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DEAL ADVISOR DIGEST

M&A Trends Report

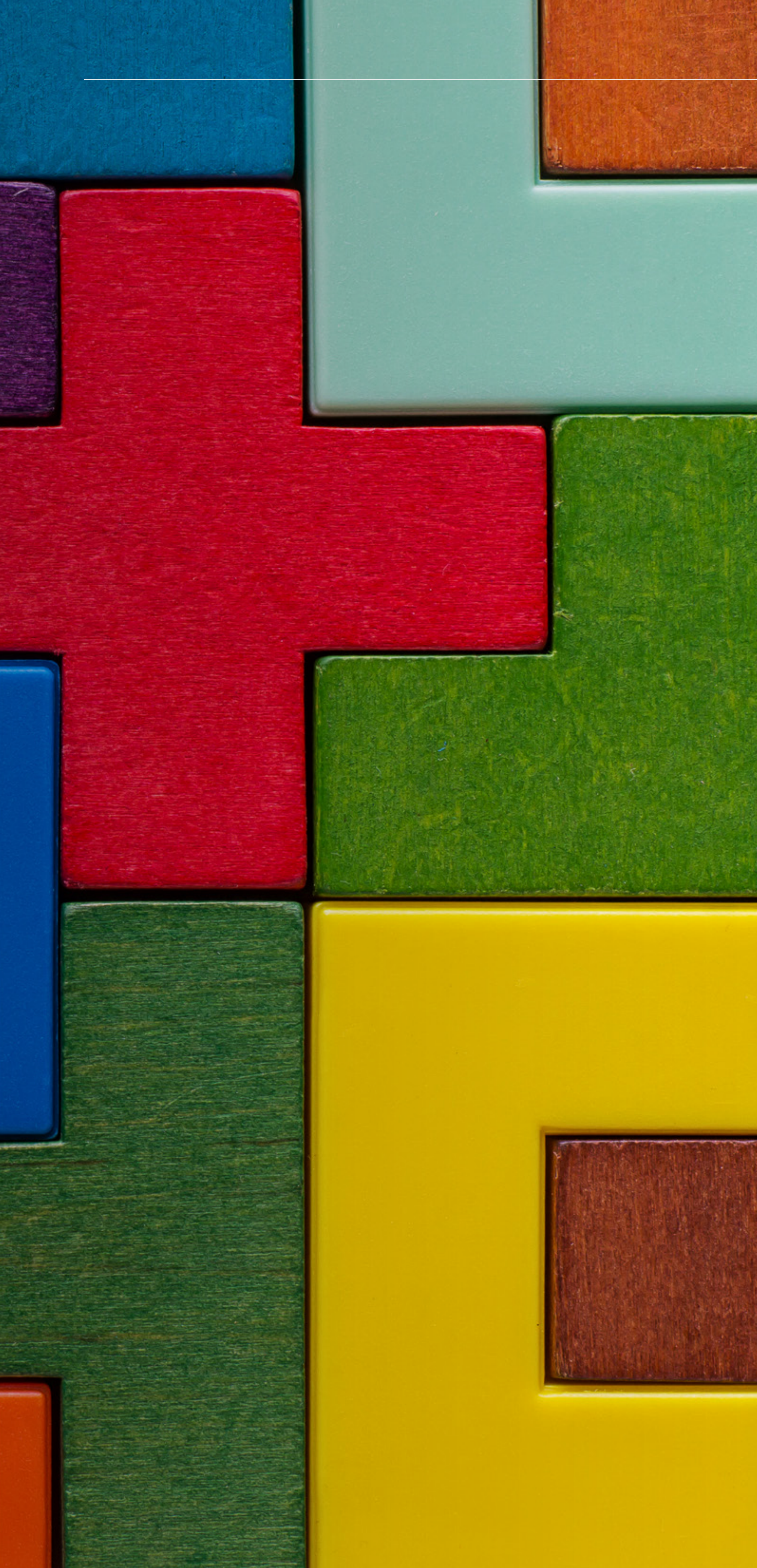
ISSUE 8

CREATING LASTING VALUE AMID CHANGE

What's Your Strategy?

BDO

In This Issue



M&A Momentum Continues

2021 saw record deal activity as global M&A value neared $6 trillion, and the year closed with a strong second half. That momentum has continued into 2022 despite a slight dip during Q1. Private equity-backed deals and large deals over $1 billion have contributed to robust overall deal activity.

Significant amounts of capital are still being deployed, and the outlook for M&A is bright but cautious, as the optimal conditions that prevailed during 2021 are meeting some competing forces. The U.S. is facing rising interest rates while Russia's invasion of Ukraine and inflationary challenges are impacting global markets. Related market conditions could cause declining valuations and even impact business performance for potential sellers, especially those that lack pricing power.

Those overarching factors should not diminish the appetite for deals, but they underline the importance of price discipline and comprehensive due diligence, which can help ensure past results are sustainable and risks are thoroughly vetted prior to close.

The road ahead could look much different by year's end. Whether you're a buyer or a seller — or both — now is the time to review your M&A playbook, evaluate your strategy, assess all growth options and prepare for long-term creation of value or a timely exit.

M&A SETS NEW RECORDS

Global deal volume saw a 24% year-over-year increase in 2021, according to Refinitiv data, while overall value rose by 64% to reach $5.9 trillion — the first year to surpass the $5 trillion mark. That blockbuster year set the stage for a strong Q1 in 2022, which marked an unprecedented seventh consecutive quarter of deal value above $1 trillion.

Private equity-backed deals in Q1 rose 18% year over year and accounted for 29% of all M&A activity, setting a new first-quarter record. In the middle market, the proportion of private equity buyouts reached a record-setting 33% by volume in Q1, per Mergermarket. Preqin reports private equity firms had $1.8 trillion in cash to invest as of February 2022, so they'll continue to be a driving force for dealmaking as they put that dry powder to work.

U.S.-target M&A comprised a stunning 51% of global M&A activity during Q1. And deals in the tech sector continue to lead industry categories, accounting for a record 25% of global value. Mega deals above $10 billion also increased by 46% in Q1, the best quarter for the category by value in three years.

2021: a record-setting year for M&A

$5.9T (↑64%)
in global M&A

$1.2T (↑120%)
in PE-backed M&A

$2.1T (↑68%)
in cross-border deals

$1.4T (↑46%)
in mid-market deals (<$500M)

$2.6T (↑82%)
in U.S. target M&A

$1.1T (↑71%)
in tech sector deals

Source: Refinitiv

CHANGES IN STORE

Amid recent record-setting transaction activity, changes lie ahead. Central bank stimulus buoyed markets since mid-March 2020, but it also risked overheating the economy. Inflationary concerns have made headlines as the consumer price index (CPI) has risen over the past year. It topped 6% in October 2021 and continued rising each month through March 2022 when it reached 8.5%, the largest 12-month increase since 1981. Inflation eased slightly in April, but it was still 8.3% higher than the previous year.

The Federal Reserve had confirmed in its **January Federal Open Market Committee (FOMC) meeting** that it would halt asset purchases and start reducing the bond holdings on its balance sheet, along with raising the target range for the federal funds rate due to "inflation well above 2% and a strong labor market." At the **March FOMC meeting**, the Fed raised rates by a quarter-point — marking the first increase since December 2018 — and it then made a half-point rate hike in May for the sharpest increase since 2000. The Fed also anticipates making additional rate increases at upcoming FOMC meetings this year. The end of historically low interest rates will also increase the cost of borrowing to fund M&A. At the same time, many companies have substantial cash on hand, and some may have recently refinanced their debt to take advantage of low rates, which can help support deal activity throughout 2022. A **Bureau of Economic Analysis report** indicates there were more than $1 trillion in undistributed corporate profits at the close of 2021, equivalent to more than 4% of nominal GDP.

The seller's market has continued in 2022, and many sellers/potential sellers are still fielding cold calls from eager buyers. However, there are several challenges for each side to address. Inflation and rising rates will lead to a higher cost of capital and a likely contraction in debt markets. Lower valuations related to rate increases could make some sellers hesitant and thereby limit available targets, although that trend could attract more buyers as well.

Persistent supply chain challenges have also impacted many different industries and added to economic uncertainty, making it necessary to assess supply chain risk as part of any deal strategy. Labor shortages caused by a wave of resignations have affected target companies, in addition to straining resources for deal teams.

Other factors that could potentially constrain deal activity in some regions or sectors include geopolitical tensions, especially the ongoing conflict in Ukraine, and uncertainty around the outcome of U.S. midterm elections in November.

The **2021 BDO Fall Board Pulse Survey** found that M&A is the top-ranked corporate strategy for 2022, but boards also face **increased pressure from investors and other stakeholders** to provide greater transparency and accountability. That scrutiny includes the need to demonstrate a commitment to environmental, social and governance (ESG) initiatives — and keep up with evolving regulatory and reporting requirements related to ESG — while maintaining profitability.

Increased Regulatory Scrutiny of Private Funds

In early February, the SEC **released new proposed reforms** for private funds that, if implemented, would add multiple new reporting and compliance requirements for private fund advisers. The potential reforms would increase visibility into specific practices with the goal of increasing protections for investors.

One requirement would mandate that advisers obtain a fairness opinion from an independent opinion provider for all adviser-led secondary transactions, which would guard against potential conflicts of interest. Obtaining a fairness opinion from professionals with technical knowledge and industry experience can have benefits for fund advisers and help contribute to investor confidence.

Contact BDO's Valuation & Capital Market Analysis practice to learn more about how they can help you understand the SEC's proposed reforms and the multiple benefits of obtaining a fairness opinion.

As buyers and sellers pursue deals in a competitive environment, they have different sets of considerations and may need to adapt as economic conditions change. Here's what each group should have top of mind to help maximize available opportunities.

Considerations for Buyers

In the competitive deal climate typified by high multiples, buyers may be paying top dollar. It's important to have a clear view of risk and a plan for how to maximize deal value, as ongoing value creation post-deal is more important than ever.

COMPREHENSIVE DUE DILIGENCE

Gaining a complete understanding of the target's overall value is part of the pricing strategy and underlines the deal thesis.

A quality of earnings report has been the traditional approach to providing details about the target's ability to sustain performance, but the process and requirements for that report have grown more complex. Data analytics has become a key tool for assessing risk as part of comprehensive due diligence. Organizing all deal-related data — which extends across financial, tax, accounting, IT, operational and human capital — can provide the relevant and accurate analysis necessary to evaluate the deal holistically. Such an analysis may also identify unexpected trends or even hidden value.

BDO'S DUE DILIGENCE APPROACH

Learn more about BDO's holistic Quality of Business™ approach to due diligence advisory ▶

STRATEGIC INTEGRATION PLANNING

Focusing on the deal rationale helps to realize expected value, but getting the most from the deal involves detailed planning around several elements. You should have a clear plan for integration that is aligned with the deal rationale and focus on the deal value drivers from day 1, as well as a strategy for transformation, which can prepare the new organization to capture anticipated synergies. In addition, an effective integration management structure can facilitate the integration and synergy capture planning as well as the execution process.

The integration plan should have a specific timeline and sequencing of activities focused on needs relevant to the integration process. Data analytics created as part of due diligence can inform integration priorities as well. The plan should address the following key areas, among others:

- Address day 1 priorities, typically focused on stabilizing the business, establishing financial control, meeting regulatory requirements, and managing the stakeholder (e.g., employees, customers, partners, etc.) experience.
- Realize target synergies.
- Optimize working capital management to ensure necessary liquidity.
- Undertake change management initiatives, including alignment of corporate cultures.
- Review staffing, right-size the organization, and confirm the right people are in the right roles.
- Review and harmonize compensation packages; plan for employee retention and succession.
- Clarify organizational responsibilities, decision authority and communication channels.
- Assess potential IT and cyber risk; ensure threat detection, incident response and compliance.
- Evaluate the real estate portfolio and update workplace strategy.

ONGOING VALUE CREATION

Strategic integration and organizational transformation are the initial stages to boost agility following the deal closing. In order to realize deal value, the strategy for ongoing value creation should build on the work of integration to foster long-term success through enhanced profitability, revamped processes and cross-functional systems.

There are multiple tactics that can improve profitability. Sales, inventory and operations planning (SIOP), supply chain optimization and strategic sourcing help free up resources and reduce costs. Conducting thorough commercial due diligence can also identify and minimize potential third-party risk.

Process reengineering for different business functions can also improve efficiencies and identify opportunities for automation. There may be gaps in budgeting, forecasting or reporting, so redesigning business processes can integrate organizational data to inform management decisions. Using a **total tax approach** can also manage reporting obligations and potentially optimize tax liabilities for the combined organization.

Reviewing and implementing the digital strategy should identify opportunities for systems integration as well. It's critical to mitigate exposure to cyber risk and ensure robust processes for data governance and protection. Data is central to all business functions, and these steps are part of the larger effort to harness that data while mitigating risk for the new organization.

These are just some of the key areas to address, but they demonstrate impactful methods to uncover efficiencies, increase productivity and improve profitability. Taken together, this approach forms a strategy for better decision-making and long-term value creation.

Considerations for Sellers

If your phone rings tomorrow and you receive an offer to buy the business, what's your next move? Would you be prepared to act swiftly? Transaction timelines have compressed amid a race for deals. Sellers who are thoroughly prepared are well suited to drive deal timing, which can put pressure on buyers to meet deadlines and reach a closing sooner. Taking a few extra months to negotiate and close a deal could lead a buyer's motivation to wane or to a price change because of shifts in interest rates and valuation. It's possible that the price you can get now won't come around again for several years — or even longer — so it's beneficial to be proactive and undertake pre-deal planning and strategy well in advance of receiving an offer.

PRE-DEAL PLANNING

It helps to have your operations, documentation, management and deal team in order before considering a potential transaction. This goes far beyond just compiling and organizing the necessary information. Determining an accurate valuation of the business is critical to help ensure exit readiness. Having a clear understanding of your business' value to a buyer can also lead to a smooth process and negotiating leverage.

By conducting preemptive financial due diligence, tax due diligence and operational due diligence well in advance of receiving an offer, you can identify and address potential risks before a prospective buyer requests that information. The process should entail organizing all data applicable to the deal in terms of financial, tax, accounting and operational information, including specific details related to staffing, IT systems, insurance liabilities and more. If planning a carve-out, that would also involve more specific due diligence activities related to the applicable business unit.

Pre-deal planning can be the decisive element in completing the transaction and getting the most value possible. Ensuring continuing profitability is a necessary element of deal strategy. Ideally, all available measures to address financial performance will already have been taken prior to receiving a call from a buyer. That process can include optimizing the profitability of products and customers, as well as streamlining or expanding offerings as applicable, which can be informed by customer data, margin optimization and demand forecasting.

Human capital management when pursuing a deal requires careful workforce planning, especially at a time when many industries have been impacted by widespread resignations and labor shortages. Sellers should update their succession plan for management and other key roles to preserve existing value for the buyer. Ensuring strong corporate culture, incentivizing staff appropriately and providing consistent communication can all help to retain talent and improve employee engagement.

PRIVATE EQUITY VS. STRATEGIC BUYERS

As noted above, private equity funds hold nearly $2 trillion in dry powder, and the percentage of private equity-backed deals has never been higher. Private equity funds will continue to play a significant role in M&A and give strategic buyers heavy competition during 2022.

The deal structure with a private equity buyer can offer some benefits for company owners in a growing economy, as opposed to making an all-cash exit. It can open access to alternate sources of growth capital, and it can potentially act as a bridge to public markets if the company is not yet prepared for an IPO. This path can also allow for more leeway in terms of growth strategies.

By contrast, selling to private equity can also cede management control and dilute the ownership stake. The fund's way of measuring value may not align with ownership's view of the business' value, as private equity buyers often target companies with high growth potential. Ultimately, deciding the right type of buyer and deal structure that best fits your goals will depend on your business' unique circumstances.

Technology M&A in High Demand

Targets in the technology sector have set new records for transaction activity, and buyers remain eager to acquire and expand digital capabilities. Tech companies can learn more about key considerations for M&A with our ***Guide to Selling Your Technology Business*** and ***Guide for Technology Companies Being Acquired by Private Equity.*** In addition, we have recently explored ***how interest rates, inflation, and geopolitical uncertainty influence TMT M&A valuations.***

M&A POWERED Platform™

Whether you're buying or selling, having a strategic deal and operations team can make all the difference. Our M&A POWERED Platform™ brings you a partner-led, multi-disciplinary team and a full suite of M&A and post-transaction services that deliver a holistic, one-stop M&A process.

Ready to make the most of your transaction? Click here to explore our M&A POWERED Platform™ and learn more ▶

Preparing to Act

Most businesses see transactions as a key component of growth, and rising interest rates won't change that view. The **2022 BDO Middle Market CFO Outlook Survey** finds that two-thirds of CFOs (66%) plan to pursue deals or partnerships this year, including M&A (31%), joint ventures (25%), carve-outs/divestitures (22%), and investment by private equity or venture capital (19%). Some companies are pursuing multiple options simultaneously to capture the best opportunity.

There is still ample capital available and a healthy appetite for deals. As buyers and sellers assess their options, diligent preparation supports strategic action and sustainable success.

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To learn more about how we can help your company through a transaction process, reach out to our key leaders:

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