M&A in 2023: the final stage of grief for boards… acceptance!

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Skyrocketing inflation and growing interest rate uncertainty in recent months have created a host of challenges in the M&A market.

The current inflationary environment is making it more challenging for companies to raise money, particularly for those companies operating in capital-intensive sectors such as exploration mining and early-stage technology. At the same time, uncertainty as to when central banks will take steps to lower interest rates, let alone bring them back to recent historic "normal" levels, has led to erratic behaviour in the capital markets and many analysts predicting a global recession.

These economic headwinds, coupled with concern over access to capital markets, is placing a higher value on cash. As companies seek out cash, many are searching out cash-rich companies as acquisition targets–and as a result financing-by-M&A will undoubtedly be in vogue once again. Inversely, companies with attractive balance sheets are starting to hunt for acquisitions among a growing pool of poorer companies with attractive (*i.e.*, depressed) valuations.

With unrelenting pressure on valuations keeping share prices depressed from recent highs, the easy road to a deal is no longer so easy. As a target's valuation drops, its board feels vulnerable and any potential buyer is dismissed as opportunistic. A valuation swells - well, there's not a lot of this happening lately, so let's move on.

So, what will it take for M&A deals to start flowing again? A return to early pandemic cheap capital would certainly help, but given that seems unlikely with inflation heading higher and life becoming more expensive, buyers and sellers will have to navigate this part of the cycle with a different kind of confidence. Most importantly, it means shifting collective expectations as boards, investors and other stakeholders reset valuations and move away from relying on easy measures, like bloated premiums on top of 52 week highs.

Pressures on the M&A market

As debt becomes more expensive, real returns are getting skinnier and building a robust model becomes a bigger challenge. What is a board to do? Harken back to first principles and the fiduciary obligations of directors. With financing markets tight, access to alternative capital restricted and shareholder activism on the rise, it is incumbent on boards to reconsider what the board views as ‘fair value’:

- What does the cash burn look like over the next 6, 12, 24 months?
- Is the growth profile as rosy as it was in previous periods?
- Is it time to look to a strategic transaction or outright sale to protect the business?

When the board arrives at the decision that it is time to sell, it is more necessary now than it has been in a long time to take a sober, second look at value, as the risk of getting it wrong is wrought with draconian outcomes ranging from impeded growth to solvency concerns and basic survival.

For some companies, this may change its rationale for M&A activity. Rather than focusing on uncovering new opportunities or searching endlessly for the perfect match, for instance, some targets need to approach deals as a means of survival. This may mean looking for deals as a means to make it through these turbulent times.

In a situation where it feels like a company may be attracting a lower valuation than anticipated, the board still needs to demonstrate to shareholders that this deal is beneficial. Needless to say, this process must be managed carefully to ensure support from shareholders specifically, but all stakeholders generally. The target’s rationale for a deal will likely require more depth than simply touting a premium to the share price. Honest and objective assessment of the short, medium and, most importantly, the long-term outlook is going to be critical, as sitting on your hands may be the biggest mistake of all. How will a board justify to shareholders that the deal of yesterday was not rich enough as the company struggles with solvency and lacks a clear path to financial stability?

Adopt a long-term mindset

As valuations decline for a myriad of reasons, it can be tempting for boards to reject a deal if the valuation seems low. In today’s market, however, this may not be a good enough reason to reject an offer. Instead, boards must look to the long-term horizon to determine what is truly in the best interest of the company and its shareholders.

Companies running out of cash need to take a strategic view of the next 12 to 24 months. Management teams must be aware of their budgets, where those budgets are trending and their options for accessing capital. Boards, meanwhile, must be willing to proactively raise money, before the situation turns desperate and be willing to transact when the opportunity arises.

The purpose of this exercise is to determine the best path to manage existing uncertainty– and provide shareholders with the best returns possible. In some cases, these efforts may indicate a restructuring is necessary. In others, it may be worthwhile to reassess the market value of the organization, look at the valuation holistically and explore M&A deals that reflect this new reality. In all but a few cases, it is likely that the valuation is not as high as it was just a few short months ago.

Get used to longer timelines

Getting a deal closed in today's M&A market will likely take longer than it did in the recent past.

For one, Canadian government intervention has increased significantly in the M&A space. Recent changes to the *Investment Canada Act*, the feds strategy around critical minerals and foreign investment and the transition to clean and renewable technologies, has the government paying closer attention to deals that may threaten national security, including the source of funding, competition and the public's confidence in the financial system. As a result, routine deals that at one time moved quickly are now moving slowly or even facing the pressure of pre-closing clearance.

Also, with a cooling market comes a renewed emphasis on due diligence. Acquirers undoubtedly take more time to complete a thorough review as the risk of losing a deal drops–targets should prepare accordingly. In most cases, this will involve getting their businesses organized more seriously before pursuing a transaction. Execution risk will be heightened and, as most M&A advisors will say, 'time is risk.' Targets will be rewarded if they can shorten the timeframe where they are pursuing a transaction or reduce the time of an interim period between announcement and closing.

Face the future

Despite that market forces are shifting and strong headwinds are making it more challenging to get a deal done, there remain pockets of strength. These pockets will get bigger as companies begin to take a more realistic view on value and move closer to the 'bid.

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