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Global M&A Activity Endures Headwinds in 2023 and Displays Resilience Going Into 2024

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Editor's note: Dohyun Kim is a Partner at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on her 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, IV, 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

- While interest rates, uncertainty and other factors negatively impacted deal activity in 2023, we saw a steady flow of carve-outs, spin-offs and joint ventures that offered creative ways to achieve strategic goals.
- Financial sponsors remained active, though at reduced levels, using larger equity contributions, seller rollovers and alternative forms of financing to navigate tighter and more costly financing markets.
- Persistent valuation gaps and heightened regulatory scrutiny meant longer negotiations over economic terms and risk-sharing provisions, and more earnouts and contingent payment constructs.
- Activism remained a significant factor, with many campaigns pressing for M&A transactions as a means to enhance shareholder value.

At the end of 2022, we had noted that volatile global financial markets and recession fears had led to a decrease in deal activity from 2021's record levels, but that the overall rate of M&A activity in 2022 was still healthy by historical standards. In 2023, with steadily rising interest rates, persistent inflation, geopolitical uncertainty and heightened regulatory scrutiny in many jurisdictions, global M&A activity slowed down further:

- The $1.95 trillion of global M&A volume through the third quarter of 2023 represented a 27% year-over-year dollar volume decline (with the number of deals down by 7%) and the lowest three-quarter total since 2013.[1]
- The decline in U.S. M&A activity was less severe, with volumes in the first three quarters down 24% year-over-year (and the number of deals down by 4%), with a modest uptick in activity at the beginning of the fourth quarter, led by deals in the oil industry.

Despite the headwinds in the market, M&A remained a vital part of companies' growth strategies and strategic initiatives throughout 2023, and the year presented opportunities for — and rewarded — thoughtful and creative dealmakers.

Steady Flow of Carve-Outs, Spin-Offs and Joint Venture Transactions

Throughout the year, we saw a steady flow of carve-outs, spin-offs and joint venture transactions. With companies continuing to focus on monetizing non-core assets and business lines in an effort to deleverage and deliver shareholder value in challenging market conditions, these structures were popular ways to unlock value. We also saw companies engage in creative and complex structuring, such as carve-outs where the seller retained a stake through long-term joint venture or partnership arrangements, as a way to bridge gaps in valuation and cope with tighter financing markets while progressing toward their deleveraging goals.

With valuation gaps between buyers and sellers persisting well into 2023, public companies looking to dispose of non-core business units often turned to spin-offs as an attractive way to unlock value while avoiding the risk of selling "low" and missing out on the value accretion that may be available to their shareholders in the future. In some cases, we have seen corporate sellers pursue a "dual track" carve-out/spin-off process, having a spin-off as a backup option in case a carve-out sale process did not achieve the desired result. We expect to continue to see more of these types of transactions in 2024.

Financial Sponsors Show Resilience, With More Equitized Deals and Alternative Financing Sources

Higher interest rates and tighter financing markets made dealmaking more challenging for financial sponsors in 2023, which was reflected in an approximately 35% year-over-year dollar volume decrease in private equity M&A through the third quarter of 2023

[1] All data is from Bloomberg, Refinitiv and/or FactSet. All activist activity data is for campaigns conducted globally by activists at companies with market capitalizations greater than $500 million at the time of the campaign announcement.

However, financial sponsors showed resilience and creativity. We saw sponsors provide more upfront equity financing, with the plan to later increase leverage when debt market conditions improve. Sponsors also teamed up with other sponsors, or, in some cases, strategic buyers, more often in consortium arrangements to muster the necessary equity.

Rollovers were frequently used to bridge funding gaps, while serving also to incentivize management shareholders and founders. We also saw buyers using various forms of seller financing to close such gaps, effectively deferring receipt of the full purchase price.

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While the leveraged loan market remained tepid, private credit funds continued to be active and take a larger share of the acquisition finance market. These funds showed their ability to finance big ticket M&A deals while providing more flexible financing solutions to financial sponsors.

Even if interest rates stabilize and eventually start declining in 2024, as the market appears to anticipate, we expect to see the creative use of financing structures continue to play a role in financial sponsor deals.

Persistent Valuation Gaps and Heightened Regulatory Scrutiny Are Reflected in Contractual Provisions

Entering into 2023, many dealmakers had anticipated that the valuation gap between buyers and sellers would narrow substantially as parties adjusted to current market dynamics. However, this adjustment process is not complete, and meaningful gaps in value expectations continue to be common.

In the case of private targets, we saw buyers and sellers utilize earnouts and other contingent payment mechanisms to bridge valuation gaps. For public targets, we saw contingent value rights (CVRs) used to work around different views of valuation, primarily in the health care sector. And many deals simply did not move forward because of parties’ inability to reach an agreed valuation.

We expect this to continue in 2024 but possibly to a lesser degree, as pressures intensify on sellers to obtain liquidity, and on buyers to realize growth and innovation through acquisitions — especially to keep up with global trends of technology and energy transformation.

Dealmakers continued to feel the pressure of heightened merger scrutiny in 2023, as regulators in the U.S. and around the world took more expansive approaches to merger control and foreign direct investment. (See “As US Antitrust Agencies Double Down on Merger Enforcement Approach, New

Deal Strategies Emerge" and "EU and UK Merger Regulators Look Beyond Horizontal and Vertical, With Digital 'Ecosystems' a New Focus.")

This, in turn, has led to greater focus during deal talks on regulatory risk-sharing and related contractual provisions (e.g., "drop-dead" dates, reverse termination fees and efforts covenants). Those have been negotiated more heavily and earlier in deal processes, especially for large-cap companies with leading positions in their respective markets and cross-border deals involving sensitive industries. In some cases, deals have fallen apart over these deal terms. Both strategics and financial sponsors have felt the pressure from antitrust officials, and we expect this trend to continue in 2024.

Activism Remains an Important Factor

Shareholder activism remains a major factor in the M&A market. In 2023, activist shareholders sought to take advantage of depressed stock prices and business underperformance to accumulate significant positions and launch campaigns. Through the third quarter of the year, 159 new campaigns were initiated globally, which was approximately 8% above the four-year average.

Despite the overall slowdown in M&A activity, the portion of activist campaigns with an M&A-related thesis remained in line with historical averages. However, a larger portion of the campaigns were focused on breakup transactions or divestitures of specific lines of business, or aimed to scuttle or sweeten previously announced transactions.

We expect activists to continue to have a meaningful impact on the M&A market in 2024, both as a result of the ongoing volatility in the market and as some of the headwinds start to subside and give rise to more transaction opportunities.

Cautious Optimism Heading Into 2024

If the factors that deterred dealmakers in 2023 — higher interest rates, inflation, recession fears — recede in 2024, the pressure on companies to look for growth opportunities and keep up with the speed of innovation (not to mention the need for financial sponsors to deploy capital) could result in a rebound in deal activity in 2024. In the meantime, the market will continue to provide attractive opportunities for thoughtful, resilient and creative deal structuring and execution.