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M&A monitor

January 2023

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Freshfields

Looking ahead following a challenging year for M&A

In this edition we reflect on dealmaking trends in 2022 and look ahead to 2023. We consider the macroeconomic and geopolitical impact on the M&A landscape this year and focus on the challenges ahead as signs of recovery start to appear.

Given the challenges in the dealmaking environment, we examine the merits of spin-offs as a meaningful alternative to M&A for companies considering strategic divestments. We look at how illiquidity and valuation challenges could affect dealmaking as the debt market readjusts, and we explore the trends in energy M&A as businesses transition to net zero. Finally, we round-up the year-end deal data.

M&A predictions and guidance for 2023

Tension between institutional shareholders and boards about strategic alternatives

We are emerging from several consecutive years where both activist shareholders and boards have been able to regularly count on institutional shareholder support for all-cash sales of companies at premia to recent trading prices. We will be entering a different environment in 2023 – where long-term, institutional shareholders have acquired their shares over the last several years at prices that not only are significantly higher than prices that represent a healthy premium to current trading prices, but also far exceed the ranges where financial analyses of the newest internal, management forecasts are putting both intrinsic values and future stock prices.

Against this backdrop, we are not necessarily going to be able to rely on institutional shareholder enthusiasm for cash sales of companies just because the transactions satisfy the traditional criteria of meaningful premia to recent trading prices and falling within the ranges of intrinsic values and future stock prices derived from internal management forecasts. The uncertainty and downsides that will be characterizing the forecasts that managements present to boards at the outset of 2023 will be fueling this tension between the approaches of boards and the approaches of

institutional shareholders to sales of companies in 2023.

These tensions between boards and their institutional shareholders over strategic alternatives may come as a surprise to many corporate clients. They will have run sale processes consistent with the latest guidance from Delaware Chancery decisions. In addition, many will have recently upped their games on shareholder engagement, “thinking like activists,” improving their investor relations messaging, being more transparent about longer term targets (rather than managing the markets only from quarter to quarter or even from fiscal year to fiscal year) and making shareholder-friendly governance concessions in a tactically wise manner. Nevertheless, we need to prepare for battles in 2023 for shareholder approvals of negotiated sales of public companies for cash consideration.

We are going to be spending a lot more time in 2023 convincing ISS, among others, why cash mergers merit their support. We may even start trying to structure more transactions as tender offers to avoid ISS recommendations, although regulatory timelines will continue to push us toward one-step mergers. Get ready for this tension. Advisors’ board presentations will show everything to be in order for a well-founded merger and then the chorus of objections emerge following the announcement.



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“ The playbook of the antitrust regulators is now clear: “Throw sand in the gears”

Commodification of private equity and the adventures of reliance on direct lenders and on equity commitments from the Middle East and sovereign wealth funds

The leveraged acquisition playbook for at least the outset of 2023 is going to be characterized by herding numerous direct lenders into leverage packages and negotiating supplemental equity commitments from the Middle East and sovereign wealth funds. The core private equity commitments are arguably commoditized at this point; it's the senior side of the capital structure and the supplemental equity that are going to require hard work.

Although the commitment papers from the direct lenders in 2023 may look similar to those from the commercial bank lenders that dominated much of 2022, the differences (and the additional burdens) will include the intensity of the diligence, the uncertainty of whether these lenders are “in” until much later in the game, and the sheer number of direct lender shops that may be needed to make this formula work given the relatively small checks each direct lender fund typically writes (due to the absence of follow-on syndication of their commitments). The big private equity bidders have internal teams that can coordinate this activity, but will middle market private equity buyers and

strategic buyers in need of leverage have the wherewithal to shepherd all this in 2023?

Meanwhile, the importance of money from the Middle East and sovereign wealth funds to fill out equity checks from the core private equity players is going to require special focus on CFIUS (as will the fact that some of the US private equity funds receive significant capital from the Middle East and Asia) and making sure that the entities signing these commitments are not just unfunded vehicles.

Outmaneuvering antitrust regulators in 2023

The playbook of the antitrust regulators is now clear: “Throw sand in the gears” – i.e., do everything possible to delay the transaction until the merger agreement’s “outside date” hits and one of the parties decides that it would be better to pull the plug and receive or pay the reverse break-up fee than extend the outside date. (Given antitrust paranoia, it is fair to expect reverse break-up fee structures, for better or worse, to be pervasive in merger agreements in 2023 even in the face of strong antitrust undertakings by buyers).

In 2023, we will see merger parties better prepared to counter the regulators’ strategy successfully. More M&A clients will adopt, from the outset of their merger discussions, clear strategies for:

- fix-it-first remedies,
- expediting responses to document and information requests from antitrust regulators,
- proactive management and leverage of the UK CMA-EC-FTC/DOJ triangle (as opposed to having these agencies leverage this triangle against us), and
- most importantly, engagement in litigation against those antitrust regulators that throw up roadblocks.

The “sand in the gears” strategy of the regulators will not work when clients get their act in order upfront on these items, and clients are now realizing this. Merger parties have learned the hard way that being reactive and planning on the fly plays into the “sand in the gears” strategy of the antitrust authorities, and that success is within reach by proactively managing timing risks (through expedited handling of requests and other process matters) and substantive risks (through fix-it-first) and, most importantly, by having a clear litigation action plan to ensure success.

In the past, boards, when considering a merger, would rather shutdown merger discussions than have to plan out in advance litigation strategies for obtaining antitrust clearance. That will change in 2023. The antitrust agencies have challenged merger parties to enhance their approaches to overcoming regulatory impediments, and the challenge will be accepted in 2023.

Reverse-CFIUS, CFIUS and foreign investment and national security regulations – the minefield expands

The word from our colleagues in Washington is that the US government now wants to figure out how to regulate or at least start monitoring closely not only inbound foreign investment (CFIUS) and the sale and licensing of sensitive technology and other key resources (OFAC; export control), but also outbound investment generally. The objective of this “reverse CFIUS” idea is not to restrict cash outflows (e.g., China has plenty of cash), but to regulate and monitor the spread of US legitimacy, managerial know-how and other intangible benefits to a foreign company that come from having, say, a name-brand US private equity house or a marquee US brand in its stockholder profile. This regime has yet to be promulgated but it is coming in 2023. Who knows what kinds of reciprocal restrictions (on investing in the US) other countries will impose on their local sources of capital as a response? As one China-born CEO of a US-based public company put it to me in December: The US and other western governments want to borrow ideas from the Chinese government.

Meanwhile, the scope of CFIUS and non-US foreign investment and national security regimes continues to expand on a monthly basis. Many merger parties in 2023 are going to underestimate the magnitude of the effort necessary to figure out not only all the foreign investment clearances required but also their impacts on timing and substantive execution risk. There will be embarrassments and frustrations in 2023 on this front.

Leveraged spin-offs – the default choice for separation transactions in 2023

Investors will never let go of their push for portfolio rationalization and separation out of non-core assets. Leveraged spins are going to be one of the alternatives of choice in 2023 for addressing this objective.

Even with prices obtainable in straight divestiture sales and carve-out IPOs way down during the initial months of 2023, there will always be the spin-off alternative if the non-core asset in question is sufficient to float on its own, even as a small cap.

Investors will continue to love tax-free spin-offs because they permit the shareholders to retain both upside opportunity and liquidity in the SpinCo and because most SpinCo's will be able to navigate the tax restrictions to position themselves to be sold quickly at a premium when markets eventually become frothy again in the coming years. Meanwhile, despite limited debt markets, leverage-lite is still usually available to put on the SpinCo and enable the parent to keep the cash proceeds to boost the core business that remains behind. (See the following article in this edition for more detail on this strategic alternative to M&A.)

Mergers of equals – will boards be heroic in 2023?

Here's where the difference between what “should” happen and what “will” happen may differ in 2023. If you are a director looking at management's outlook for the next 15 months, there's a good chance that you are thinking, “I don't want to be a director of an underperformer for 2023.” One solution is to find a complementary

company facing similar challenges, determine if there are some attractive revenue and cost synergies, whether antitrust clearance is doable, whether the two corporate cultures are compatible, and, if these boxes can all be checked, then do an all-stock merger based on a fair, relative valuation. That often means an at-market exchange ratio, but may mean something slightly different after further analysis of trading multiples. In any event, the key to such an all-stock merger-of-equals transaction is not any premium to market trading prices in the exchange ratio, but the value generation for shareholders from the synergies and multiple potential bumps.

Yet, it takes heroic boards and management teams to get these deals done. Why? Because, by definition, 50% of the directors and executives from the two companies are going to be out of a job or in less glamorous positions at the combined company by the day after closing. These are the deals that “should” be happening in 2023 and many directors know it. Whether they “will” happen remains to be seen. To the extent they do not happen, we will start to see more dispersion among the underperformers in 2023 and those directors and executives at companies performing poorly relative to peers in the tough times of 2023 will be prime personal targets for activists and will wish they had been cheerleaders for an accretive merger of equals even if it meant not having a personal role at the combined company after closing.

Sell or spin? The strategic alternative to M&A



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Spin-offs can present an attractive alternative to M&A for companies considering strategic divestments and given the challenges to dealmaking in the current environment – illiquid capital markets presenting financing issues, counterparties struggling to agree pricing assumptions in an uncertain macro environment and regulatory hurdles to deal execution continuing to grow – we expect this to continue into 2023. This is particularly the case in sectors such as industrials and pharmaceuticals, which are dominated by conglomerates that have grown inorganically through acquisitions and in which these separate businesses have retained some degree of independence and separation from the wider group.

Spin-off transactions can be structured in different ways but ultimately involve the distribution by a listed company of shares in its subsidiary (the SpinCo) to its shareholders, thereby establishing two separately owned and managed companies. They are attractive to companies if there is a belief that the trading value of the group is less than the sum of its parts and this value can be realised if otherwise distinct divisions or businesses are able to trade separately. Often, the SpinCo will benefit from refreshed management focus, or may be freed from costs or regulatory constraints associated with the remaining group that previously

weighed on its valuation. The spin may also attract new investors with a more specialised focus. It is also frequently the case that the tax base for the SpinCo assets held by the parent company is low because they have been held for a significant period of time. This again leads to pressure on achieving a satisfactory valuation multiple in a M&A transaction to justify the tax on the capital gain, which is difficult in the current environment. Conversely, a spin-off will usually be structured to be tax-neutral for the parent, and the market can be left to its own devices to determine the appropriate valuation over time.



Companies should also expect an increase in share price volatility in the short-term following the spin-off as the market adjusts to repricing the separate investment proposition presented by each company.

Tread carefully

It is worth bearing in mind, however, the potential pitfalls in achieving a spin-off. An obvious factor that will need to be considered is the potential for dis-synergies to be created by duplicating public company and back-office functions and overheads, and whether these may outweigh the perceived benefits of other cost savings. Companies should also expect an increase in share price volatility in the short-term following the spin-off as the market adjusts to repricing the separate investment proposition presented by each company, and as investors take the opportunity to adjust portfolios. Company boards may be reluctant to proceed with a spin when equity capital markets are uncertain, with the potential embarrassment factor to consider of a post-spin drop in share price, that may leave investors unhappy that a third-party sale was not pursued. Also, the effect on the inclusion of the parent company and SpinCo in relevant share indices needs to be considered.

While a board may have greater confidence that a spin will complete compared to a third-party sale which is conditional upon antitrust or other

regulatory approval, our experience advising multinational conglomerates on complex spin-off transactions shows that a pre-spin reorganisation may still trigger foreign investment filings in many jurisdictions around the world. Depending on the nature of the transaction, it may be reasonable to expect these to principally be technical filings rather than substantive approval processes, but the cost and resource impact should not be overlooked. Additionally, issuers will need to consider the jurisdictions in which its shareholders are based to determine whether the spin-off requires a prospectus or other disclosure documentation to be prepared under overseas securities laws, or a waiver to be sought from applicable securities regulators. The impact of such regulatory processes can be significant and should be planned for well in advance.

Preparation is key

The extent to which the SpinCo is integrated within the parent company will determine the level of post-closing transitional support that is required – if separating the businesses will require the parent to commit to an expensive

long-term transitional support arrangement for the SpinCo, the spin-off might seem less appealing than a sale to a strategic acquirer that may be more able to support SpinCo with its existing infrastructure from day one. The complexity of setting up both short- and long-term transitional arrangements, putting intra-group arrangements onto arm's length terms in a tax efficient manner, or creating the distributable reserves needed at the parent company level to spin the assets to shareholders are just some of the factors that contribute to the typically long lead times (as well as costs and management time) required to achieve a spin-off. All this needs to be appropriately weighed against a sale which may be simpler in certain respects and through which the company will receive at least some proceeds.

Whether or not a spin-off transaction is the best course of action for a company looking to dispose of a business unit will depend on a multitude of factors, but as we look ahead into 2023, we expect it will remain a meaningful alternative to M&A for a wide range of companies.

Signs of recovery in debt market emerge

After a record-breaking deal year for private equity in 2021, 2022 was rather different. The impact of the war in Ukraine was felt in many countries as supplies of energy, food and other commodities became more precarious, leading to increased costs and rising inflation. The low interest rate environment that supported leveraged investments over recent years ceased with many central banks around the world ending quantitative easing and raising interest rates. Additionally, government debt levels remain elevated as a result of state support provided during the pandemic.

Against that background, debt and equity investors slowed down investments as they re-assessed valuations, projections and return expectations. In Europe, this led to reduced buy-out activity throughout most of 2022, both as a result of the gap in valuation between buy-side and sell-side and the reduced availability of debt in the syndicated loan and bond markets. Direct lenders were able to gain increased market share as equity investors looked for liquidity and opted for certainty on price and terms in an uncertain market.

Lack of liquidity and investor confidence has meant that processes to obtain committed debt financing in 2022 have taken longer than usual. Negotiation with a large number of direct lenders – and sometimes CLOs directly in parallel – has been required to ensure that financing commitments are obtained on common terms by the relevant bid deadline. Many direct lenders required frequent renewals of committee approvals, leaving equity investors uncertain as to the quantum and terms of debt for the proposed

investment until signing, affecting equity investors' ability at times to progress terms meaningfully on the acquisition side. As investor confidence improves, we expect timelines will return to normal and processes for syndicated debt and direct lending deals will be run in parallel, with fewer direct lenders needing to be approached.

Alternative capital providers on the rise

We expect private credit providers to continue to grow assets under management and to continue to provide an alternative source of credit for transactions in competition with the syndicated loan and bond markets.

Positive signs of initial recovery in the debt markets and increased new deal activity have appeared towards the end of 2022. As we move into 2023, investors are hopeful that a new normal will be found on debt pricing and valuations – which will be one of the key challenges for the new year – with increased deal activity expected as a result.



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Climate crisis drives dealmaking



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In the wake of COP27, companies across the globe are reassessing their net zero plans, science-based targets, and offsetting strategies. At the same time, the use of hydrocarbons continues to rise and is some distance from its predicted peak. As a result, investments in hydrocarbons are still expected to be a mainstay of 2023. That said, we also expect many companies to remain on course with planned transitions to net zero, either because climate change is jeopardising their business, or they can see commercial opportunity from being part of the solution – or both.

Beyond hydrocarbons?

The energy sector had a bumper year in 2022 with profits rising to new heights, due to tensions between China and the West, the war in Ukraine, and global supply issues, resulting in rocketing energy prices. Against this background, we have seen continued investment in hydrocarbons, as many players focus on security of supply and diversified sources of energy rather than face the consequences of energy shortages or unscrupulous suppliers. Driven by continued strong global demand for energy, especially in Asia, and ever-increasing demand in Europe, investments into upstream LNG as well as related downstream infrastructure are forecast to keep growing for the next few years. Whilst hydrocarbons are still expected to be a source of energy

for years to come, the recognition of the threats of climate change means that policymakers are increasingly steering capital away from carbon intensive businesses. The combination of ESG pressures, Europe's taxonomy regulation and central banks' policies are leading many investors and banks to decarbonise their portfolios. This opens up opportunities for investors to focus on the transition from hydrocarbons to renewable sources rather than avoiding carbon-intensive assets. We therefore expect increased investment activity. To succeed, investors will need to navigate the evolving regulatory backdrop of subsidising, capping and restricting energy supply and prices, and increased scrutiny under foreign investment and national security regimes.

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**Public grants
are being made
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industrial
applications.**

Sustainable balance – with momentum

It is increasingly recognised that the climate crisis will only be solved through international collaboration. The G7 climate club initiative as well as the Inflation Reduction Act in the United States are evidence that more action is needed to achieve the goals of the Paris climate agreement.

To achieve net zero, the search is on for scalable and cost-effective green technologies. Public grants are being made available to bridge the profitability gap of decarbonised industrial applications. One notable example is the United States DOE's 'Hydrogen Shot' programme, which started in 2021 and seeks to reduce the cost of clean hydrogen. Another example is Europe's requirement to balance short to mid-term energy needs with longer term green energy targets. This dilemma becomes evident in the push for investment in fast-track new LNG import terminals. This new infrastructure, if operated for the usual 25 to 35 years, would be in stark conflict with the net zero ambitions of the European Union, unless they can be converted from LNG supply to the supply of hydrogen or its derivatives.

Outlook for 2023 and beyond

We expect investment into renewables to remain in high demand. We therefore expect to see new partnerships and increased competition for renewable or other decarbonising investments. The focus on renewables will sit alongside the expected continued investment in hydrocarbons in the short and medium term.

Investment in the development of innovative technology is key to achieving net zero. Whilst some markets are open to exploring technologies that may be perceived as controversial or experimental, such as fracking, carbon capture and utilisation/storage or new nuclear solutions, others are more reluctant. Overall, we believe investment in this area is likely to increase, particularly in novel green technologies.

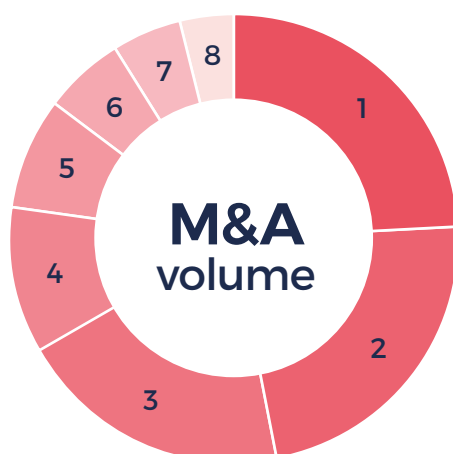
Finally, volatility in energy prices as well as in new regulations will keep the players in the sector on their toes. Constant monitoring and adaptation, both when developing and investing into new assets or managing existing portfolios, will be key to success.

Global M&A Q4 2022, activity by sector



Sector	Value \$bn	%
1 TMT	920.2	23.87
2 Industrials and materials	737.1	19.12
3 Consumer*	544.5	14.12
4 Financials	469.3	12.17
5 Energy and power	367.9	9.54
6 Real Estate	298.9	7.75
7 Healthcare	298.7	7.75
8 Infrastructure and transport	218.3	5.66
Total	3,854.70	100

* Includes retail



Sector	Volume	%
1 TMT	9,906	24.17
2 Consumer*	9,358	22.83
3 Industrials and materials	8,154	19.89
4 Financials	4,315	10.53
5 Healthcare	3,250	7.93
6 Real estate	2,379	5.80
7 Energy and power	2,115	5.16
8 Infrastructure and transport	1,513	3.69
Total	40,990	100

* Includes retail

Global M&A Q4 2022 – value and volume

Global*	USA*†	Europe*†	Asia-Pacific*†
M&A value \$3,855.04bn	M&A value \$1,732.24bn	M&A value \$958.44bn	M&A value \$832.28bn
M&A deal volume 41,004	M&A deal volume 10,215	M&A deal volume 12,892	M&A deal volume 13,432
Top 3 deals	Top 3 deals	Top 3 deals	Top 3 deals
1 Activision Blizzard/ Microsoft \$68.7bn	1 Activision Blizzard/ Microsoft \$68.7bn	1 Atlantia/ Schemaquarantatre \$52.1bn	1 Housing Development Finance/HDFC Bank \$60.4bn
2 VMware/ Broadcom \$68.3bn	2 VMware/ Broadcom \$68.3bn	2 Firmenich International/ Koninklijke DSM NV \$20.7bn	2 Ramsay Health Care/ Investor Group \$22.1bn
3 Housing Development Finance/HDFC Bank \$60.4bn	3 Twitter/ X Holdings I \$40.2bn	3 Swedish Match/ Philip Morris Investments \$17.2bn	3 Baring Private Equity Asia/EQT \$7.5bn
Inbound: most targeted markets	Inbound: markets investing into US companies	Inbound: markets investing into European companies	Inbound: markets investing into Asia-Pacific companies
US 10,215 deals ◀ \$1,732.2bn	US 8,387 deals ◀ \$1,526bn	UK 2,310 deals ◀ \$269.2bn	China (mainland) 3,383 deals ◀ \$241.4bn
UK 3,185 deals ◀ \$386.7bn	Canada 336 deals ◀ \$37.7bn	US 1,600 deals ◀ \$192bn	Japan 3,324 deals ◀ \$113bn
China (mainland) 3,719 deals ◀ \$272.8bn	UK 259 deals ◀ \$25.6bn	Italy 568 deals ◀ \$65.1bn	India 706 deals ◀ \$110.3bn
Outbound: most acquisitive markets	Outbound: markets US companies are investing into	Outbound: markets European companies are investing into	Outbound: markets Asia-Pacific companies are investing into
US 11,250 deals ▶ \$1,875.2bn	US 8,387 ▶ \$1,526bn	UK 2,183 deals ▶ \$257.1bn	China (mainland) 3,488 deals ▶ \$240.5bn
UK 2,901 deals ▶ \$330.5bn	UK 537 deals ▶ \$72.1bn	US 761 deals ▶ \$88.1bn	India 1,171 deals ▶ \$113.8bn
China (mainland) 3,630 deals ▶ \$257.3bn	Netherlands 177 deals ▶ \$34.7bn	Italy 667 deals ▶ \$72bn	Japan 3,162 deals ▶ \$108bn

Financial sponsor M&A – top 3 deals with buy-side financial sponsor involvement



* Deal value includes net debt of target | † Includes domestic deals | Source: Refinitiv | Data correct to 31/23

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