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THE EVER-CHANGING SHAPE OF THE M&A MARKET

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CHANGING ECONOMIC LANDSCAPE AND HIGHER INTEREST RATES

The world has drastically changed recently, and not just for the short term.

Central banks have been raising rates, at the fastest pace since the 1990s and to date, most policymakers do not expect a return to 2% inflation before 2025.

According to Fitch's latest global economic outlook, the direction of interest rates in emerging and developed markets is beginning to seriously diverge, with the majority of emerging market central banks keeping their rates unchanged or beginning to cut them, while major developed market central banks continue to raise them in the face of persistently high core inflation.

In the ever-evolving landscape of mergers and acquisitions (M&A), current economic factors significantly influence the strategies of market participants.

Higher interest rates are currently casting a shadow over the industry, causing global M&A deal makers to navigate uncharted waters. Recalibrating financial dynamics has more than ever become an imperative for success.

IMPLICATIONS FOR VALUATIONS, FINANCING, AND DEAL-MAKING

The resurgence of high interest rates introduces a new layer of complexity for financial sponsors and corporates.

Valuation dynamics, financing challenges, complex negotiations, and operational adjustments all demand greater attention. Market players must adapt their strategies, remain agile, and effectively address these issues.

In terms of financings, high interest rates resonate through the M&A ecosystem, immediately impacting valuations and valuation models. Elevated interest rates affect discount rates used in valuation models, and influence cash flows and cost of capital. As interest rates rise, the cost of capital increases, affecting the valuations of future cash flows and potentially reducing returns on investments. Previously, valuation models based on lower interest rates might have overstated the present value of future earnings, introducing a risk of overvaluation. This is no longer the case.

High interest rates also pose a challenge to deal financing. Borrowing costs escalate, making debt financing more expensive for acquirers. The financial profile of leveraged buyouts decreases as costs of servicing debt increases. This paradigm shift forces companies to reevaluate their financing structures, and they are increasingly forced by lenders to rebalance towards more equity-based financing models.

Sellers face challenges as they bought at high valuations at a time where interest rates were exceptionally low, and buyers seek more favourable terms to mitigate the impact of increased interest expenses. We are in the crux of this strategic conundrum, and this is undoubtedly the main reason why there has been a recent slowdown in deal-making.

Lower valuations may influence buying activity as cash-rich players seeking to deploy capital must suitably compromise with their counterparts to close transactions, in both debt and equity markets.

Deals also take longer to close. According to a recent report by Ansarada, the first quarter of 2023 saw the longest average M&A deal duration recorded since COVID, with deals taking an average of nearly ten months to complete. The average deal duration in the second quarter of 2020 was 10.9 months (333 days).

While the current landscape might appear uncertain and challenging, additional attention must therefore be paid to financial valuation, financing flexibility, and rigorous due diligence.

TRENDS AND STRATEGIES IN M&A

According to Refinitiv, European M&A deal value in the first half of 2023 was down nearly 30 percent compared to H1 2022.

This trend is expected to continue in the second half of the year. On an annualised basis, the rate of activity in this first half of the year would imply that deal value ends the year 23% lower than 2022.

Certain topics will be influential in the second half of the year. Portfolio reviews, build-ups, public to private deals, divesture of non-core assets and transformative transactions will be driving the market going forward. The dynamism of certain sub-sectors such as digital transformation, AI-driven transactions and renewables will also spur deal-making activity. Those who are able to proactively leverage these conditions will emerge stronger than their peers.

FOCUS ON RENEWABLES

The renewables sector is becoming a magnet for M&A activity. Fuelled by innovation, favourable policies, and economic viability, companies active in this space are prime targets for strategic alliances and acquisitions.

Falling costs, supportive government initiatives, and the urgency of the global energy transition make the sector a hotspot for investors seeking both sustainable impact and profits.

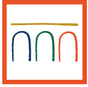
Established energy players are seizing the opportunity to diversify their portfolios, while financial investors are eyeing sustainable assets. As the green revolution gains momentum, M&A in renewables is reshaping the landscape.

According to McKinsey[1], at least 175 global acquisitions of renewables developers have been announced since 2018 (excluding asset transactions), accompanied by a steep increase in total deal value due to an increase in average deal value (from $150 million in 2018 to $425 million in the first half of 2022).

Despite market uncertainty, deal activity and multiples remain high, reflecting a sustained appetite for acquisitions.

The dynamism of the sector, which is set to increase over the coming decade, inspires optimism first for the world but also for the global M&A industry.

[1] Ready, set, grow: Winning the M&A race for renewables developers, Mc Kinsey & Company, December 2022.



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