is this becoming more of a concern when you are carrying out deals?

If we look at the US market, anti-trust is definitely becoming more and more of an acute focus in the deal process. We are aware that anti-trust reviews are taking longer and that we need to be more careful. While some countries are focusing on streamlining their anti-trust response, others are increasingly looking at domestic deals – the situation is diverse across the region.

Simon Branigan

Global Head of Corporate
Linklaters

Simon Branigan, Global Head of Corporate at Linklaters, discusses the current M&A climate, including the current impact of regulation on dealmaking

Broadly speaking, what is the current state of the global M&A market? There has obviously been a lot of ups and downs over the past few years, and we've seen a significant drop compared to a record 2021. Where do we stand now?

While M&A activity is certainly down compared to a blockbuster 2021, we are still seeing considerably high volumes of activity. This is both what we're seeing in the market and what we're hearing from some of the large investment banks – which is actually more positive than you might be hearing from the commentators.

Based on our own experience, we're seeing this activity across a wide range of sectors. It is true that while activity is slightly down compared to last year, it still continues to be incredibly busy. Yet the environment is complex, and it remains to be seen how many deals go through to a successful completion. I'm an optimist, but also a realist.

Speaking of this optimism in the market, are there any particular sector where you expect to see a recovery towards the end of this year?

There remains a lot of capital to deploy among financial sponsor clients, and this will drive activity over the next six to nine months.

I expect energy dealmaking to be particularly buoyant, whether this is in relation to the energy transition or consolidation among energy suppliers. We also will likely see some Russia-related M&A, as large global players look to divest their Russian assets, while also diversifying away from fossil fuel.

Healthcare dealmaking also looks set to be very busy, with a number of large deals coming through at the moment. Telecoms and technology – in particular digital infrastructure – have been incredibly hot over the past few years and will continue to drive M&A activity over the next 12 months and beyond.

While operating in a tougher macroeconomic climate, there is an argument to say that corporates will have more of a pressing strategic region reason to conduct M&A than PE firms. Do you think this could result in corporate M&A increasing, while private equity takes a pause?

I think that pressure will still be on financial sponsors to deploy capital. That is not to say that there will be lower volumes on the corporate side. Looking into the medium to long term, I do think there will be a continued increased in volumes in mainstream corporate M&A.

Assets are relatively low value at the moment, and I think there are a number of bargains out there, which, of course, will appeal to financial sponsor players. I think there will be an increase on both sides.

Rising energy prices across Europe are currently putting huge pressure on energy firms across the region. Do you expect to see more distressed or rescue-type transactions in the sector over the next year or so?

Definitely – it is a trend we're already seeing play out across continental Europe, particularly in countries particularly badly hit by the Russian-Ukraine crisis, such as Germany.

I suspect this trend is less likely to happen in the UK, where a lot of the large energy firms are profiting from rising oil and gas prices, and which has recently led to political intervention. I think for these energy companies who are not in a distressed situation, we will actually see a rise in strategic M&A as they continue to source deals to help further their ESG goals and diversify their assets away from fossil fuels. Pressure from shareholders and activist investors will increasingly drive this need. I think there will be an increase in deal opportunities in this area.

We have witnessed an increase in regulatory intervention over the past few years – both merger control and FDI. Has this affected the types of transactions dealmakers are pursuing?

It is correct to say that anti-trust regulators, whether in the UK, EU, China, or the US, are becoming much more interventionist.

The vast majority of transactions we are seeing going to phase two merger clearance review will fail. It's quite a high risk. One thing this has taught me is to make sure to involve top-class anti-trust colleagues at a very early stage in the deal process.

For many deals that we are involved in, the client will say there are no anti-trust issues – no overlap. This may be true on the face of things, yet once you start to dig a bit deeper there are issues one may not have previously considered.

To mitigate any risk, you need to make sure you have your most trusted colleagues in the front and center of the deal process, to manage both the conversations with the regulators and clients' expectations on the other side. If you don't, then this can present real risks to the successful completion of the transaction.

And what about on the foreign direct investment side? We have seen a rise in protectionist sentiment over the past five or six years. Is this something that is affecting your work day-to-day?

Yes – it is a something within particular sectors and geographies that needs to be considered when looking to eliminate executional risk and the ability to successfully complete transactions.

In that sense, it does affect our day-to-day operations in terms of its impact on transactions. That impact will depend on the nature of the assets and the sector. Obviously, sectors such as defense or technology will raise potential alarm bells, depending on the jurisdictions involved.

Again, it goes back to my previous point in ensuring that the right anti-trust specialists are brought in right from the very start of the transaction. If there's even the slightest complexity with foreign direct investment, then it's absolutely key to make sure that you have those specialists to help clients navigate those challenges.

Staffan Mörndal

Partner
Verdane

Staffan Mörndal, a partner at technology-focused firm Verdane, discusses the current investment market for growth-stage tech companies

Compared to this time last year, when we were working on the last edition of this report, the M&A market has shifted hugely. What is your assessment of the current state of the deal environment? Do you think deal levels will drop substantially next year?

There are going to be fewer majority-type deals, I think, in the coming months than there used to be. If there is no particular reason for an exit, you will probably wait. However, if you are a growth-stage company and need to fund negative cashflows, you need to do primary fundraising. In response to the current market, most companies are therefore refocusing on less capital-intensive paths to get where they want to be, with a higher focus on profitability than growth. Therefore, we expect to see lower levels of activity in the market, and changes in the types of activity – say, an increase in distressed activity, for example. I would also say that the average asset is not performing as well as it did a year ago; there are a lot of companies that are trying – and failing – to raise money.

"I really believe that technology will continue to shift the world and will continue to create really interesting investment opportunities, but probably some of less experienced investors in the technology space will drop out in the next couple of years"

How does that change the dynamic? Does it take longer to get deals done, if companies aren't performing as well as they used to?

I don't think deals take more time than they used to do. However, people are more uncertain about where the environment is going. In general, it's difficult to have a view on things like the Ukraine effect, energy prices and inflation.

People are more uncertain – you also have a market that is more of an investors' market than an entrepreneurs' market, if you will. As an investor, time used to really work against you – everybody had to work really quickly, because otherwise you wouldn't get the deal done. Now, it's a little bit different – processes tend to drag out a little and prices are more likely to decrease than to increase if there are delays.

What makes Verdane a bit different is that we have always done different types of deals. We do growth tech – that's our space – but within that we do different sizes of deals and also different types: minority, majority, and portfolios. Minority deals are probably at a similar level as before, while majority deals have decreased – for those, it tends to be possible to wait and hope to get a better price.

And then, we see more portfolio opportunities than we have the last two years. Those are deals involving GPs, LPs, or corporate VC or corresponding market actors who own several assets, often minority stakes. For example, a corporate VC with 30% ownership stakes in a handful of companies whose parent company decides to discontinue the corporate VC arm. Or you might have a GP that decides to sell to make it a bit easier to fundraise, or a GP finding itself in a situation where it is prudent to derisk its portfolio by selling tranches of its holdings. With the climate for fundraising being more difficult this year than it has for the past couple of years, LPs may insist on being shown a few KPIs before they commit to a new fund. There are a lot more drivers for portfolio deals now than there used to be.

You mentioned that Verdane specializes in tech-focused deals. The industry has seen valuation multiples come down in the past year – how has this affected deal activity? Is it difficult for buyers and sellers to agree on price? Does this mean we will see an increase in creative solutions to bridge expectation gaps?

Absolutely. I tend to see a lot of that, no matter what. But, of course, what makes it extra difficult now is that you both have a shift downwards of multiples, no matter if you look that EBITDA multiples, contribution margin, or sales multiples, but at the same time you also have uncertainty about what the multiple is based on, especially if it's EBITDA. You might have high fluctuations in grain prices or energy prices or other possibly short-term effects which could affect EBITDA margins, even if the mid- to long-term outlook hasn't changed. So, you definitely get some discrepancies. And, of course, creativity can solve some of that. I would agree with you that on average more deals are being done with creative structures than a year or two ago.

Technology has been an interesting sector to watch – it has grown to take up a significant portion of overall global M&A over the last few years. Do you think we will see a cooling off in deal activity next year?

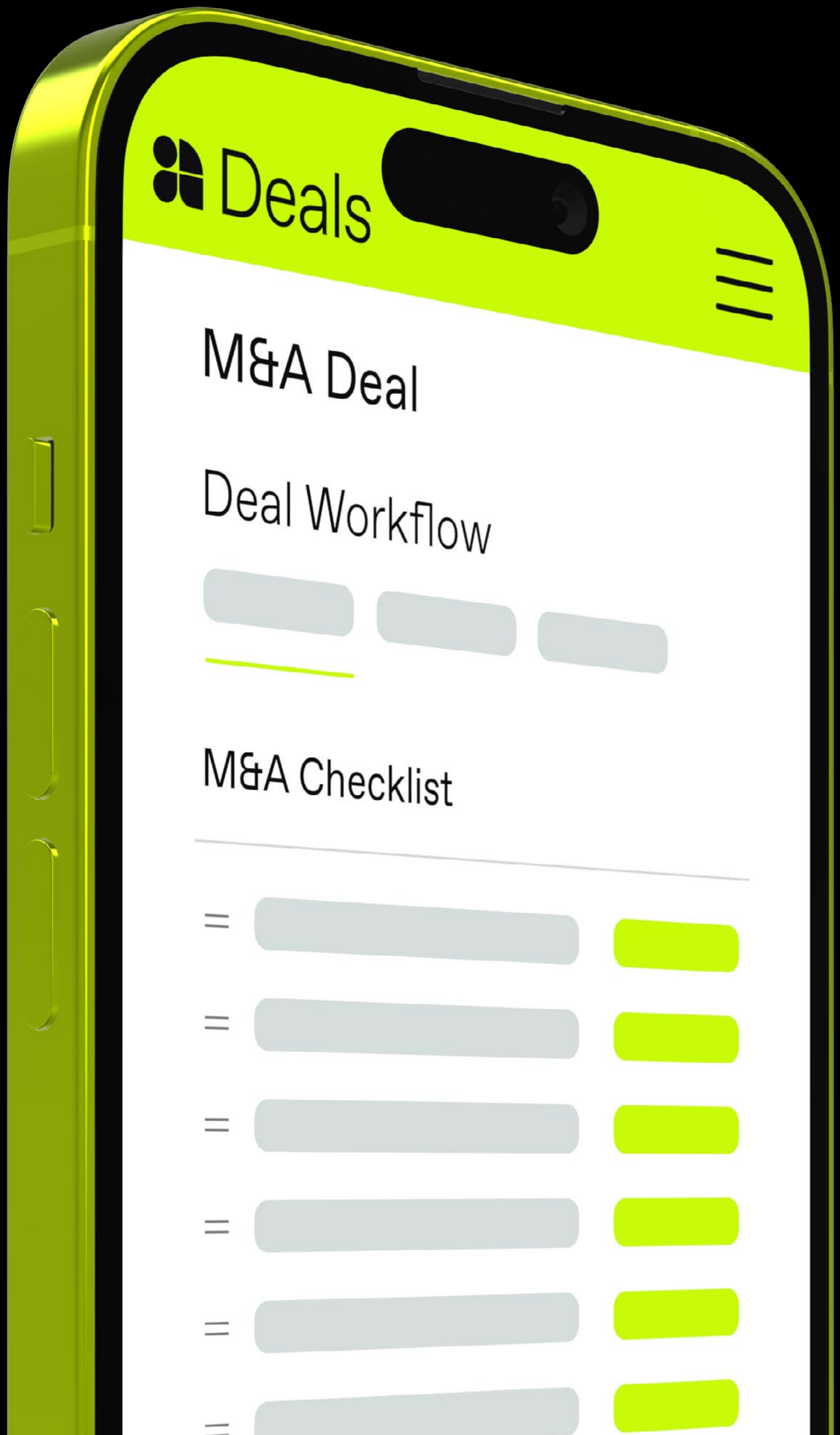
I think that, in the last two years, basically everybody has tried to do technology. No matter if you had previous experience or obvious capabilities in your team. I really believe that technology will continue to shift the world and will continue to create really interesting investment opportunities, but probably some of the less experienced investors in the technology space will drop out in the next couple of years.

I don't think you will see a significant decrease in the levels of activity from people who are set up to do technology investments, like Verdane. We have data scientists, we have experts in CRM, online marketing, databases setup, CTO due diligence etc. We have a data warehouse with more than 80 companies in our portfolio with APIs sending us data every day. All of that helps us to be more data-driven.

I think the barrier to entry for people who want to do tech investments but haven't set something like this up is going to continue to grow. And I think as times get tough, we will see several of those players leaving the tech space and going back to deals which have more stable cashflows but slower growth.

Given the more challenging macroeconomic environment, do you expect PE firms to hold onto portfolio companies for longer?

Yeah, I think that a lot of firms will ask for extensions and keep companies until they see that the climate for an exit is better. Some LPs may not be too happy about that and, in some cases, that could trigger portfolio transactions. But many, of course, will understand that you might need another year to find the best exit.



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