Harvard Law School Forum on Corporate Governance

US M&A Levels Remain Healthy

Posted Maxim Mayer-Cesiano, and Jonathan E. Berger, Skadden, Arps, Slate, Meagher & Flom LLP, on Monday, January 9, 2023

Editor's note: Maxim Mayer-Cesiano is a Partner and Jonathan E. Berger is an Associate at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on their Skadden memorandum. Related research from the Program on Corporate Governance includes Are M&A Contract Clauses Value Relevant to Target and Bidder Shareholders? (discussed on the Forum here) by John C. Coates, Darius Palia, and Ge Wu; and The New Look of Deal Protection (discussed on the Forum here) by Fernan Restrepo and Guhan Subramanian.

Key Points

- Volatile global financial markets and recessionary fears have led to declining boardroom confidence and a decrease in deal activity from 2021's record levels but are still healthy by historical standards.
- Strategic drivers of M&A activity are in place, and high levels of corporate and financial sponsor dry powder are available to support deal activity.
- Economic stresses, uncertain financing markets and heightened regulatory scrutiny make it crucial for parties to conduct robust due diligence and negotiate deal terms to address downside and termination risks.
- In a down market, buyers may find opportunities to acquire appealing targets that were previously out of reach.

Acquisition market participants in the U.S. approached dealmaking with greater caution in 2022 than they did in 2021. Steadily rising interest rates and financing costs, persistent inflation, geopolitical uncertainty, heightened global regulatory scrutiny and a general decline in boardroom and investor confidence have all contributed to this change. Unpredictable market dynamics have made sellers wary of overly opportunistic buyers, while buyers have been cautious of overpaying in what they may see as a new normal. It has become more difficult to reach agreement than it was during the booming M&A market of 2021.

However, M&A has proven to be a permanent fixture of companies' capital allocation toolkits, and M&A engagement continues even as general market sentiment shifts. Factors that have driven M&A over the years are as present today as ever, including strong corporate earnings; the sentiment that a "buy" strategy can prevail over a "build" strategy in adapting to meet changing customer needs quickly and well; and the desire to manage corporate portfolios to align with goals announced to investors.

Despite the more cautious approach in 2022, deal volume globally remained on par with 2018, 2019 and 2020, and aggregate deal value was higher in 2022 than in 2019 and 2020, at roughly the 2018 level, according to investment data company Preqin.

> **M&A has proven to be a permanent fixture of companies' capital allocation toolkits, and M&A engagement continues even as general market sentiment shifts.**

As markets remain volatile in a low-growth or recessionary economy, the M&A environment will likely be challenging, so mitigating deal risks effectively will be a critical priority. For those who can navigate these challenges, successfully assessing and minimizing risks, there may be opportunities for substantial rewards.

Efficient Capital Deployment and Financing

Investors and lenders are becoming increasingly selective with their capital allocation given the meaningful rise in interest rates and cost of capital. Buyers who require third-party acquisition financing face more reluctant lenders and higher borrowing costs. As acquirers turn more regularly to private lenders and other sources of capital (as opposed to syndicated or traditional credit lines or bank loans), they may have to shoulder increased risks or other tighter terms that de-risk the loans for the lenders. (See "A Playbook for Borrowers Facing Economic and Debt Market Pressures.") The specter of further market pullback adds to the uncertainty about financing and could limit market engagement.

> **For those who can navigate these challenges, successfully assessing and minimizing risks, there may be opportunities for substantial rewards.**

Still, both strategic buyers and private equity funds have dry powder. While down from the record levels in 2020 and 2021, dry powder in private equity funds remained at $1.2 trillion as of the third quarter of 2022, according to the PitchBook Global Private Market Fundraising Report. And U.S. corporations' cash on hand in U.S. banks remained higher as of mid-2022 than at any point prior to 2020, according to the U.S. Census Bureau. While financing may limit the number of buyouts at the largest valuations, private equity will likely find opportunity in carve-outs as corporations dispose of assets to streamline and focus their businesses.

Together, these forces make it likely that there will continue to be engagement in the market, even if overall economic performance lags. Those with considerable cash reserves and the willingness to transact with less leverage will likely see ample opportunities to buy at potentially significant discounts. Strategic acquirers and investors with longer-term investment horizons will also have an advantage.

Disciplined Approach to Due Diligence

As a buyer's market begins to emerge, acquirers will find it easier to insist on robust due diligence. They should seize the opportunity to do so, to mitigate the risks of an unpredictable market in which company values may be declining. Disciplined diligence can help expose deficiencies in a target, including legal and business liabilities and other vulnerabilities that are material to its valuation and the ultimate decision of whether or not to proceed with an acquisition.

Declining markets do not always provide the luxury of extended due diligence, though. There may even be greater urgency from investors to deploy capital quickly, exploit narrow windows of opportunity and produce returns (to avoid having unutilized cash, particularly in this inflationary environment).

We expect participants who are able to strike a balance and conduct meticulous yet efficient due diligence to be rewarded by the market.

Downside Protection and Termination

In the current environment, both sides need to consider what could go wrong.

That includes understanding the path to regulatory approval. Competition regulators around the world are adopting new approaches to assessing mergers and are scrutinizing transactions that they would have waved through in the past. In addition, sanctions directed at Russia and newly imposed national security reviews and trade regulations can complicate and delay some transactions. Further regulatory clearances are sometimes required under those regimes. (See "Disparate US, EU and UK Sanctions Rules Complicate Multinationals' Exits From Russia.")

Termination and deal withdrawal considerations tend to become more central in negotiations during a lagging market. A terminated or withdrawn transaction may result in costly termination fees, litigation and other undesirable consequences, particularly for public companies that may be sensitive to market perception. Conversely, being forced to consummate an unfavorable or unaffordable transaction in a down market can also be costly and complicated.

Well-considered deal terms can provide flexibility and additional risk mitigation for buyers and sellers. They include:

- covenants and conditions that take into account volatile market conditions;
- the duration of the contract term and outside date;
- the scope of the material adverse effect (MAE) clause and its exceptions;
- the size of any termination fee and regulatory "ticking fees" to compensate for delays; and
- termination triggers.

(For perspective on the U.K. market and due diligence and deal terms there, see "The Widely Forecast Recession in the UK Will Likely Reshape M&A.")

Innovative Opportunities

In a down market, we expect dealmakers to hunt for targets that were previously too expensive. For instance, the falling valuations and performance headwinds in the technology sector present opportunity for incumbent businesses to acquire previously unattainable disruptors, likely for far less than it would cost to build their own modernizing technology.

Sound acquisition strategies among participants who can remain nimble should yield opportunities to unlock value through acquisitions that would not have been possible in a more expensive marketplace.

(For perspective on China M&A, see "Focus of China Cross-Border M&A Turns to Government-Favored Sectors and Away From West.")