Alantra's Top 10 trends to watch

2023 Outlook

ALANTRA

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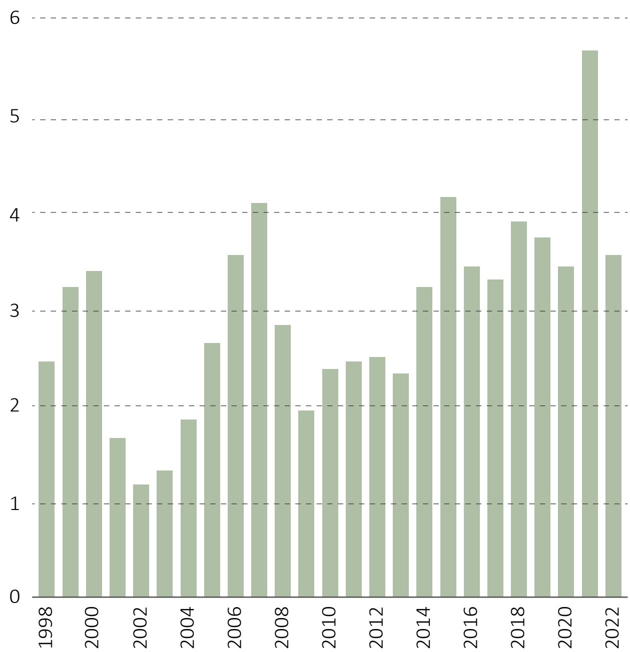
Though the top-end of the M&A market was notably impacted by the tighter lending, inflationary pressures and longer deal timelines throughout 2022, with lower valuations opening more options for funding, the mid-market offered a safe harbour for those looking to transact.

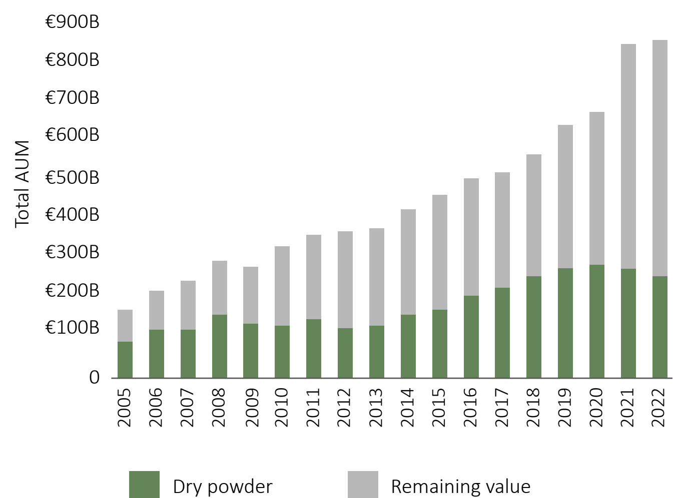
With the second half of 2022 plagued with uncertainty, deal activity and fundraising dropped to pre-pandemic levels after 2021's boom year. This was largely due to external influences – war in Ukraine, an energy crisis, high levels of inflation, expensive and difficult to access capital – all factors that have followed us into 2023.

These influences had a direct impact on M&A and investor appetite, with 2022 seeing a reduction in M&A value by 37% worldwide[(1)] and total assets under management estimated to have declined by more than 15%.[(2)] This does however, reflect a return to pre-pandemic deal volumes (as illustrated by the graph below), with 2022 reflecting a correction of the rocketing valuations seen throughout 2021, where pent-up demand was released following 2020's COVID-19 fuelled uncertainty.

M&A Deals by Value (1998 – 2022)



Source: Refinitiv



Source: Refinitiv

(1) 'Dealmakers brace for slow 2023 recovery after global M&A sinks', Reuters, December 2022
(2) 'Moody's changes to positive from stable the outlook on Eurasian Bank's ratings' Moody's, December 2022

However, there are early signs of recovery already appearing in the market. With it in the best interest of both governments and institutions to reduce inflation, there will likely be a push to do so in the first half of 2023. Equally, energy prices appear to have peaked and economic growth looks to be holding across Europe and the US. While companies and investors continue to actively monitor the macroeconomic conditions, there is a growing perception that recessions (where they occur) may be modest and not as deep as previously feared. Therefore, by mid-2023 when stability begins to return to the markets, we expect a bounce back in investment activity.

The current market differs from that of the historic economic downturns, for example the Great Financial Crash, as there remains large amounts of liquidity still available to deploy and record levels of PE dry powder that will need to be put to work. Additionally, the need to innovate remains a priority for boards and investment committees, either to reduce costs or to accelerate growth. Today, this can be achieved through Technology or Energy. Advancing in digitalization or energy transition will become a competitive advantage in the years to come and thus, also continue to fuel activity throughout 2023, despite headwinds.

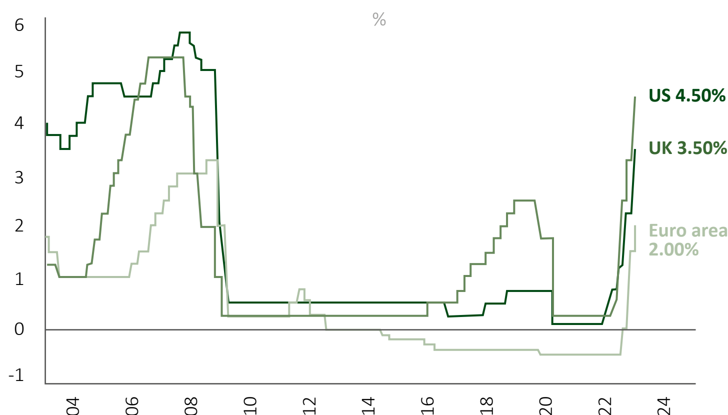
So long as there are no further escalations of the external factors influencing the markets, with central banks already giving convincing signs that inflationary pressures are moderating, we believe there may well be a return of investor confidence and stabilisation in the second half of the year.

With this backdrop in mind, Alantra's top 10 trends to watch in 2023 are:

1
INCREASING COST OF CAPITAL

In Europe, the cost and availability of credit in the debt markets turned negative in 2022, with high yield and wider fixed income credit markets largely shutting down as inflation rates rose and fixed income securities priced in a previous yield world become easy to buy at below par. Similarly, the US saw banks reporting over US$70bn of 'stuck syndications' as underwriters were hesitant to take on further risk until the backlog moved. This has made it difficult to complete LBOs at the top end of the market, which in turn impacts negatively on mid-market relative value and execution risk.

This is likely to settle through 2023, with inflation rates potentially stabilising as economic and government bodies likely take steps to reduce rising rates. Private credit has grown in popularity to fill the gap where liquid markets remain volatile, but market capacity and continued strength in private credit fund raising means mid-market deals will however be able to access the financing they need



Source: Refinitiv Datastream; upper limit of the Fed funds target range shown

Source: Refinitiv Datastream

2
THE RETURN OF BANKS' PROFITABILITY

2023 will see banks making money again after 10 years of almost zero interest rates. Rising central bank rates helps most banks expand their 'Net Interest Margin' (NIM) as asset books reprice onto higher rates, boosting profitability. Banks still face some headwinds: the macro-outlook and inflationary pressures may diminish customers' ability to pay (increasing the 'cost of risk'), but the tailwind of higher interest rates is likely to prove the more powerful force. Rising profitability and capital should enable [European] banks to regain their competitive advantage, winning back market share from 'non-bank lenders' funded by wholesale funds, who have made significant inroads since the financial crisis

3
INCREASING USE OF ALTERNATIVE DEAL STRUCTURES

Companies and investors are expanding their traditional deal approaches to either de-risk deals and investments or achieve growth through a wider range of synergies. For example, private equity may limit the percentage they take in businesses, and in some cases, create joint ventures with other private equity firms to share cost and de-risk deals. In times of uncertainty, minority deals also create much needed liquidity for business operators while allowing the company to continue to generate the cashflow required to sustain growth. This also allows for a larger partnership between investors and founders/CEOs and a sharing of expertise to aid businesses through the changing market landscape.

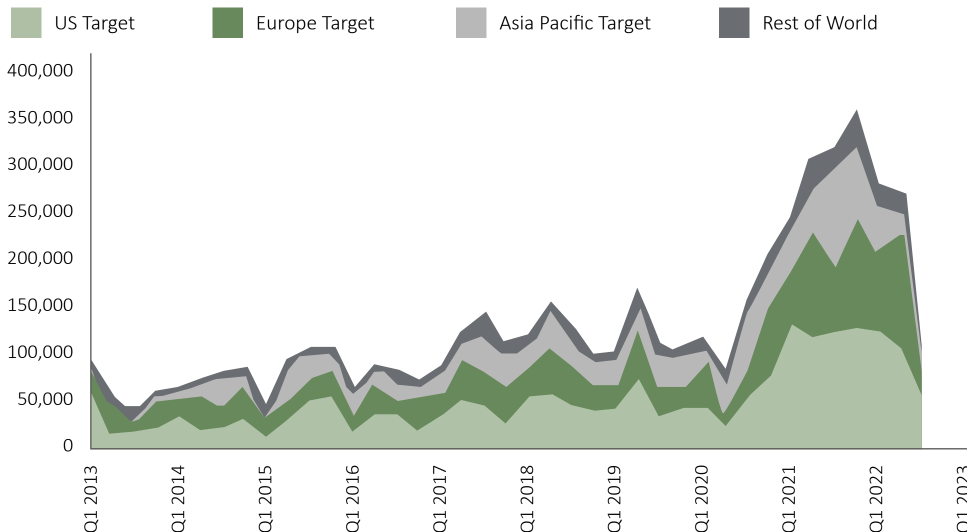
With an abundance of dry powder still available, private equity may opt for an increasing amount of full equity deals to avoid being stung by expensive debt options

4
SECONDARIES TO HIT NEW HIGHS

Secondary transactions reached new highs in 2022, totalling $57bn, and this is set to grow further in 2023. LP demand for liquidity, driven by reduced liquidity in private equity and a dry exit market, is expected to push record levels of deal flow in the secondary market over the next 12 months

5
PRIVATE EQUITY'S FLUCTUATING MARKET SHARE

In the current market, we believe PE will apply even greater scrutiny to new investments, compared to H1 2022. The first priority has been to stress test existing portfolio investments, for both performance in the new macroeconomic backdrop and debt serviceability- particularly those investments that have been funded through the debt fund market and are not fully hedged. This was evident at the end of 2022, with a 66% drop in PE deals. It is clear however, that the continuing need to invest- driven by the significant liquidity in the market- is driving a return in activity levels, albeit not quite at H122 levels. The increased cost of debt capital is clearly impacting deal structures and in most cases valuations. Albeit, for the very highest quality of assets, we believe pricing could well remain stable. Additionally, as this year progresses, we expect there will be an increase in the number of opportunities that need to deleverage, particularly those assets with floating yield debt



Source: Refinitiv

6
THE POTENTIAL RETURN OF CROSS-BORDER ACTIVITY

2022 saw cross-border M&A rebound from the lull triggered by the global pandemic. In fact, in the first quarter of 2022 cross-border volume made up over 40% of all global M&A transactions.[(3)] Cross-border M&A still offers the best opportunity for accessing new technology, easy expansion into new markets, and diversifying a company's offering, as illustrated by recent deal activity out of LATAM and Japan. Additionally, there could be an increase in US to Europe activity as US buyers take advantage of the strength of the dollar

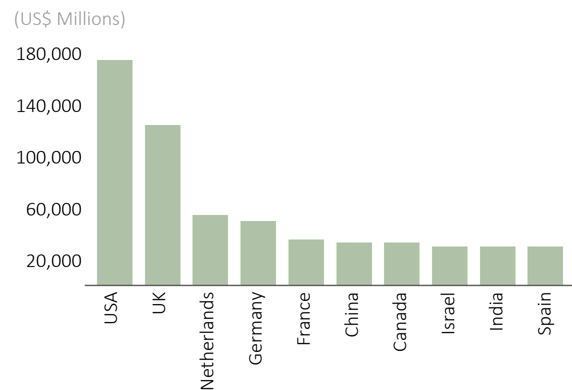
7
ONGOING SUPPLY CHAIN AND LABOR SHORTAGE ISSUES

Though the headlines were widely reporting mass layoffs in the technology markets, this is potentially offset by the ongoing difficulty in filling skilled positions. Ultimately, companies that are unable to fill skilled roles will continue to face operating and performance issues. Though tech start-ups will likely look to cut workforces- as those who focussed on growth over stability in the last two years struggle to gain further funding- other sectors may turn to M&A to fill their skills shortage – such as Industrials, Aerospace & Defense, Logistics, Energy, Education, and Healthcare.

With ongoing supply chain disruption, it is likely companies will turn to M&A to re-locate or streamline disjointed or inefficient energy models. With the migration of traditional supply chains to more technology focussed and innovative options to maintain pace with the dynamic and demanding environment. This has fuelled a rapid rise in M&A volumes and investor interest in the supply chain and logistics sector that will continue through 2023

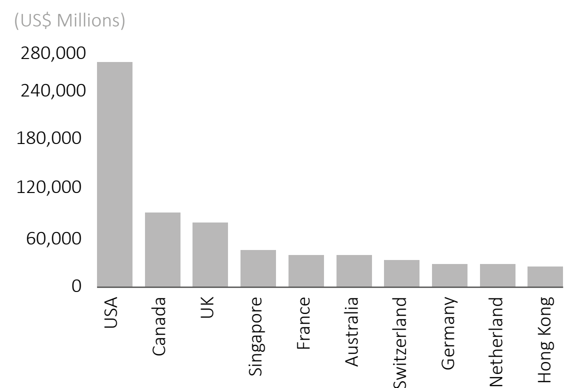
(3) 'The Big Picture: 2023 M&A Industry Outlook, S&P Global, Dec 2022

Cross-Border M&A
Most Targeted Nations YTD



Source: Refinitiv

Cross-Border M&A
Most Acquisitive Nations YTD



Source: Refinitiv

8

ENERGY TRANSITION INCREASINGLY TAKING CENTRE STAGE

There are opportunities for businesses and investors in need of reliable and low-cost energy in 2023. Though this is not a new trend, there has been a forced shift in energy supplies, with Europe now sitting in a unique global position. For the first time, there is continent-wide government interest and funding to move away from traditional energy options and as energy costs soar, companies are also forced to review their current energy supply.

For business leaders, acquiring energy alternatives would aid in reducing spiralling energy costs and protect production lines against energy shortages. This would not only increase production and build robust supply chains in the near-to-long-term, but also enhance processes and increase productivity and innovation. In addition, this creates a competitor advantage as many companies look to offset rising running costs by increasing prices of their products and services

9

TECHNOLOGY INCREASINGLY USED FOR VALUE CREATION

Digitalisation now offers the opportunity to reduce business costs while increasing revenue generation. Enhancing technology can help companies remove unnecessary costs by increasing efficiency with technology, and appeal to new customer bases, both of which have become critical against a difficult economic backdrop. To deliver these opportunities quickly, business operators can look to M&A to adopt technology that would otherwise take years to grow at an excessive expense internally. Smaller technology businesses that offer solutions to companies looking to increase production, reduce costs, and protect business interests are readily available in the current market, and early adopters gain competitive advantage by ensuring smoother sailing during times of market turbulence

10

FURTHER DEAL DUE DILIGENCE & ONGOING ESG REQUIREMENTS

Following 2021's record breaking deal sizes and valuations, many expect governments in the US and Europe to begin regulating industry consolidations and cross-border deals believed to pose a security risk. We are already seeing this come into effect when in 2021, with President Biden signing an executive order that urged the Federal Trade Commission (FTC) to address prior 'bad mergers' allowed under previous administrations. In 2021, the FTC pledged to block mergers that they believe violate antitrust laws. And, in the same year, the US Justice Department sued to block a massive $30bn merger between two of the 'big three' insurance brokers – Aon and Willis Towers Watson and is reportedly seeking to block Microsoft Corp.'s acquisition of Activision Blizzard to prevent mass consolidation of the video game space.[4]

Equally, The European Commission recently expanded its jurisdiction when reviewing cross-border deals in the EU. As more M&A activity goes on and more industries consolidate, we expect more antitrust enforcement to disrupt mergers in the market.

In addition to government policies, with market uncertainty, financial buyers have increased the time taken to perform due diligence and, in some cases, have been negotiating stronger indemnity provisions to protect themselves against downside risks facing the assets they are looking to buy. As deals become less competitive with rising borrowing costs and lower valuations, competition around deals may reduce and allow opportunity for buyers to complete further target due diligence and negotiate stronger legal terms.

Equally, we expect guidelines related to environment, social, and governance (ESG) principles to have more impact on M&A and investments over the next 12 months. The importance of ESG consideration has increased notably across all sectors and with the shift in energy supplies across Europe, it is likely to only intensify. For companies, being able tow profile their sustainability options can be a core differentiator, especially as the market becomes more competitive and deals may be harder to complete and investors more cautious about deploying capital. Those companies that can prove they are at the forefront of ESG developments are able to generate significant market interest and will likely achieve higher valuations from acquirers and investors looking to either increase their own ESG standing or diversify their portfolio

(4) FTC Seeks to Block Microsoft Corp.'s Acquisition of Activision Blizzard, Inc., Federal Trade Commission, Dec 2022

In conclusion, 2023 is set to be another rollercoaster year for M&A and investors. The first half is likely to continue to be plagued with uncertainty, with macro political and economic headwinds continuing the correction in the valuations and deal volume highs of 2020 and 2021. When deal dynamics adjust to current financing markets and inflation begins to stabilise (likely in the second half of the year) due to the levels of liquidity in the system, we believe transaction volumes and activity will recover and though 2023 will not be record breaking, we will likely see activity at similar levels to those of 2019.

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