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2023 M&A Outlook: Recapping Key Takeaways from Dealmaking in 2022 and Navigating New Challenges

Coming off record-setting levels in 2021, M&A deal activity cooled in the second half of 2022. A multitude of factors – including soaring inflation, steadily rising interest rates and the higher cost of financing, geopolitical turmoil, ongoing supply chain disruptions and instability, volatile equity markets and a general decline in investor confidence, among others – not only precipitated this slowdown in M&A, but has also fueled a change in the market’s approach to dealmaking. As we recap dealmaking in 2022 and look ahead to the outlook for M&A in 2023, we consider significant trends, developments and challenges that will continue to play out over the next year and discuss the key takeaways for dealmakers.

Long gone is the seller’s market and buying spree of 2021, which saw unprecedented and unsustainable M&A levels, with dealmakers throwing caution to the wind to execute transactions. Buyers and sellers alike have become increasingly more selective and cautious in their approach to dealmaking. Depressed company valuations have triggered a gap between sellers’ and buyers’ expectations for deal prices, and higher acquisition financing costs have only widened the gap. At the same time, a host of new challenges and hurdles have emerged, including heightened regulatory scrutiny, further complicating the landscape for M&A and making the ability to execute deals more difficult.

Despite the slowdown from 2021, a more selective and cautious tone to dealmaking, and amidst ongoing macroeconomic headwinds and uncertainty, the global M&A market has remained impressively resilient. Overall M&A deal volume and value in 2022 were at healthy levels based on historical standards, largely in line with and resembling of yearly levels preceding the 2021 spree.

M&A continues to be an imperative and viable strategy for growth and remains a strong value proposition even with looming economic uncertainty and market shifts. The fundamentals and key drivers of M&A historically are still in place in the current environment. For growth-conscious buyers, the answer to the age-old “build vs. buy” question arguably points in the direction of strategic acquisitions now more than ever given the need for transformational and rapid growth to stay



competitive in today's ever-changing market. In fact, the volatility and headwinds may be conducive to deal activity and drive M&A, with lower valuations unlocking compelling and better-priced opportunities for savvy dealmakers.

Adapting to Higher Financing Costs

The increasing interest rate environment has made, and will continue to make, borrowing money more expensive and the ability to access capital more difficult. Investors and lenders are becoming increasingly selective in deciding how to deploy and allocate their capital given the rising cost of capital, and buyers using third-party acquisition financing therefore face, in addition to higher borrowing costs, hesitant lenders that are insisting on stricter loan terms and more robust acquisition diligence cycles. Buyers who depend on acquisition financing will need to adapt to this market accordingly—those that continue to rely on highly-leveraged debt financing may be pushed out and find themselves sitting on the sidelines.

Although the higher cost of acquisition financing will continue to pose challenges for M&A transactions, one way in which buyers may respond is by deploying caches of dry powder to write larger equity checks and deleverage debt financing—many private equity funds and strategic buyers have ample resources at their disposal to do so. Although down from the record marks in 2020 and 2021, both private equity funds' dry powder (around \$1.2 trillion as of the third quarter of 2022, according to PitchBook) and U.S. corporations' cash on hand has continued to exceed pre-pandemic levels.

Furthermore, given the decline in traditional bank-led leveraged financing and the high demand for credit, investors will continue to find strategic opportunities in the private debt market. Private equity fund sponsors and institutional investors with dry powder may turn to creative tactics in deploying their capital, such as taking advantage of direct lending and private debt placement opportunities that provide the upside of equity-like returns in the form of a more secure debt product.

Cashing in on Discount Opportunities

Despite, or perhaps because of, the macroeconomic headwinds, there will be compelling opportunities for buyers to selectively hunt for better-priced deals. Given the markdown of EBITDA multiples and falling or moderating valuation levels across industries, as well as performance issues plaguing, among others, the technology sector, savvy buyers will be able to pursue strategic acquisitions that may otherwise have been too expensive and potentially acquire target businesses at discounts. Although the availability of debt financing will inevitably curtail the number of mega leveraged buyout deals, the economic conditions and operating environment in 2023 should cause companies to look to shore up their balance sheets, streamline their operations and focus on their core businesses, thereby leading to an increase in divestitures and carveouts of noncore assets or spin-offs of business units. Activist investors can also be expected to pursue and press forward on M&A-related campaigns in this market, creating additional opportunities.

Many are speculating that the technology sector may see a spike in M&A deal activity. Having been hit especially hard by declining company valuations and performance headwinds, buyers may find attractive opportunities to acquire cutting-edge technology or disruptive platforms that would be too difficult or costly to develop on their own. Furthermore, many emerging tech companies may have been forced to abandon or halt their IPO plans in 2022—due to unfavorable conditions for public equity markets, which nearly froze traditional IPOs, and a slumping de-SPAC market—and could be actively seeking alternative exit strategies. Heightened deal activity and appetite for M&A in the tech space was supported by a recent study conducted by Ernst & Young, which found that “72% of tech CEO respondents plan to pursue M&A in the next 12 months, compared with 59% of CEO respondents across all industries.”

Conducting Robust Due Diligence

As the hot seller's market from 2021 begins to fade away, it's not a surprise that risk sentiment has cooled. Consistent with the theme of selective and cautious dealmaking, buyers will continue to prioritize, conducting robust due diligence. Facing an uncertain market with declining valuations and performance headwinds, it will be imperative for buyers to effectively identify risks and liabilities, investigate operational issues, assess quality of earnings and attempt to forecast future financial performance and evaluate synergies of prospective targets, as these are instrumental factors to fully understanding the value of a business that may impact deal pricing or give rise to the need for mitigating deal terms or



protections. In addition to taking an even deeper dive into commercial, financial, operational and legal matters, supply chain resilience will remain a focal point for certain industries, and ESG matters will be further integrated into due diligence investigations. Furthermore, as discussed in greater detail below, assessing any antitrust or regulatory risks will be critical from the earliest deal stages—buyers will incorporate enhanced regulatory assessments into their due diligence reviews and strongly consider the regulatory risk profile in making the decision to pursue or price an acquisition.

Although the need for meticulous due diligence is greater now than ever, and buyers will find it easier to insist on it in the current environment, inherent timing pressures from a deal execution standpoint always warrant efficiency, and dealmakers may need to act fast to take advantage of compelling opportunities. Accordingly, steadfast, proactive buyers who can obtain tactical insights into prospective targets through robust but efficient diligence will be most successful in taking advantage of these M&A opportunities.

Structuring Deals

In order to alleviate and bridge the valuation gap between buyer and seller expectations for deal prices, the use of earnout provisions—which provide for the contingent payment of future consideration to the seller if the acquired business achieves certain performance metrics or financial goals—may become more common. Earnouts may address cautious buyers' difficulty with properly valuing a business in an uncertain economic environment and/or mitigate risks in circumstances where a target is facing reduced earnings, supply chain issues, rising costs or other performance headwinds. Sellers may be increasingly willing to accept earnouts on the basis that buyers are undervaluing targets, and improving economic conditions provide a greater chance for achieving the earnout thresholds.

Alternative deal structures, including joint ventures or club deals, may become more attractive vehicles for dealmakers to pursue acquisition opportunities across various industries. Partnering with other market participants is not only an effective tool to mitigate risk of a particular acquisition target in the current economic environment, but may also resolve potential funding issues or alleviate dealmakers' concerns with deploying capital given the challenging financing market.

In addition, with uncertainty at the crux of dealmakers' concerns, representations and warranties insurance (RWI) will continue to be a staple in private M&A transactions, as buyers will push for even broader sets of representations and warranties as a means to obtain post-closing coverage for unknown risks and liabilities, and sellers will posture to minimize post-closing exposure and maximize certainty of proceeds at closing. With strong demand for the product, fierce competition among insurance vendors and a buyers-market in the RWI space, we expect insurers to continue to adapt and expand their product offerings to capture an increased share of the deal market and stay competitive. Although smaller-sized deals have historically not made great candidates for RWI (given the relatively high underwriting costs and premiums), insurers have evolved by making the product more accessible and extending to the smaller deal market, a trend that will continue with increased insistence for RWI-backed deals of all sizes. As insurers employ other innovative approaches with respect to pricing, coverage and product offerings, buyers are taking the initiative to dictate their own RWI terms and present them to the market.

Navigating Stricter Regulatory Enforcement

Stricter regulatory enforcement has been an ongoing challenge for dealmaking, and antitrust authorities across the globe are more aggressively scrutinizing and attempting to block deals. The U.S. Department of Justice (DOJ) and Federal Trade Commission (FTC) have taken increasingly active positions, adopted expansive approaches and invoked novel theories of competitive harm and antitrust doctrine to intervene in transactions that would have previously cleared the initial waiting periods. Regulators are substantively broadening the scope of their merger reviews to capture more deals, considering a wider range of factors, applying more detailed and skeptical scrutiny, insisting on novel and impactful remedies, and amplifying enforcement by displaying a willingness to turn to litigation to challenge and block transactions. In addition, new procedural hurdles and obstacles have been introduced throughout the process, from the continued suspension of early termination of the waiting period under the HSR Act to the FTC's increased practice of issuing "warning letters" (advising parties that, despite the expiration of the waiting period, the antitrust investigation remains open and, if the parties close the transaction, they do so at their own risk).



As a result of heightened regulatory scrutiny, buyers and sellers face increased risks that a transaction will not be completed within a certain timeframe, will be challenged and/or potentially blocked altogether, or will be subject to harsh and potentially unpalatable remedies required by regulators. It will be critical for dealmakers to consider the ramifications of an extended deal timeline and the consequences of a terminated or abandoned transaction. A drawn-out deal can lead to hefty litigation costs, additional transaction-related expenses, deterioration of company value, attrition and other operational issues, and may ultimately result in severe remedies by regulators, potentially eroding the benefits of the deal and setting the stage for renegotiation of terms or a party being forced to consummate a transaction that is not what they originally negotiated. If the deal is ultimately terminated or abandoned, it could result in additional costly termination fees as well as undesirable reputational consequences that may negatively impact future ability to transact.

Against this backdrop, antitrust and regulatory enforcement risks have come to the forefront of deal planning and dealmaking. To mitigate such risks and navigate the hurdles of stricter scrutiny effectively, buyers and sellers alike need to conduct preliminary comprehensive regulatory assessments (which go well beyond the typical market share analysis and horizontal overlap inquiries) at the outset, prepare for increasing unpredictability in outcomes, factor in lengthier deal timelines and formulate strong regulatory strategies in order to avoid pitfalls along the way. Deal teams should also deploy additional tactics to mitigate regulatory risk, including through well-negotiated contractual terms and agile, effective approaches and responses to regulators.

It will be paramount for dealmakers to place greater emphasis on the regulatory provisions in acquisition agreements with the expectation of stricter regulatory scrutiny—many traditional deal terms have proven critical to manage the allocation of risk between the parties, some of which are emerging as new developments or simply regaining importance and ubiquity in light of the tougher regulatory environment. We have seen the following protections, mechanisms and themes play out in recent deals:

- Longer outside dates and heavily-negotiated terms regarding outside date extension rights
- Spike in usage and size of reverse termination fees triggered by the failure to obtain regulatory approval
- Usage of “ticking fee” mechanisms to compensate for delays (i.e., payments directly in exchange for, or an increase to the reverse termination fee upon, extensions to the outside date)
- Expansive formulations of customary closing conditions to capture developments in antitrust enforcement (including to address receipt of “warning letters” and/or entry into “timing agreements”)
- Increased focus in negotiations around the regulatory covenants, including which party controls the regulatory strategy, the scope of “efforts” generally required to obtain regulatory approval, and the level of divestitures or other remedies that can be imposed upon the buyer
- Covenants expressly requiring a commitment to litigate in order to obtain regulatory approvals (and potential “tolling” of the outside date pending litigation)
- Emphasis on the scope of interim operating covenants in light of lengthier interim periods and potential gun-jumping concerns

Dealmakers have also utilized a number of strategic tactics and approaches with regulators in responding and adapting to new enforcement trends. Among other strategies, we have seen parties more frequently pursuing preemptive measures and divestitures to alleviate potential regulatory concerns on the frontend, the use of “timing agreements” with the DOJ or FTC to delay closing a transaction for a period of time in order to allow investigations or discussions with the DOJ or FTC to be concluded, proactively asserting pro-competitive merits of a deal through white papers and offering formal remedy packages to regulators during extended but ongoing review periods. Buyers are also willingly (and, in a number of recent cases, successfully) defending challenges to transactions mounted by the DOJ and FTC through litigation.

Conclusion

Although a return to the record highs of 2021 may not be in store for the immediate future, it has been said that 2023 may bring a new normal to M&A. Amidst the uncertainty, one thing is certain: the M&A environment will continue to



pose challenges for dealmakers. In order to overcome structural hurdles posed by valuation gaps and higher acquisition financing costs, navigate enhanced regulatory scrutiny and transact successfully in an uncertain economic climate riddled with other challenges, conducting robust due diligence, effectively mitigating risks and getting the fundamentals of deal structuring and execution right will be more important than ever. Despite the headwinds, we expect savvy dealmakers who can successfully thread that needle—particularly well-capitalized strategics and private equity buyers with dry powder—will find compelling opportunities to unlock value and growth in 2023 and beyond.

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