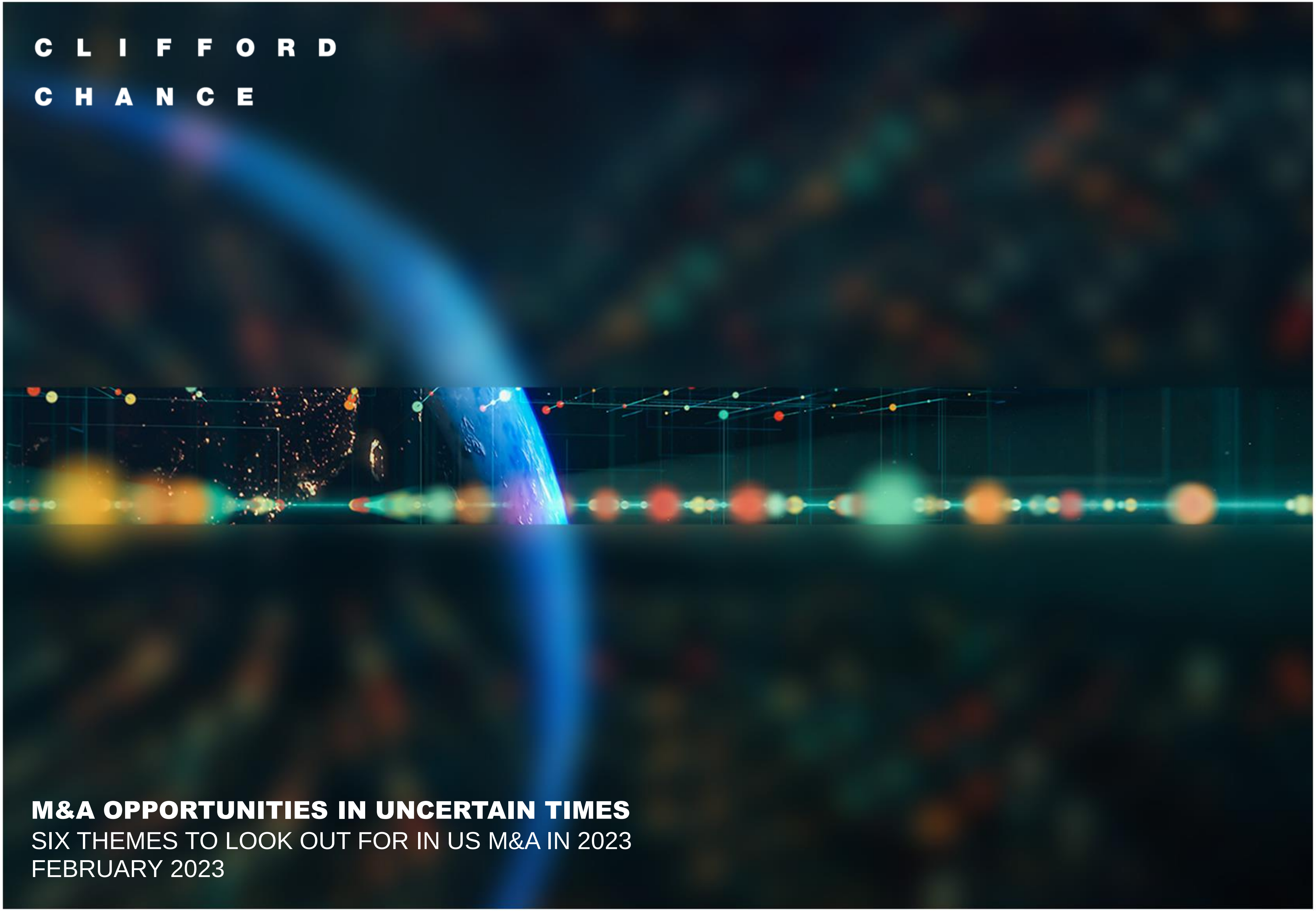

CLIFFORD CHANCE

M&A OPPORTUNITIES IN UNCERTAIN TIMES

SIX THEMES TO LOOK OUT FOR IN US M&A IN 2023

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During 2022 the M&A market cooled from its rapid trajectory and returned to pre-pandemic levels. The descent was a result of a combination of geopolitical instability, inflationary forces – which turned out not to be transitory, and both domestic and international regulatory hurdles.

Nevertheless, we saw sophisticated buyers utilize creative structures and deal terms to find pockets of value in the market and also capitalize on depressed business valuations, especially those of the growth darlings of 2021.

The US M&A market in 2023 will be a tale of two-halves. Although we expect economic growth will continue slowly and a heightened level of uncertainty in the capital markets will persist in the first half, we expect the cloud of uncertainty to dissipate, and the debt financing markets to open up in the latter half of the year.

Thus, expect (i) sophisticated buyers to continue to utilize the successful tools of 2022 during the first half and (ii) an increasing amount of buyers to re-enter the market and buyers to return to their traditional investment strategies during the second half.

AT-A-GLANCE

1. **Deal Structures:** Embrace flexibility, particularly in deal structuring.
2. **Alternative Investment Strategies:** Consider alternatives like minority investments, PIPEs, structured equity and bespoke debt arrangements, joint ventures, divestitures and spin-offs to maximize value.
3. **Regulation:** Heightened regulatory scrutiny will lead to a greater focus on interim operating covenants and increased reverse break-up fees.
4. **Public Company Takeovers:** Look for higher take private deal flows and proxy battles.
5. **Outbound Investment:** Favorable US$ rates will lead to opportunistic outbound deal activity.
6. **Due Diligence:** Well organized processes and the sell-side's ability to properly present their businesses that are up for sale will be increasingly important to maintaining deal flow.

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AT-A-GLANCE
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Deal Structures

Buyers and sellers will need to be flexible with deal structuring. In respect of acquisitions made by public companies, paying some or all of the purchase price by way of stock consideration may remain unattractive given current volatility in the global capital markets. Buyers are increasingly looking to defer the payment of deal consideration over time so that the target's business case presented by sellers can be adequately tested in the years immediately following closing – typically structured as earn-outs that are tied to an agreed upon financial metric of the target business (i.e., EBITDA). Sellers will seek to negotiate for (i) earn-out amounts to be paid on a sliding scale in lieu of a payment of the full earn-out if a target is met or exceeded; and (ii) the right to catch-up payments to the extent the targets in prior earn-out periods are not met but are then exceeded in later earn-out periods – all of which are open for debate with a buyer.

Alternative Investment Strategies

Assets coming to market in the large cap buyout space will be fewer than in previous years meaning auction processes will remain highly competitive. Some buyers will decide that it is not economically feasible to participate in those types of auctions during the first half of 2023. This backdrop is further heightened by stricter antitrust enforcement globally and debt financing sources being limited and expensive. To compensate, many financial investors and strategic buyers will deploy alternative investment strategies to seek value. Strategics who are taking a risk averse approach to M&A during the current downcycle or have less cash on their balance sheets, may seek value through joint ventures with other strategics and minority investments in growth assets/businesses (in lieu of putting cash to work through internal R&D initiatives in a time where efficient deployment of capital is preferred). Strategics may also seek to divest certain non-core assets through divestitures and spin-offs as they look to adjust/rationalize asset allocations.

Financial investors will deploy dry powder in investments that can be fully equitized – such as through minority investments. They will increasingly look to make growth equity investments in attractive growth businesses whose valuations have been hit by rising interest rates. These types of investments are also popular because typically they do not require leverage finance. Financial sponsors will seek to safeguard and strategically grow their existing portfolio by pursuing bolt-on acquisitions for those portfolio companies – albeit being mindful of increased scrutiny of such transactions by US antitrust authorities.

Regulatory Headwinds

Heightened antitrust scrutiny from the US Department of Justice and Federal Trade Commission will persist in 2023. Buyers and sellers should expect interim operating covenants to become negotiated in greater detail due to the potential of an elongated interim operating period. Buyers should expect sellers to continue to pursue the inclusion of a hell or high water covenant in the acquisition agreement. On this basis, buyers will need to proactively look at potential overlaps of the target business with buyer's business and other investments, put together a plan for carving out of the transaction perimeter, or divesting as part of a negotiated remedy, those overlapping assets / business units that could heighten antitrust concerns, and derive a valuation of those overlapping assets / business units, collectively to determine whether the transaction will remain attractive in such event. Additionally, buyers will need to get comfortable offering reverse break-up fees that may exceed the 2022 market average in exchange for looser antitrust covenants, such as a hell or high water provision.

AT-A-GLANCE
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Public Company Takeovers

2023 has the potential to be a busy year in take private transactions. Attractive public companies are trading at significant discounts, particularly in the tech sector, while private market valuations and deal multiples remain stubbornly high. Since public companies are subject to greater regulation than privates, they traditionally have more seasoned and transparent records of operating results, which may make obtaining debt financing easier and more economical for buyers. Financial sponsors will actively seek large public company targets that are trading at large discounts to their 52-week highs – stemming from the need to deploy built-up sums of dry powder to meet investment horizons in a single investment.

What's more, the change in universal proxy voting – making it easier and less costly for investors to seek appointments of members to public company board of directors – will make minority investments in US public companies more attractive for financial investors, who will more easily gain leverage when negotiating board positions and/or strategic business changes with existing company boards. Consequently, financial investors will be able to effect corporate outcomes with less capital invested.

Outbound Investments

We will see a rise in outbound M&A activity from US buyers to other parts of the globe. This upshot will result from the US dollar remaining strong due to ex-US geopolitical instability and increasing US interest rates – creating a pricing advantage for US buyers. However, we anticipate that such advantage will begin to normalize in the second half of 2023 as US interest rates stagnate and global interest rates play catch-up to the US market. Nevertheless, throughout 2023 M&A will be the most effective way to expand geographically, strengthen supply and distribution pipelines, acquire customers and broaden talent pools. As part of the diligence process, US buyers should equip themselves with counsel who understand the nuances of particular ex-US markets to properly address execution risks.

Due Diligence

Deal pace in the first half of 2023 will overall remain muted as sellers grapple with accepting lower valuations and buyers focus on conducting thorough financial and legal diligence to ensure they get the economics correct. To increase deal speed, sellers should proactively provide sufficient documentation to close out diligence requests efficiently, and also prepare executives to answer an increasing amount of diligence queries – the importance of management team preparation and readiness cannot be underestimated and will determine the success of certain sale processes. Buyers should focus on addressing financial and legal red flags through valuation discounts or through its package of representation and warranties, covenants and indemnification rights in the purchase agreement – because we are seeing a rise in claims from buyers in the current environment and so they need to be carefully and clearly documented and understood by all parties.

For non-control transactions involving founder businesses, although a great deal of trust will be placed with the founders as to driving growth in the years ahead, buyers should focus on conducting diligence on corporate governance, internal financing controls and related party transactions to have a better understanding of how the founder operates the target's business – this insight will be crucial to understanding the way the business is run, any pitfalls that may exist and will help determine whether they can be rectified quickly and cost effectively or if they would deter a buyer from proceeding with making the investment. This form of due diligence is becoming more important than ever.

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