

The year ahead in M&A:

Our deal-making predictions for 2023

Contents

In this edition of M&A Insights we share our deal-making predictions for the year ahead. Despite the uncertain geopolitical landscape, inflationary pressure and rising interest rates we are cautiously optimistic for the varied opportunities the next 12 months will bring. Our trends to monitor include a strong year ahead for energy and infrastructure; hotspots of activity in the Middle East and Japan; renewed interest in digital assets; and further efforts by private equity funds to create value through complexity. We also take a deep dive into some key corporate data points to identify further areas to watch.



This PDF contains
interactive elements

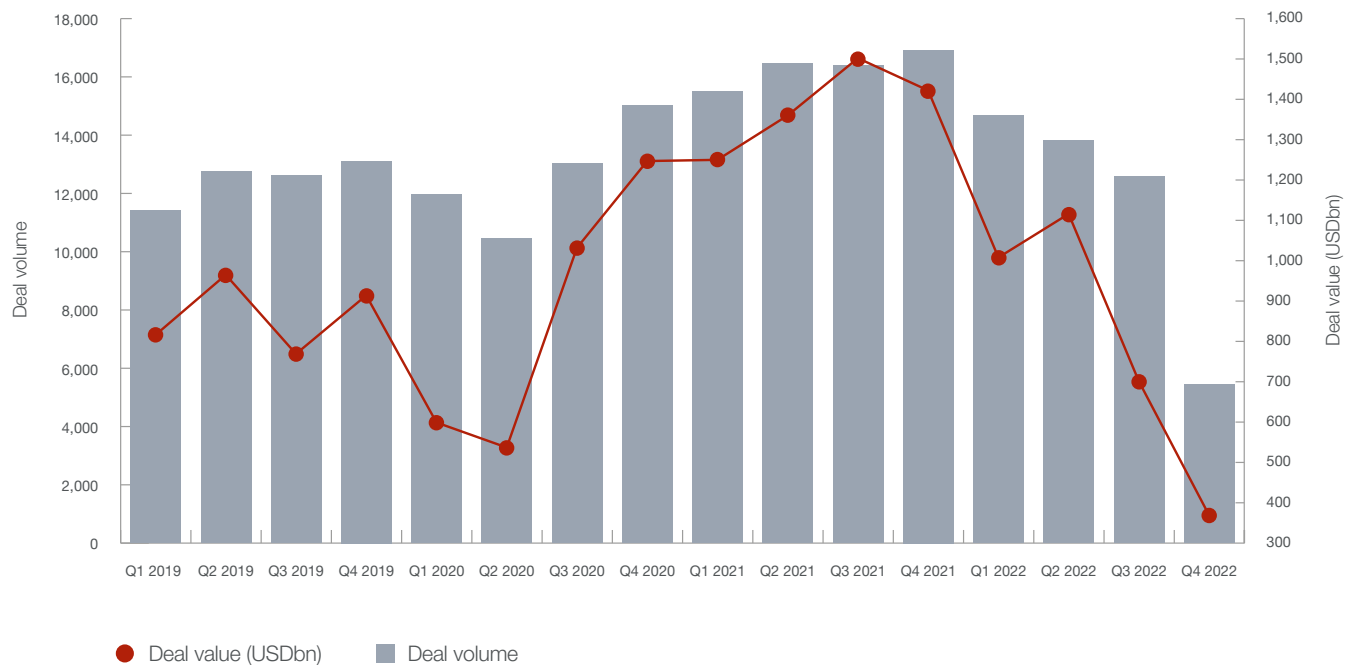
Run on energy and infrastructure deals set to drive further market evolution

The energy crisis has turbocharged energy and infrastructure M&A. As activity intensifies, corporates will continue investing alongside financial sponsors – who in turn are partnering with developers to access new greenfield opportunities in the energy transition

In the midst of a global energy crunch that has reinforced the need for security of supply, we expect a blockbuster run of energy and infrastructure deal-making in the year ahead. In the six months to the end of November the value of energy and power deals outstripped those in every other sector, the first time this has happened since the beginning of 2019.

M&A drops amid market headwinds

Deal value and volume (2019-2022)

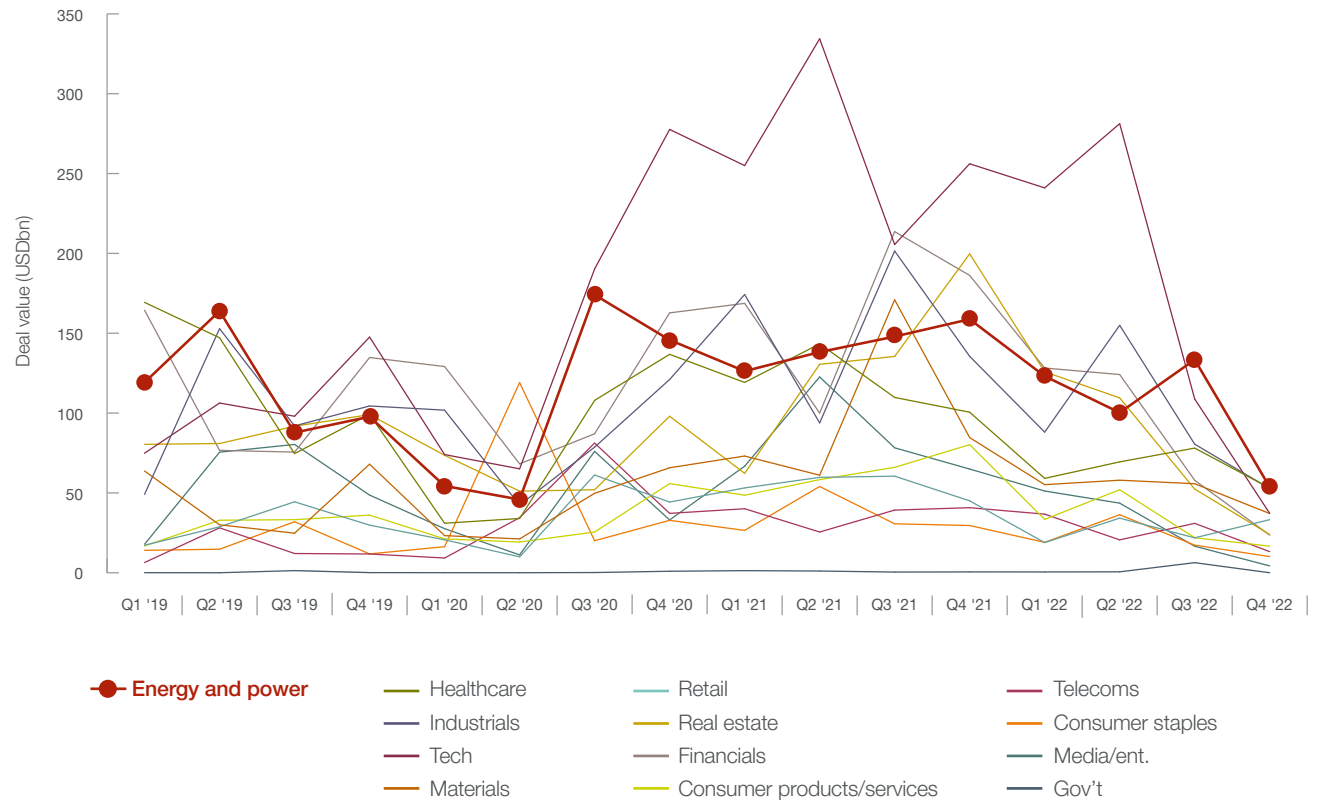




Energy producers are generating record revenues and oil futures remain high, albeit not quite at the levels they reached during the summer of 2022. Energy majors' growing cash reserves and desire to decarbonise their portfolios make them prime candidates to pursue renewables deals and invest in new technologies throughout 2023 and beyond – provided their shareholders sanction bids rather than push for funds to be returned through buybacks.

Energy and power is top sector in H2 2022

Deal value (2019-2021)





Infra deals largely immune to syndicated debt crunch

We expect infrastructure investors to remain among the most active financial sponsors in the market, with their transactions largely immune to the sort of conflict-induced uncertainty that has interrupted the flow of syndicated debt, at least in Europe.

In the U.S., the Inflation Reduction Act and the Infrastructure Investment and Jobs Act have channelled significant funding into the energy and infrastructure sector in the forms of grants, loans and tax incentives, much of it targeted at projects that contribute to energy transition. These incentives are spurring further private investment and we expect activity both in initial investments and secondary trades to remain robust.

Financing is typically easier to access for energy and infra acquisitions than other forms of sponsor investments because the assets' longer hold periods (often 20+ years) lessen the impact of current shocks like the war in Ukraine.

It's also true that many infra deals do not require leverage as they involve the trading of stakes in assets that already have debt in place. The concept of debt portability is well-understood in the market, where refinancing deals are structured so the transaction does not invariably trigger a change of control that requires the debt package to be reset.

Sponsors pursue greenfield investments

Within the energy and infrastructure sector some interesting deal trends have emerged. The first is that with so much capital to deploy and auctions increasingly competitive, sponsors are teaming up with developers to access greenfield investment opportunities.

These deals follow a typical private equity-style playbook, with the initial acquisition establishing an overarching framework agreement through which the sponsor commits equity financing in return for a first look at new projects. Once the framework is in place, each subsequent investment can be structured as a normal co-invest.

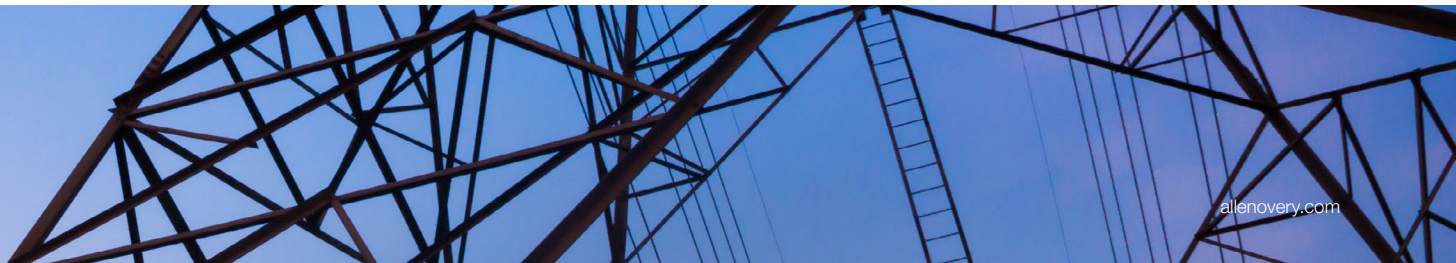
We also expect more strategic buyers and sponsors to acquire and develop assets together, with consortium deals helping corporates to deleverage their balance sheets, limit concentration risk and pursue a wider variety of opportunities.

Regulations to manage electricity price shock make valuations difficult

But while there is money available and an appetite for deals, assets are proving tricky to value. Soaring gas and electricity prices have led to a range of regulatory measures being introduced to ease the impact on businesses and consumers. In Europe for example, windfall taxes on "excess profits" – which in countries such as the UK have been applied evenly to all electricity generators – make for a patchwork of regulation that presents challenges in accurately predicting future project revenues and therefore assessing with confidence what targets are worth.

In some cases this is leading to deals being put on hold as parties wait for the volatility to ease, while in others buyers and sellers are being more flexible in order to reach an agreement on price. Where parties are unable to find a solution, we are seeing earn-out mechanisms negotiated that ratchet up and down in response to shifting market conditions.

In some recent European deals, parties have considered complex hedging structures involving contracts for difference alongside more straightforward terms that adjust the sale price by reference to the price of electricity post-closing. Indeed, more of our deals in 2022 featured earn-outs compared to 2021, and they are set to remain a feature in 2023 for as long as the uncertainty persists.





European sponsors seek value through complexity amid debt market volatility

Europe's exposure to the war in Ukraine has hit its syndicated debt markets hard. The flow of funds will return – but in the meantime sponsors are pursuing ever-more complex deals to create value

Away from **infrastructure**, the forward view for sponsor-led deal-making in Europe is more challenging – at least for the early part of the year.

The volatility seen across financial markets – driven in part by Europe's exposure to the war in Ukraine – has seen the syndicated market for leveraged loans largely disappear. Arrangers, who are already facing challenges in selling down “hung” deals to free up their balance sheets, are finding it almost impossible to price debt amid the threat of an escalation in the conflict and a further deterioration of credit conditions. For financial sponsors, this makes asset values even harder to calculate.

Sponsors expected to assume 100% of market risk on debt

Right now – outside of assets with stable revenue streams and long hold periods – banks will often only underwrite debt packages if the issuer assumes 100% of the market risk, raising the prospect of a sudden increase in pricing midway through a transaction. There used to be a ceiling on how far banks could flex the price of a leveraged loan during the syndication phase, but those days are gone. Ironically, the turning point was the Russian debt crisis in 1998.

This is creating the most challenging conditions for European private equity deal-making in years. Twelve months ago, the availability of financing was barely given a second thought; sponsors had optionality, costs were low and packages could be arranged at speed.

Financing discussions front-loaded in deal process

Today, debt is having to be put in place by deal teams before many of their investment committees will even entertain a bid. Earn-outs, vendor loans and rollovers (ie where sellers invest a portion of their equity in the PE-controlled acquisition company) are increasingly common as sponsors look to reduce the sums they need to pay.

Without easy access to syndicated debt due to increased risk aversion among banks and weak demand from investors, sponsors are in daily discussions with private credit funds as they look to secure financing. A clear opportunity exists for direct lenders – awash with capital – to develop strong future pipelines if they can build mutually beneficial relationships.

One area where these dynamics are less significant is in the ESG space. Here, it's potentially easier to justify a higher equity contribution where the focus of a fund's limited partners is on social and environmental impact rather than pure financial returns. More broadly, we also don't expect the gloomy backdrop to prevail throughout the whole of 2023. The leveraged market is exactly that – a market – and history shows that when it comes back it will be with a bang.



Market volatility driving more complex deals

Until then, sponsors – who were sitting on more than USD3.7tn of dry powder at the end of November, an all-time high – will continue creating value through complexity, for example by targeting undermanaged carveouts or aggressively going after two or more complementary assets at the same time.

By realising synergies from the outset of a transaction, sponsors are able to make a more compelling case to sellers as well as their own investment committees. But closing multiple contingent transactions is an order of magnitude harder than participating in an auction and executing a leveraged buyout.

It is also more risky – sellers will push for reverse break fees and hell-or-high-water clauses to hold buyers accountable for securing regulatory approvals.

PE sponsors considering wider variety of ownership structures

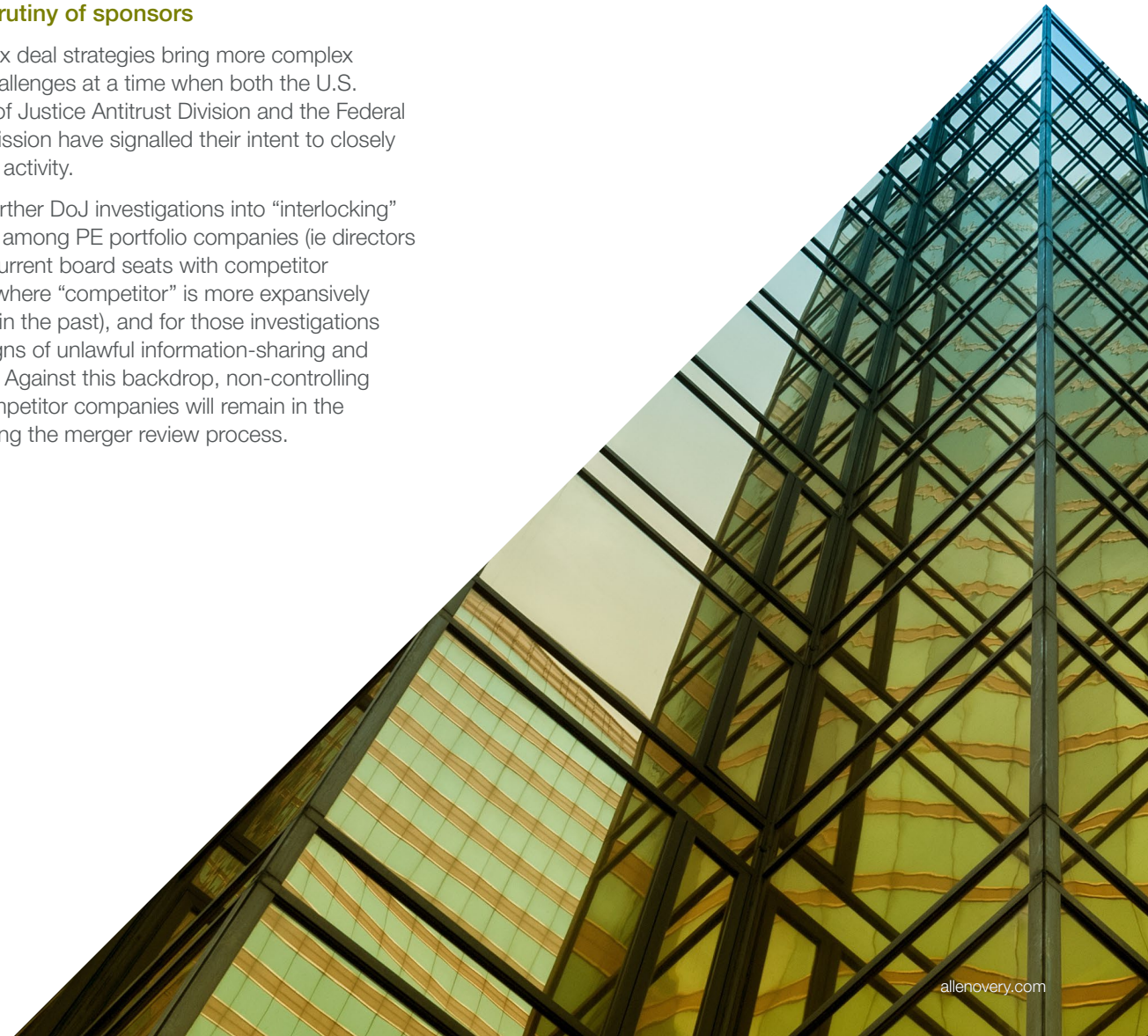
The trend towards complexity extends to ownership structures, with PE sponsors showing greater appetite for a wider variety of post-closing models including investing in assets via joint ventures with strategics.

This sort of flexibility enables sponsors to put capital to work despite the external headwinds, with deal terms including “put” and “call” options that give sponsors certainty they can get to a control position when market conditions improve.

Antitrust scrutiny of sponsors

More complex deal strategies bring more complex regulatory challenges at a time when both the U.S. Department of Justice Antitrust Division and the Federal Trade Commission have signalled their intent to closely scrutinise PE activity.

We expect further DoJ investigations into “interlocking” directorships among PE portfolio companies (ie directors holding concurrent board seats with competitor businesses, where “competitor” is more expansively defined than in the past), and for those investigations to look for signs of unlawful information-sharing and coordination. Against this backdrop, non-controlling stakes in competitor companies will remain in the spotlight during the merger review process.





Southeast Asia, Japan, UK and Middle East primed for deal-making in 2023

We expect these four markets to be a nexus for M&A activity in the months to come. And while the primary drivers are different, they all share a common trait – a relative openness to foreign investment

Deal activity by value in Southeast Asia and India fell in the second half of 2022, mirroring the overall downward trend. However we expect this to reverse in the year ahead; both markets have been boosted by their greater recent openness to foreign capital relative to China and have seen strong interest from investors in sectors including financial services, logistics, tech and infrastructure.

Japanese corporate overcome their aversion to sales

Deal-making in Japan by contrast rose slightly in Q4, and we expect it to be a market to watch in 2023. For the past decade the Japanese M&A story has been largely about outbound investment, driven by a stagnant domestic economy, a general lack of demand from Japanese shareholders for buybacks and a preference for top-line growth over cost-cutting.

Fast-forward to today and the landscape has shifted dramatically. Japanese corporates appear to be overcoming their cultural aversion to sales. Inbound investment is on the rise as they refresh their balance sheets and belatedly embrace the shift to digitalization.

The yen – for so long one of the world's most stable currencies – has dropped heavily against the dollar. Japan's central bank has had to hold interest rates down due to the sheer scale of the national debt, which is the highest in the world relative to GDP.

On the flip side, Japan's economy is large, its infrastructure is good, its laws and courts are reliable and it has few restrictions on foreign investment. These factors combined with the currency effect will drive M&A activity through 2023 and beyond.





UK opportunities to invest at attractive values

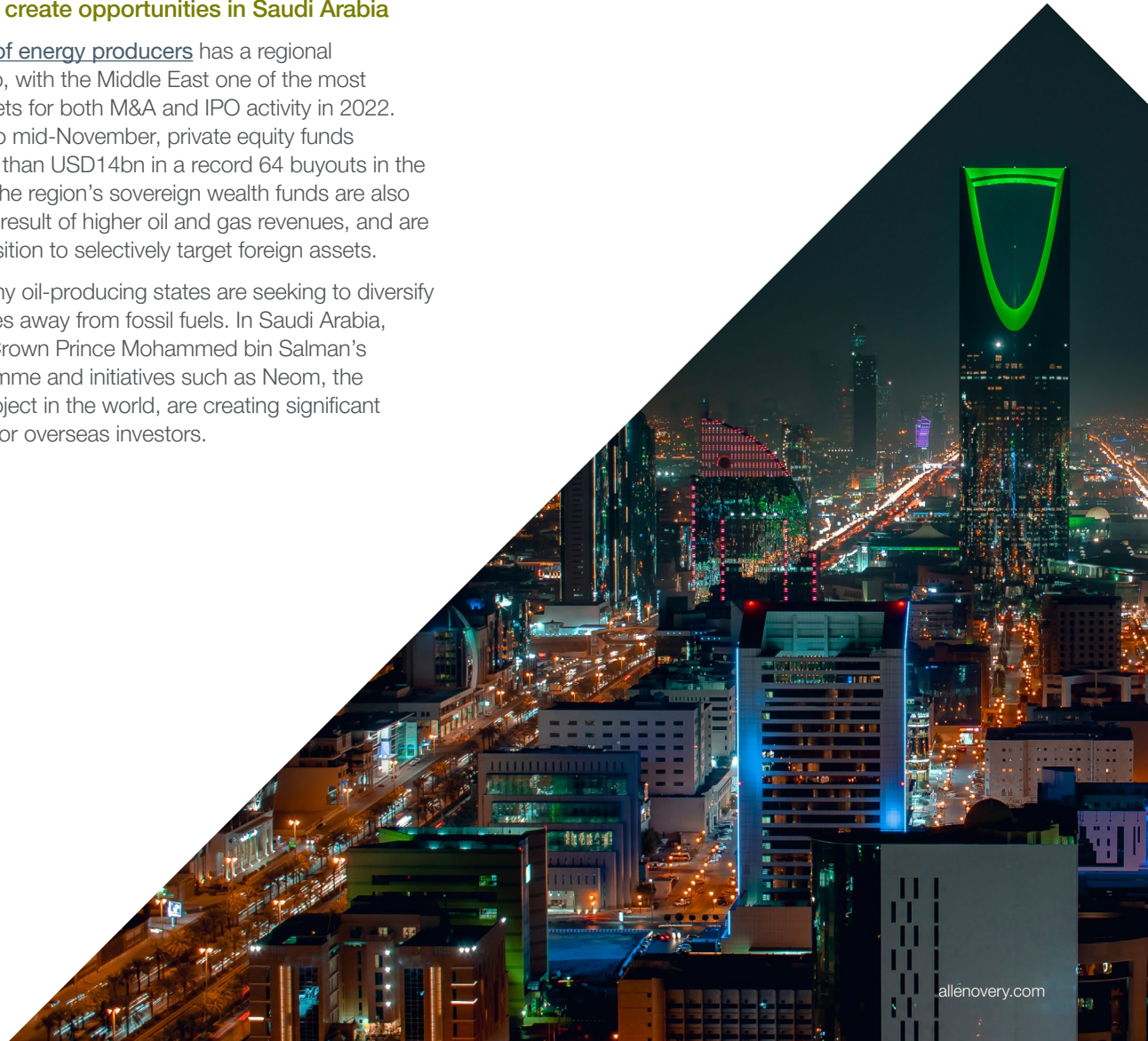
Much has also been made of the weakness of the pound and the opportunities this presents to buyers, particularly from the U.S. However this driver needs to be weighed against the expected near-term recession and overall confidence in the economic outlook. M&A remains the key tool for growth and we expect cash-rich corporates to take advantage of the value opportunities that exist in the UK market – as well as an uptick in combinations that seek to realise synergies where buyers are prepared to take a longer-term view on the deployment of capital.

Foreign direct investment (FDI) rules have been strengthened with the introduction of the National Security and Investment Act (NSIA), but the UK remains a relatively benign environment for FDI screening outside of truly sensitive areas. We foresee interest in public companies being focused on the FTSE250, where values are most attractive, and that the U.S. will remain the dominant source of inbound investment. However, the deals that are being done are often executed at premiums above historic averages, suggesting boards are adopting a robust position in relation to opportunistic approaches based on current market values.

Gigaprojects create opportunities in Saudi Arabia

The success of energy producers has a regional dimension, too, with the Middle East one of the most buoyant markets for both M&A and IPO activity in 2022. In the period to mid-November, private equity funds invested more than USD14bn in a record 64 buyouts in the Middle East. The region's sovereign wealth funds are also cash rich as a result of higher oil and gas revenues, and are in a strong position to selectively target foreign assets.

In parallel, many oil-producing states are seeking to diversify their economies away from fossil fuels. In Saudi Arabia, for example, Crown Prince Mohammed bin Salman's reform programme and initiatives such as Neom, the largest gigaproject in the world, are creating significant opportunities for overseas investors.



Digital assets will remain in demand – despite the crypto winter

Recent troubles in the crypto markets are unlikely to see deal-making curtailed. Instead, digital assets, Web3 and Metaverse targets will continue to be sought after as non-tech players look to open new markets

No assessment of future M&A activity would be complete without considering tech, which for so long has been the biggest sector for deal value and volume.

Despite tech stocks taking a hit in 2022 after a stellar run through the pandemic, we expect appetite for the most sought-after assets – including semiconductors and software – to continue, not least because strategic buyers remain well-capitalised.

Crypto trading platforms set to be active buyers

One interesting area to watch in 2023 will be deal activity around crypto assets, the Metaverse, NFTs and Web3. In North America, crypto-related M&A volumes in 2022 remained strong – not quite reaching their 2021 peak but higher than in 2020 – and despite the collapse of FTX we expect trading platforms to be among the most active buyers in the months to come.

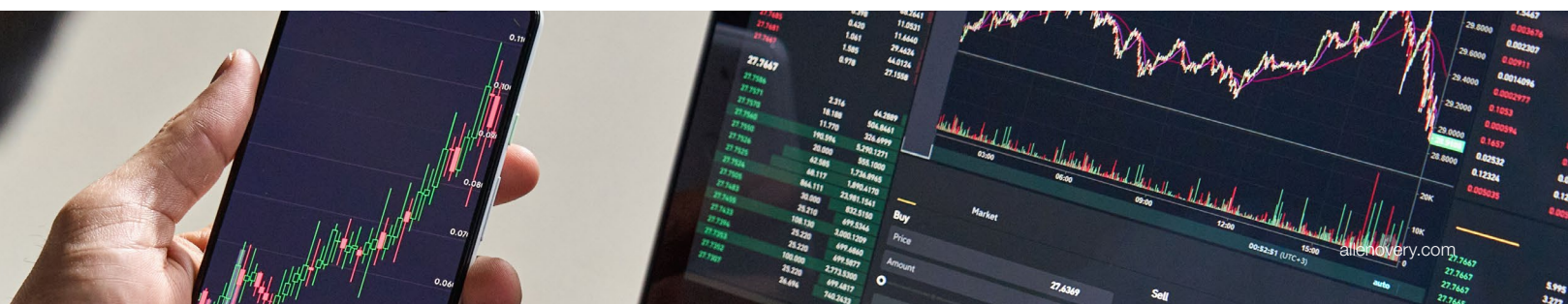
We are also seeing strong interest from outside the sector, with consumer businesses looking to copy the success of brands such as Nike, which has leveraged its acquisition of digital asset developer RTFKT to drive deeper engagement with its customers by packaging virtual sneakers with the sale of physical products.

NFTs continue to interest consumer brands

The desire to replicate these sorts of innovative business models will generate future M&A activity as brands buy in new capabilities, while we also expect tech companies to continue targeting systems integrators who are developing ways to port digital assets between different platforms.

As far as deal structuring is concerned, the continued trend towards using equity as consideration in crypto-related transactions will remain, with tech stocks far below their 52-week highs. And this is not just a theme we are seeing in public deals – an increasing number of private M&A transactions also feature similar structures.

Here, those hardest hit by the crypto winter – who have less leverage in negotiations – are accepting sale proceeds heavily skewed towards acquirer stock alongside a portion of cash which they are using to pay back their VC investors. As with other segments of the market, valuations are challenging, with earn-outs used to manage differing expectations.



What corporate data tells us about future M&A activity

We track a range of metrics to assess the likelihood of future deal activity across sectors. This analysis points to hotspots of M&A in tech, consumer, life sciences and possibly mining in the year to come

Another way of assessing where deal activity may be concentrated in the months ahead is by analysing corporate data. We have constructed a model that tracks a range of indicators to assess a company's likelihood of being involved in M&A, from its growth potential (a combination of its revenue growth over the past three years and its projected future growth, among other things) to its deal-making fundamentals (net debt/EBITDA; forward price/earnings ratio; cash ratios plus further data points) and its acquisition history (number of acquisitions over the past decade, biggest deal, activity among its peers and more).

By combining and weighting these numbers we are able to generate an M&A score for individual corporates on a scale of one to 10, where those rated 10 have the highest likelihood of being involved in deals.

Comparing M&A scores and market cap reveals potential for acquisitions

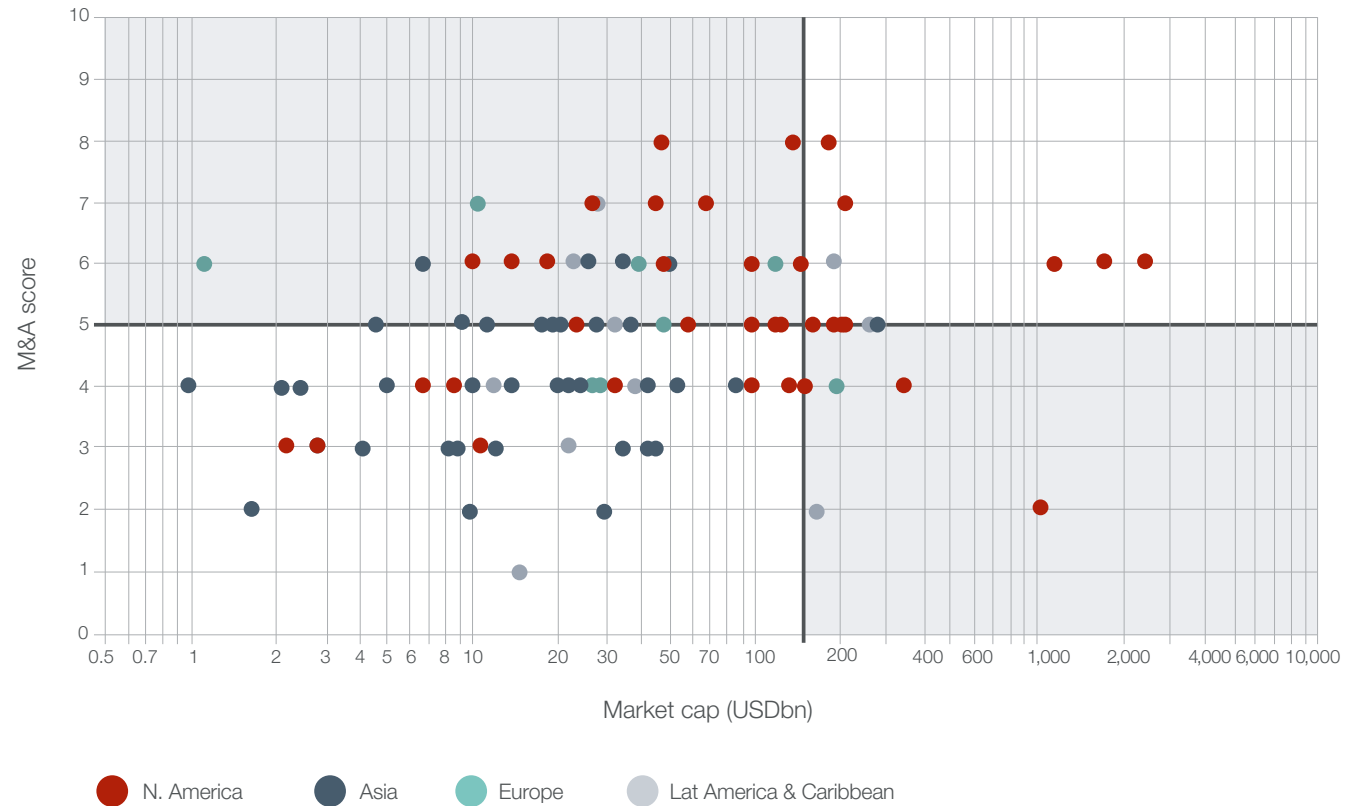
We monitor this data in real-time for the 100 biggest companies by revenue across 13 sectors. Comparing the M&A scores against each corporate's market capitalisation adds a further dimension by revealing the businesses that have the most capacity to raise acquisition finance through equity issuance.

Plotted as graphs we can create four-box grids where those in the top right quadrant are in the best position to do deals (high market cap, higher M&A score), those in the top left are candidates for consolidation (high M&A score, lower market cap), those in the bottom right may be considering divestments (higher market cap, lower M&A score) and those in the bottom left are potential targets (lower M&A score, lower market cap).

Tech, life sciences, consumer and mining in the spotlight

The following charts pick out the four sectors (tech, consumer, life sciences, and mining and metals) that show the greatest potential for deal activity. Despite supply chain issues, revenues among the biggest tech companies continue to grow, and they may see any struggles among smaller innovators in the bottom left as an opportunity to acquire valuable IP. Likewise, these bottom-left businesses are likely to attract interest from companies outside the sector.

Top 100: Technology - Growing revenues; valuable IP in focus

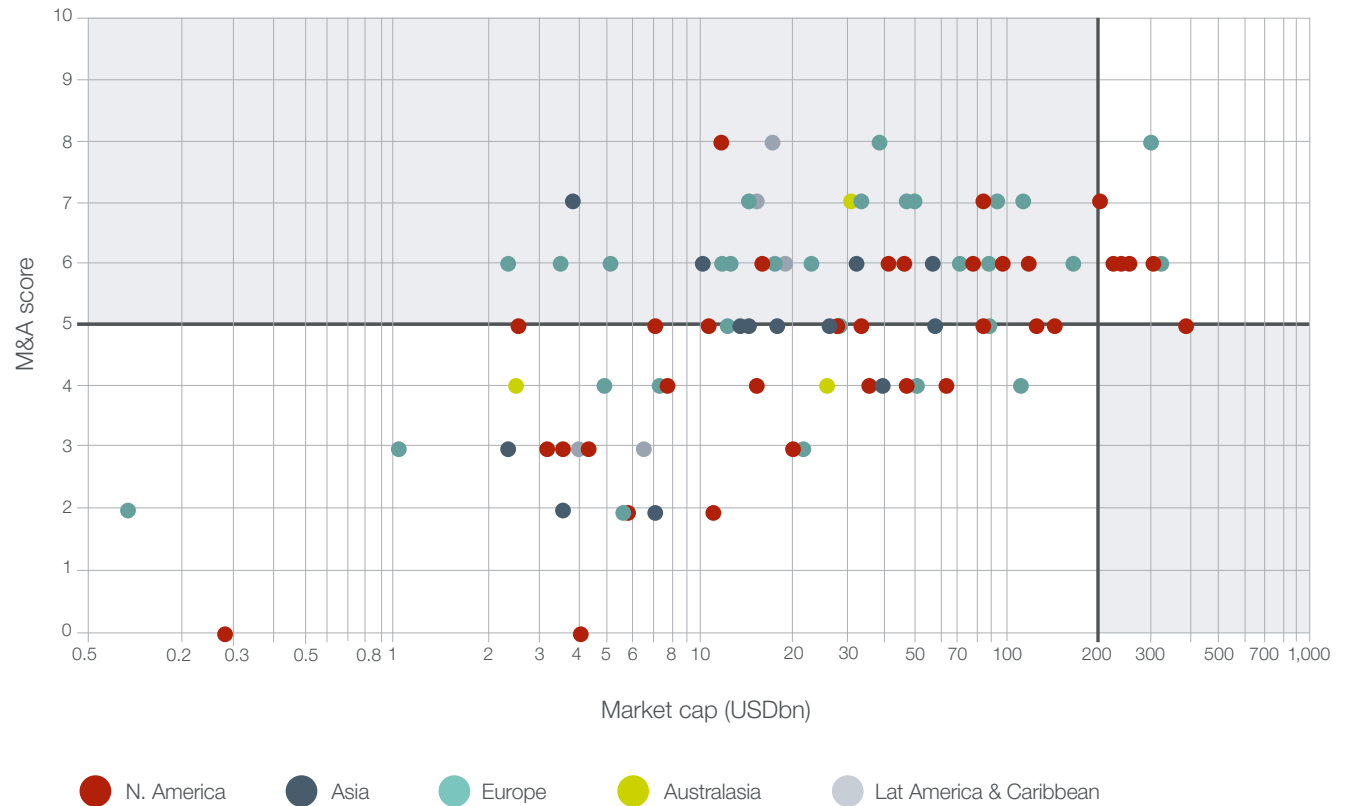




Consolidation top of consumer M&A agenda in 2023

In consumer, distress and the need to adjust to the tougher economic climate is expected to drive consolidation in the year ahead. Many of the top 100 are seeing revenues rise slowly, if at all, although the biggest players have the firepower to acquire top line growth. A significant proportion of the top 100 carry M&A scores above five, suggesting a cohort primed for M&A.

Top 100: Consumer - Challenging economic conditions expected to drive consolidation

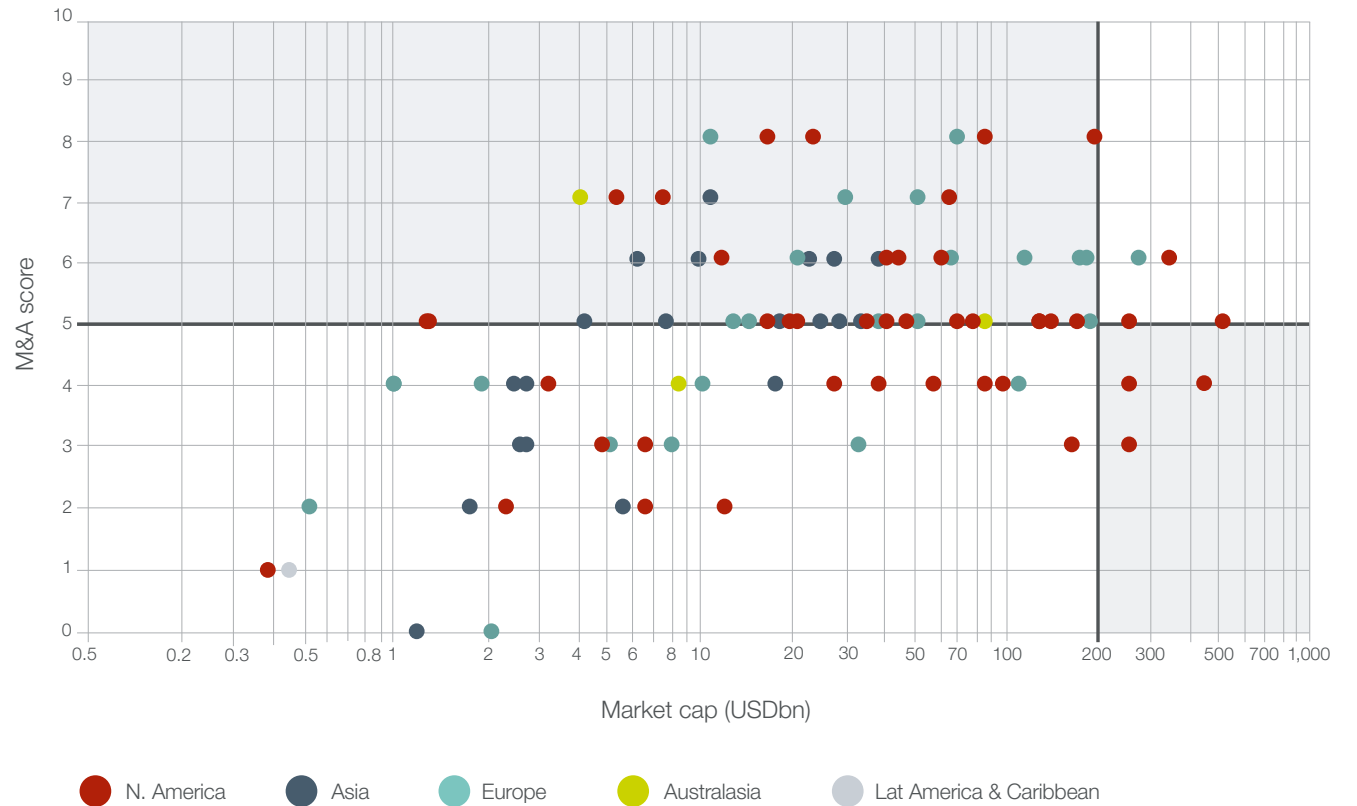




Patent cliffs put pharma revenues at risk

After a quiet H2 for M&A, life sciences and healthcare deal-making appears set for a rebound in 2023. The major players are cash-rich, biotech valuations are normalising after a bullish few years, and patent cliffs put approximately USD180bn of the biggest pharma companies' revenues at risk between now and 2028.

Top 100: Life Sciences - Biggest players are cash-rich; looming patent cliff

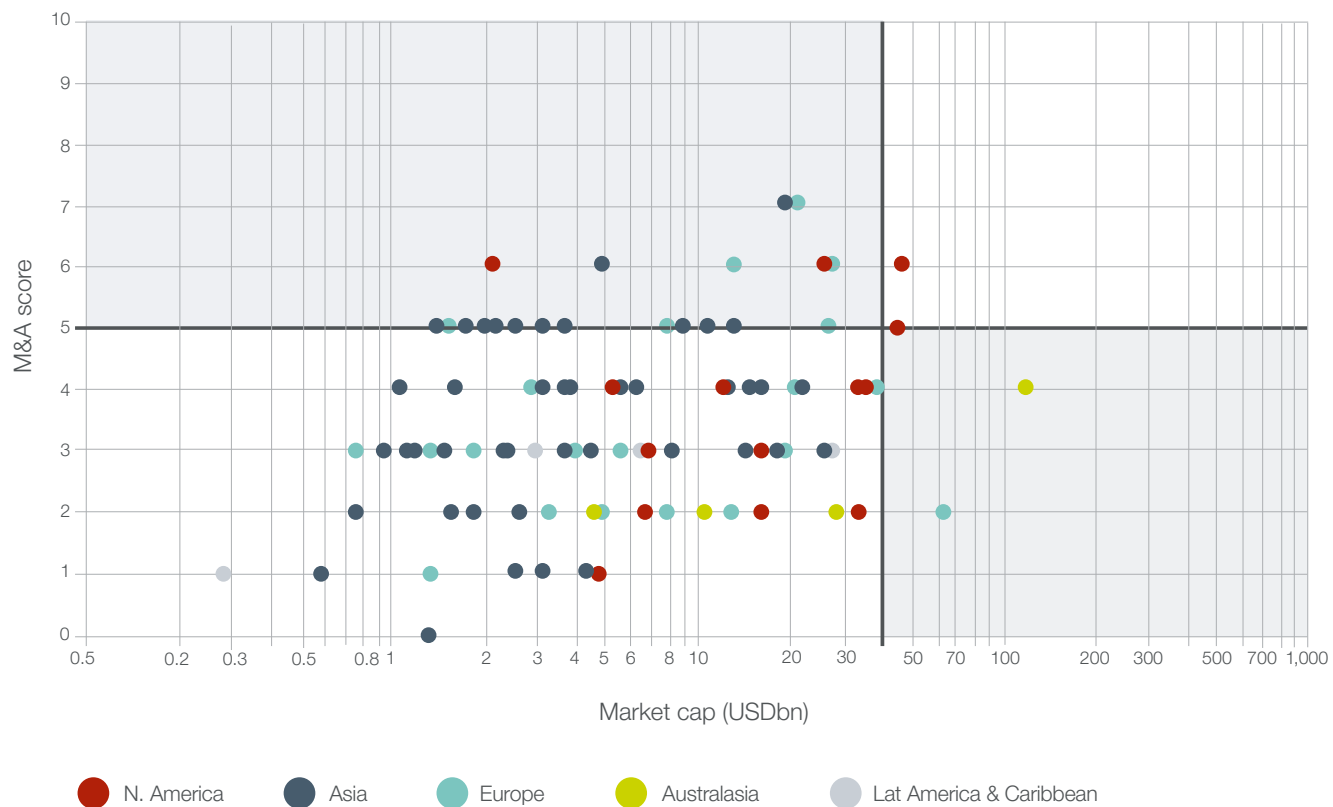




Scarcity and demand set to accelerate mining deals

Finally, the number of mining companies in the bottom left of our chart points to the possibility of M&A activity in 2023, not least because of rising demand for raw materials and fears over security of supply (car makers for example have taken to [signing deals directly with miners](#) to guarantee provision of the materials they need for EV batteries). Around USD400bn of investment in critical minerals is needed by 2030 to meet climate goals, while Saudi Arabia has announced it is planning to invest USD32bn in the sector.

Top 100: Mining and metals – Metals in huge demand; high number of potential targets



Click [here](#) for our office contact details

Global presence

Allen & Overy is an international legal practice with approximately 5,600 people, including some 580 partners, working in more than 40 offices worldwide. A current list of Allen & Overy offices is available at www.allenoverly.com/global_coverage.

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. Allen & Overy LLP is a limited liability partnership registered in England and Wales with registered number OC306763. Allen & Overy (Holdings) Limited is a limited company registered in England and Wales with registered number 07462870. Allen & Overy LLP and Allen & Overy (Holdings) Limited are authorised and regulated by the Solicitors Regulation Authority of England and Wales.

The term partner is used to refer to a member of Allen & Overy LLP or a director of Allen & Overy (Holdings) Limited or, in either case, an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings. A list of the members of Allen & Overy LLP and of the non-members who are designated as partners, and a list of the directors of Allen & Overy (Holdings) Limited, is open to inspection at our registered office at One Bishops Square, London E1 6AD.