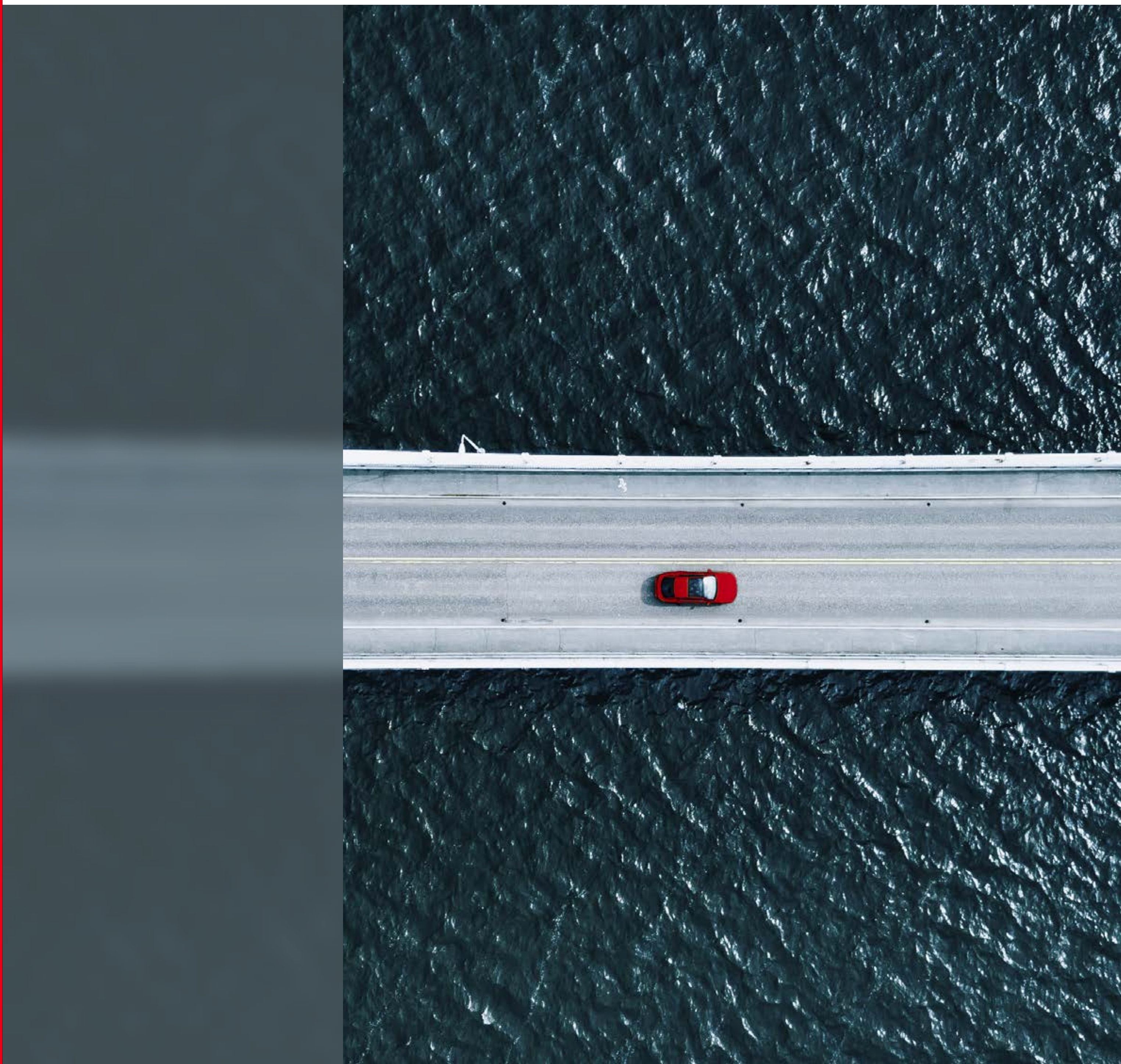
The ABC's of Private Equity M&A: Deal Flow Impacts of AI, Big Tech and Climate Change



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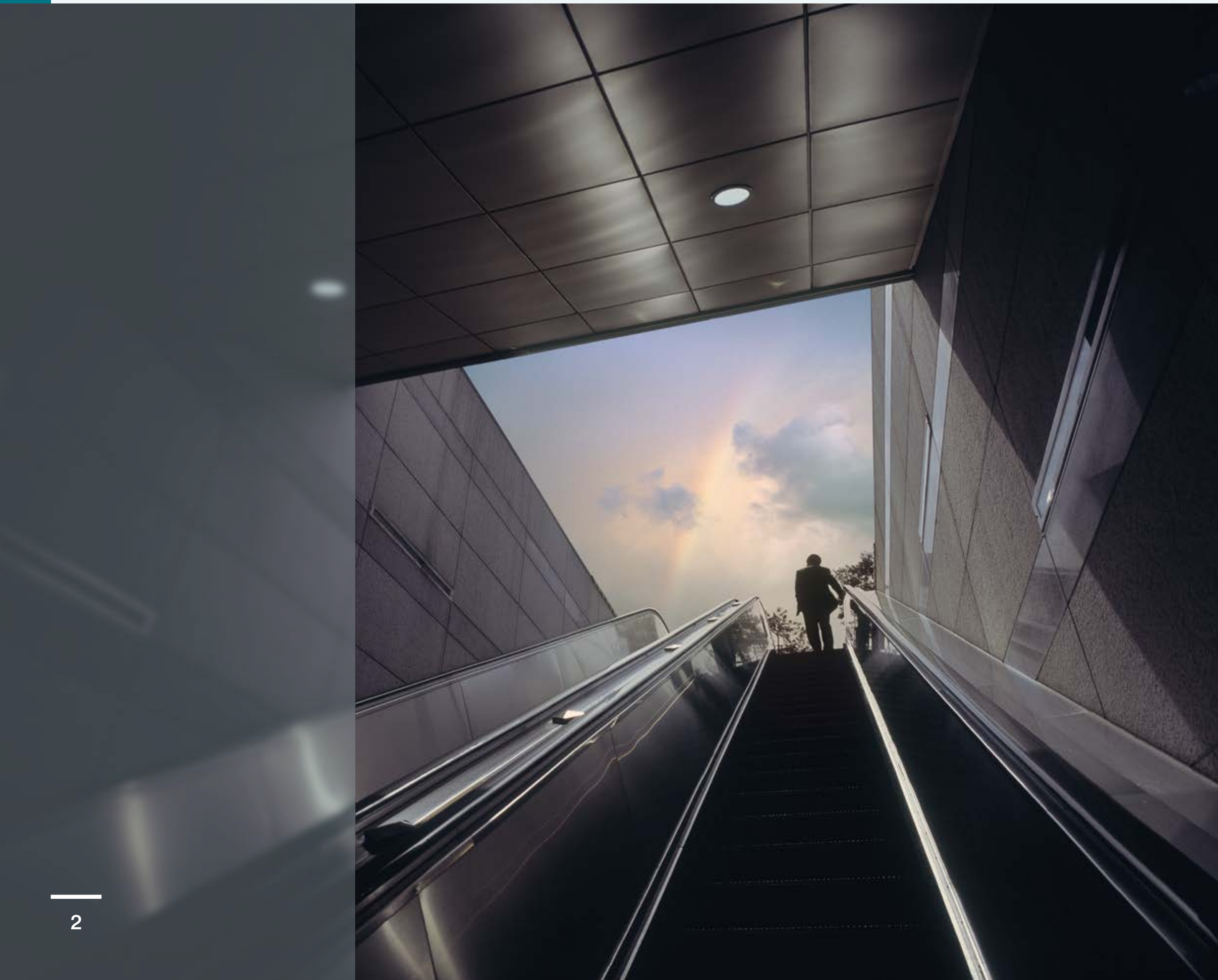
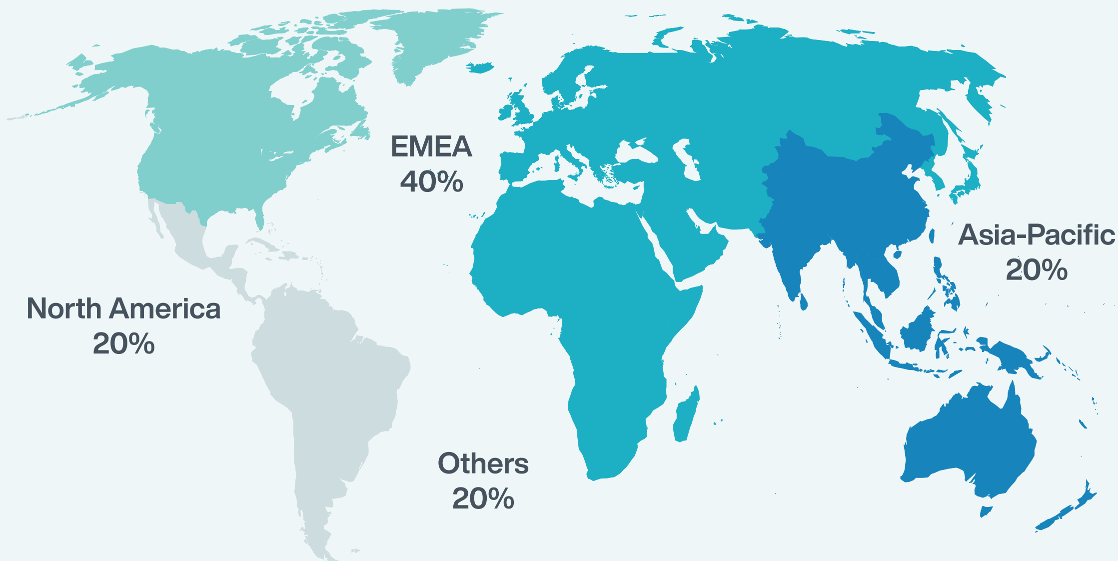


Methodology

In the first quarter of 2024, Mergermarket surveyed 25 senior executives from corporate development teams and private equity. The demographic distribution of the respondents is in the below map.

Mergermarket Survey



- Survey included a combination of qualitative and quantitative questions.
- All interviews were conducted over the telephone by appointment.
- Results were analyzed and collated by Mergermarket.

Foreword

The global mergers and acquisitions market has hit the ground running so far this year, despite the persistent challenges posed by uncomfortably high interest rates and one of the most difficult geopolitical climates in recent memory.

The majority of central banks globally are grappling with curbing inflation while avoiding derailing economic growth. The higher cost of capital that is a natural function of higher rates continues to make debt financing expensive, forcing both corporates and private equity firms to be more price sensitive and disciplined in their due diligence approaches.

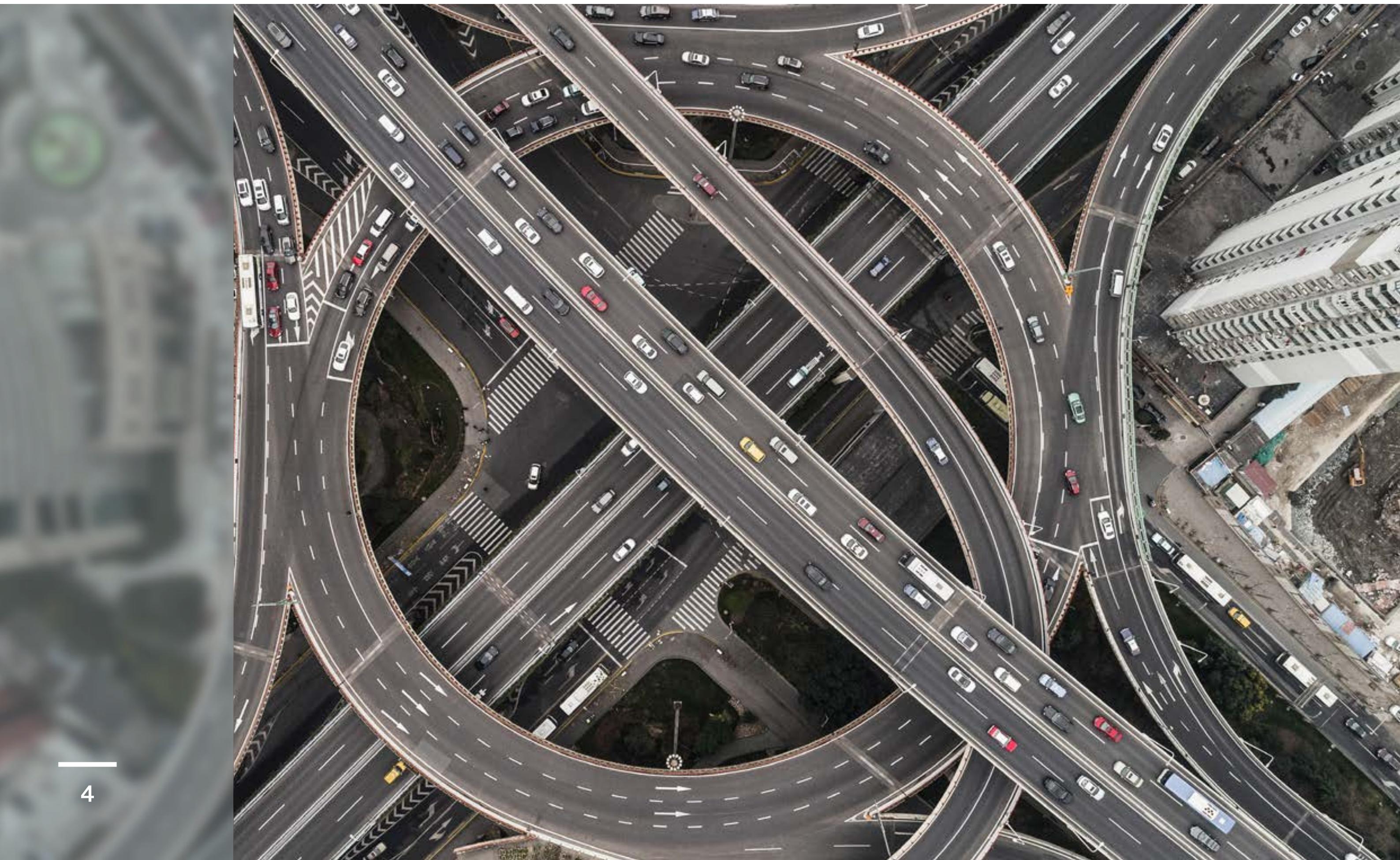
Dealmakers are also having to adapt to an increasingly demanding regulatory landscape shaped by the urgent need to address environmental, social, and governance (ESG) concerns. The growing focus on sustainability and antitrust by policymakers is adding new layers of complexity to transactions.

The rapid advancement of artificial intelligence (AI) is also motivating dealmakers to capitalize on this technological sea change, with many viewing AI as a key driver influencing their buy-side strategies. At the same time, the importance of thorough due diligence has never been greater, with cybersecurity, supply chain resilience, and ESG factors becoming critical considerations in assessing potential acquisition targets.

This report examines the current M&A landscape, focusing on the unique perspectives and strategies employed by private equity firms and corporates. While both groups are keen to capitalize on opportunities presented by the market, they have unique objectives and face distinct challenges when making investment decisions.

The report also explores the exit strategies employed by strategics and sponsors, highlighting the growing popularity of alternative routes such as continuation funds and other secondary transactions that have served as a critical liquidity lifeline in a notably slower exit environment.

In a complex M&A landscape, it is only the most adaptive executives who will be able to respond to today's myriad opportunities and challenges and thus create lasting value in their deals.



Key Findings

A Brighter Future

Dealmakers are optimistic about the next 12 months, with 64% of respondents expecting M&A activity to increase. This is likely to be driven by improving market conditions and capital availability, despite ongoing challenges presented by today's elevated interest rate conditions.

Tighter Rules

Regulatory frameworks are the top focus for 28% of respondents when evaluating potential deals, with the latest US Merger Guidelines signalling a shift towards more stringent antitrust enforcement and sustainability-related regulations such as the EU's Corporate Sustainability Reporting Directive and forthcoming Corporate Sustainability Due Diligence Directive ratcheting up.

IT and ESG in the Spotlight

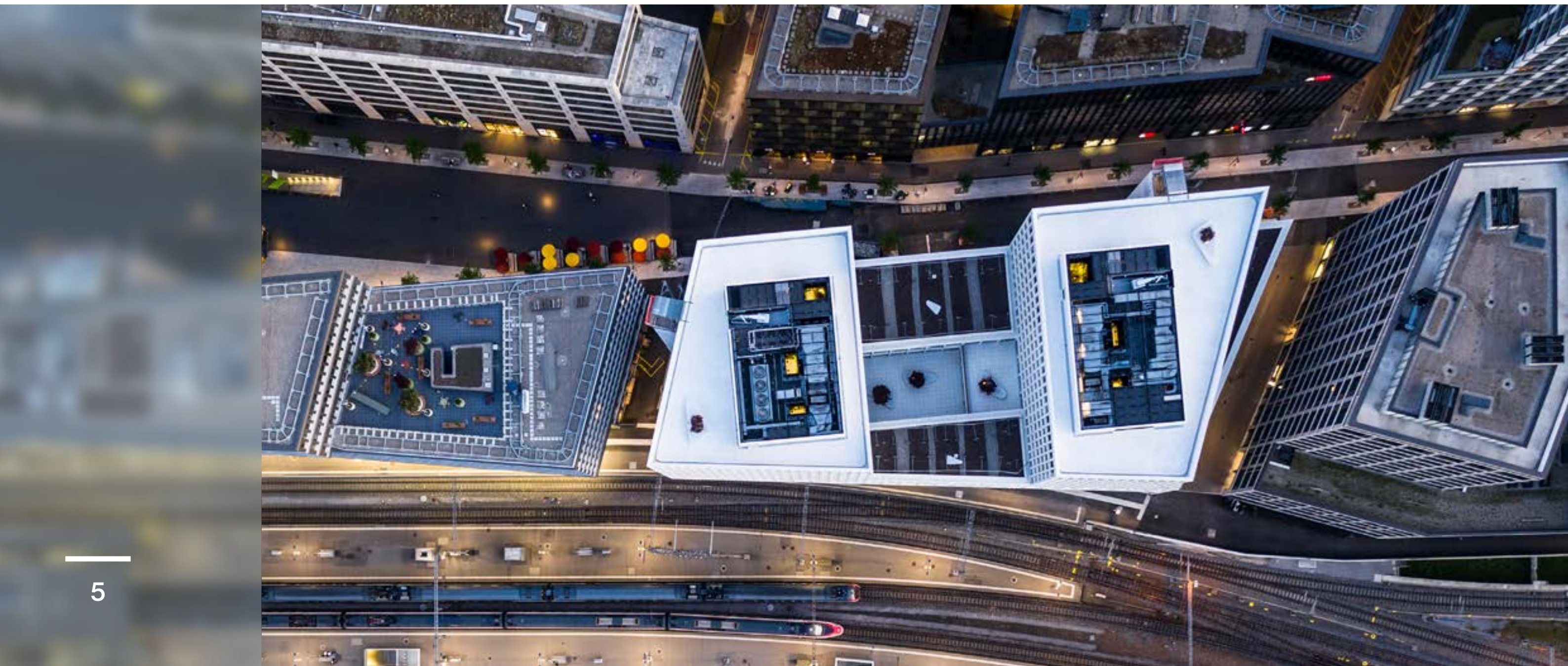
Information technology and environmental and climate risk due diligence have become the most critical areas when evaluating transactions over the past year. More than half (52%) of respondents selected each as crucial for identifying potential liabilities and value creation opportunities, forcing dealmakers to adapt their risk assessments.

Clean Breaks

Sales to corporate buyers are expected to be the most dominant exit routes in the next 12 months (44% of respondents), as investors seek clean breaks from their assets and strategic premiums to maximize value. This is followed by continuation funds and secondary transactions (32%), which provide critical liquidity alternatives to PE investors amid a slower exit environment.

Artificial Intelligence Gets Real

AI is a key focus for private equity firms, with 76% indicating that technology and AI-enabled acquisitions will significantly influence their buy-side strategies, while 48% prioritize add-on transactions to strengthen existing investments and achieve synergies.



Part 1: Deal Flow Dynamics

Following a slower period for M&A starting in 2022, big deals are back and dealmakers are more bullish about the future, but challenges such as climate change and geopolitical tensions are tempering this growing optimism.

In one sense, global M&A has made a strident comeback so far this year. First quarter activity shows that US$914bn-worth of acquisitions were announced, a full 46% year-on-year gain, according to Mergermarket data. At the same time, the number of transactions over this period decreased by 9% to 9,528, as higher rates and a degree of uncertainty have tempered the market's animal spirits.

Ample cash reserves on corporate balance sheets are spurring these big-ticket transactions, with the private equity industry's contribution to total deployed capital lagging. Buyout firms announced US$254bn of transactions globally in the first three months of the year, a 26% increase.

Instead, sponsors have been focusing more on smaller, less leverage-intensive deals, with PE deal volumes jumping by 18% year-on-year to 2,575 transactions. Further illustrating this trend, private equity's share of total M&A value in Q1 this year stood at 28%, down from 32% in the first quarter last year.

In essence, megadeals are back, particularly in resilient sectors like energy, financial services, healthcare and technology, but broad-based activity continues to lag. Major transactions included US-based Capital One's takeover of rival lender Discover Financial Services, valued at US$35.3bn, and Synopsys's US$35.3bn purchase of Ansys, which saw the tech giant buy into the AI-augmented simulation software arena.

While jumbo deals are being announced, headwinds continue to blow. Over the first half of this year, rate cut expectations in the US were pushed back due to slowing disinflation and relative economic strength. The US annual inflation rate in April was 3.4%, only slightly lower than March's 3.5%. Combined with a robust labor market and still rising GDP, the Federal Reserve took the decision to delay a pivot that was previously expected as early as June.

However there has been some movement on monetary policy in other markets, with both the European Central Bank and Bank of Canada reducing their headline rates by 25bps in June, signalling that a more accommodative path is within reach. Further progress on rates will reduce the cost of capital and could see private equity begin to back larger deals once again.

M&A momentum

However, all things considered, M&A momentum is demonstrating remarkable resilience to today's macro pressures. Our survey further supports this positive outlook, with the majority of respondents expecting deal activity to rise in the next 12 months.

Specifically, 4% anticipate a strong increase and 60% predict a moderate rise, these expectations being driven by improving market conditions and capital availability.

Technology and wider telecommunications, media and tech (TMT) sector continues to dominate M&A activity from both a value and volume perspective. Key deals, such as Synopsys's purchase of Ansys and Hewlett Packard Enterprise's US$14.3bn bid for Juniper Networks, highlight the ongoing demand for technological advancements and integration capabilities. The sector is expected to remain highly active, driven by continuous innovation and digital transformation needs. **According to our survey, 40% of respondents expect technology to be among the most active sectors in terms of M&A dealmaking over the next 12 months.**

Powering up

The energy, mining and utilities (EMU) sector has been a significant contributor to the increase in M&A value. The transition towards renewable energy sources and the need for technological innovation in energy efficiency are driving consolidation and strategic acquisitions. In addition, elevated prices for metals such as gold, copper and nickel and rising demand for critical minerals like lithium, cobalt, and rare earth elements, are motivating mining companies to consolidate to secure essential resources.

These resources are integral to advancing technological innovations and supporting the global shift towards renewable energy. **Nearly a third of survey respondents (32%) believe that renewables will be one of the most active sectors for M&A, while 28% say the same for more traditional energy deals.**

Rattling sabres

The most urgent risk to today's improving M&A market is the fractious geopolitical environment. Iran's unprecedented attack on Israel in April raised the prospect of threat escalation in the Middle East and adds to the long-term competitive stand-off between the US and China. Recent tensions in the South China Sea between Asia's largest superpower and Taiwan also pose a substantial threat. **Indeed, geopolitical conflicts are perceived as the most significant risk to dealmaking, with 28% of survey respondents identifying it as the top macro factor.**

> "Geopolitical conflicts threaten to impact the target origination and selection process," says the managing partner of a private equity firm in Spain. "Decisionmakers might prefer to refrain from investing in good opportunities if the target is in a region of a conflict. We have to change our perspective completely here in terms of which targets have the best prospects in the short and long term."

Regional conflicts, trade tensions and shifts in international alliances create an unpredictable environment, not only affecting investor confidence and cross-border transactions, but also upending supply chains. **Consistently, supply chain disruptions remain a critical concern and are also highlighted by 48% of respondents as a significant risk to M&A.**

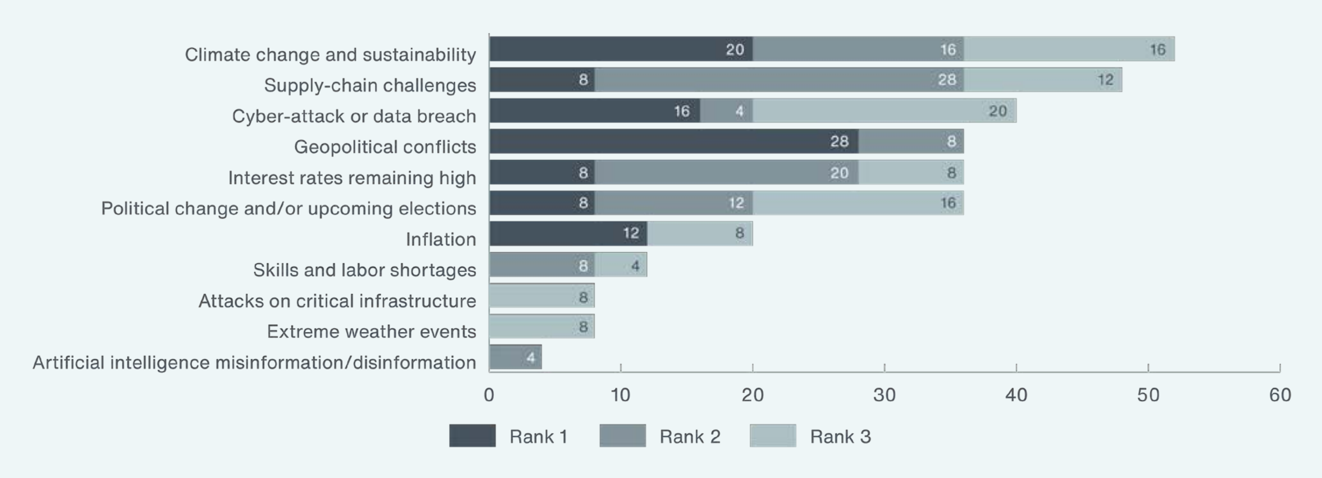
Geopolitical tensions continue to exacerbate supply chain vulnerabilities exposed by the COVID pandemic. That said, the desire among companies to nearshore – bringing production closer to home and better securing supply chains – could also provide the rationale for further M&A activity.

Meanwhile, 52% highlighted climate change and sustainability as posing a major risk to dealmaking. This threat stems from both the direct physical impacts of climate change and the potential for regulatory and market shifts as the world transitions to a low-carbon economy. Failure to properly account for climate and sustainability risks in M&A transactions could lead to significant financial losses and reputational damage in the future. Acquirers must carefully evaluate a target companies exposure to these risks under various climate scenarios and time horizons, assessing the adequacy of their physical risk defenses and measures. It is equally important for the soundness of a companies governance and its ability to adapt to both market and regulatory expectations.

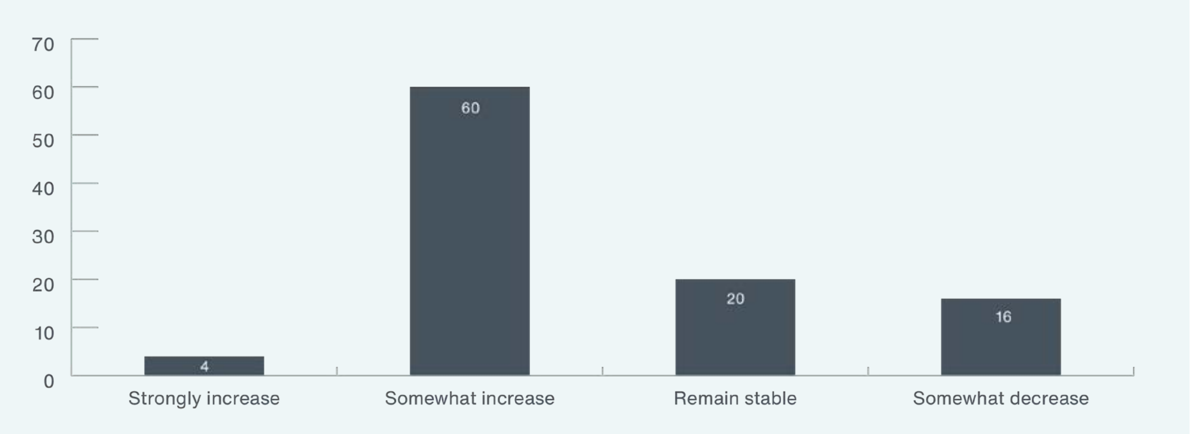
As the director of M&A at a Canadian corporate shares, this is not always straightforward:

> "Addressing the climate change risks has become a priority. We cannot delay plans to increase decarbonization activities. Considering a target's potential to decarbonize operations is tough. We do not always possess the right information in this regard and companies are not particularly forthcoming. We have to use external sources to gather information, which may not be accurate."

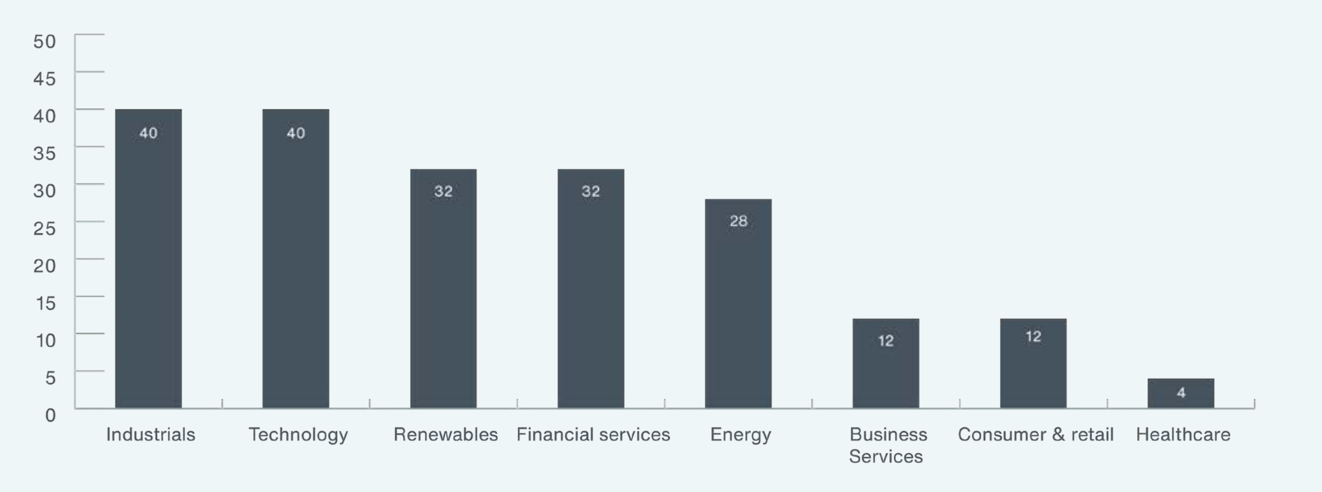
1. Which of the following macro factors currently present the biggest risks in M&A dealmaking? (Select top three and rank 1-2-3, where 1 = biggest risk)



2. How do you expect the level of M&A activity to change over the next 12 months? (Select one)



3. Which of the following sectors do you believe will be the most active in terms of M&A dealmaking over the next 12 months? (Select top two)



Part 2: The Mechanics of M&A

Buy-side dealmaking is set to increase in the next 12 months, so are valuations. Meanwhile, executives will be focusing on IT and ESG due diligence to get those deals across the line.

Corporates are sitting on copious cash stockpiles and private equity funds have war chests stocked with dry powder. It's estimated that non-financial US companies held approximately US$7.9tn in liquid assets in Q1, up from US$6.1tn four years ago, while European companies outside of the finance sector had €22.1tn as of 2022 (the most recent reading). Meanwhile, financial sponsors currently have some US$2.5tn in cash reserves.

In line with this firepower, a 60% majority of respondents indicate that buy-side dealmaking will be their primary focus over the next 12 months. The wall of capital available should ensure competitive tension for deals and investors are expecting asset prices to tick upwards, although not excessively so.

Taking into account the valuation movements over the previous six months, 16% of respondents expect valuations to strongly increase over the next six months, while 72% anticipate only a slight increase.

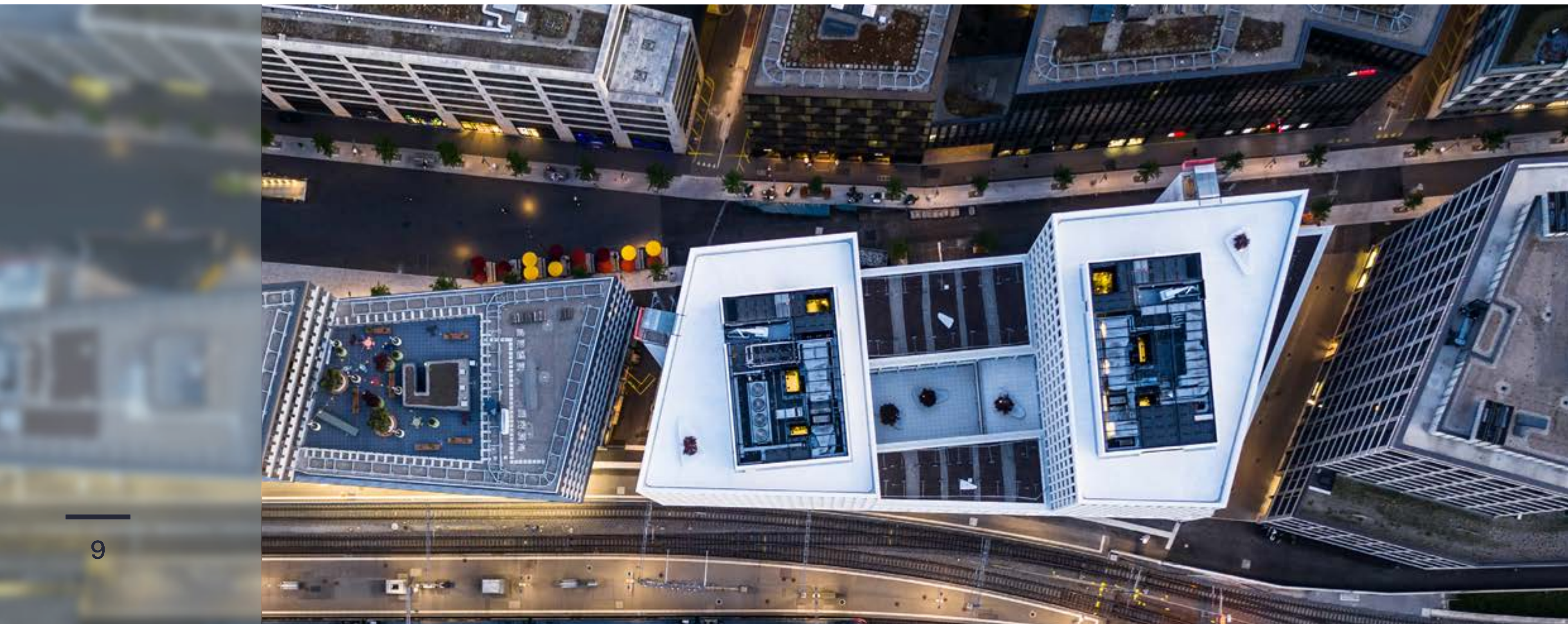
Playing by the rules

When considering these forthcoming transactions, dealmakers have one aspect above all others on their minds i.e; regulation. **Our survey found that 28% of respondents flag regulatory frameworks as their number one focus when weighing potential deals and a further 24% have this as their second priority area.**

The latest Merger Guidelines, introduced by the Federal Trade Commission (FTC) and Department of Justice (DOJ) in December, mark a significant shift towards more stringent antitrust enforcement in the US. “It's essential to know the level of scrutiny, the compliance requirements, and the challenges that may be faced during and after the deal,” says the head of strategy at a US corporate.

The biggest changes include lowering market concentration thresholds that trigger presumptive illegality, increasing scrutiny on vertical mergers, and addressing competitive harm in labor markets.

Additionally, the guidelines emphasize concerns with serial acquisitions, partial ownership, and minority stakes. Moreover, sustainability regulations are ratcheting up in various jurisdictions, with the US increasingly following Europe's lead in mandating climate-related disclosures and setting net-zero targets, adding another layer of complexity for dealmakers to navigate when assessing potential acquisitions and their long-term viability.



Doing your diligence

Acquirers have an expanding catalog of risks to consider when evaluating deal targets, increasing the scope of their due diligence exercises. **Over the past 12 months, information technology and environmental and climate risk due diligence have become the most important areas when evaluating transactions, with 52% of respondents selecting each as critical.**

As the impacts of climate change become more apparent and regulatory pressures increase, it is essential for acquirers to assess both the physical risks posed by climate change and the transition risks associated with the shift to a low-carbon economy.

> "Dealmaking is now being significantly impacted by climate risks and sustainability," says a global director of M&A and strategy at a French corporate. "We have to include stricter due diligence methods to identify sustainability risks. Not identifying the underlying risks will lead to liabilities and management challenges down the line."

Physical risks include acute hazards such as floods, wildfires, and hurricanes, as well as chronic threats like rising sea levels, drought, and extreme temperatures. These risks can lead to direct damage to assets, supply chain disruptions, and business interruptions. Acquirers should evaluate the target's exposure to these risks under various climate scenarios and time horizons and assess the adequacy of their physical risk defenses and adaptation measures.

Transition risks arise from the policy, legal, technology, and market changes that are expected to occur as the world moves towards a low-carbon future. These risks can impact a target's revenues, operating costs, capital expenditures, and access to capital.

Acquirers should assess the maturity of a target's approach to managing transition risks, including their alignment with Task Force on Climate-related Financial Disclosures (TCFD) recommendations, their performance relative to industry peers, and their plans for mitigating potential financial impacts.

Conducting thorough environmental and climate risk due diligence enables acquirers to make more informed decisions about the long-term value and resilience of a target. It can help identify opportunities for value creation, such as investments in clean technologies or climate adaptation measures, as well as potential liabilities that may affect the deal's financial structure or valuation.

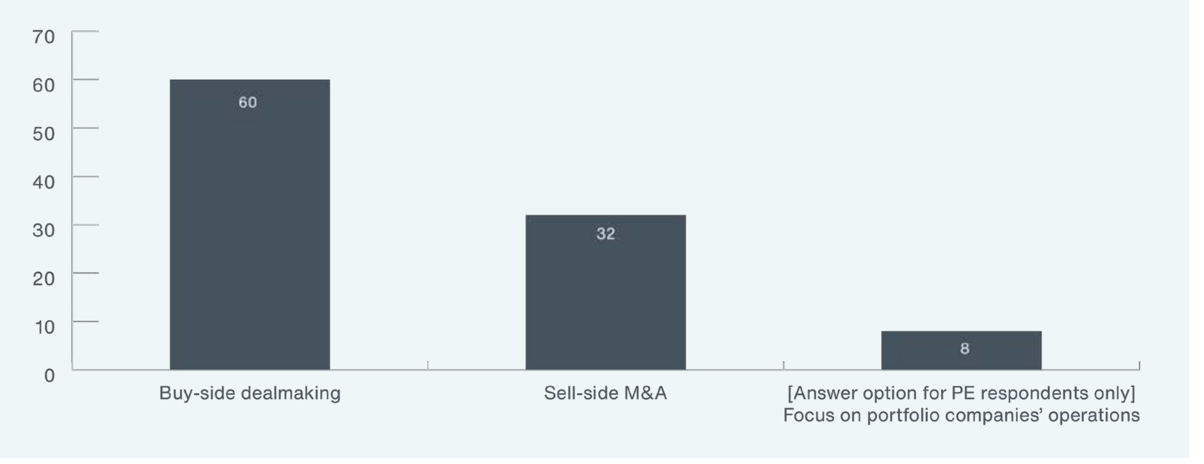
Exit poll

On the divestiture front, sales to corporates will be a predominant exit route over the next 12 months, with 44% of respondents anticipating this path to generate the largest volume of company sales. Strategic buyers are widely seen as reliable, willing to pay a premium for acquisitions that provide immediate synergies and competitive market advantages.

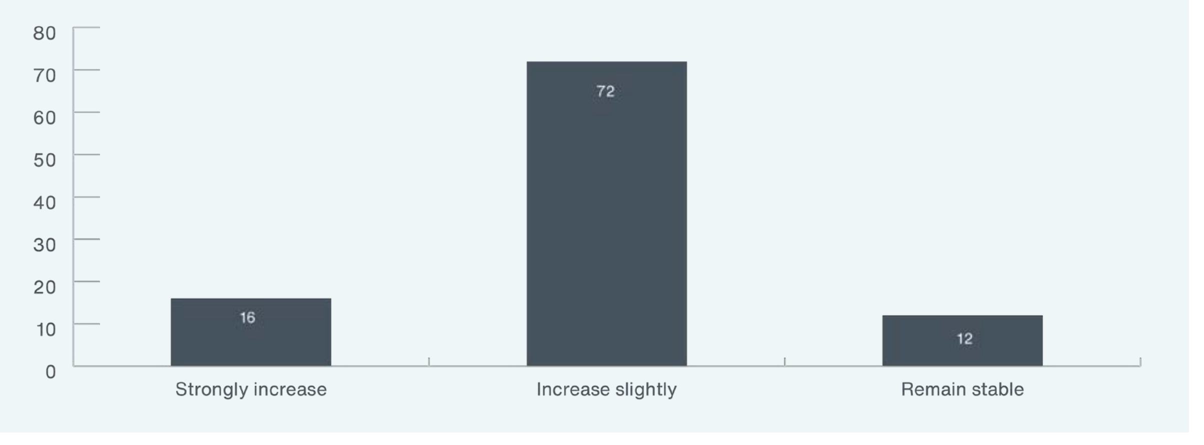
While IPOs can achieve higher valuation multiples compared to private sales, especially if the company is in a high-growth industry or is a sub-sector leader, the so-called IPO window is prone to closing on sharp shifts in risk sentiment, and lock-up periods make them far less "clean" exits.

Continuation funds and other secondary transactions are expected to follow strategic sales closely, with 32% of respondents favoring these non-traditional but increasingly popular methods of realizing liquidity. In times of market volatility and macroeconomic uncertainty, such as today's high-rate environment, secondaries offer a reliable alternative. These deals allow limited partners (LPs) in private equity funds to sell their interests before the end of a fund's lifecycle. Continuation funds also enable general partners (GPs) to retain ownership of high-quality assets for longer periods, allowing them to weather constrained exit conditions. By rolling assets into a new vehicle with new investors, GPs can continue to support and grow the underlying business operations of portfolio companies while giving existing LPs an out.

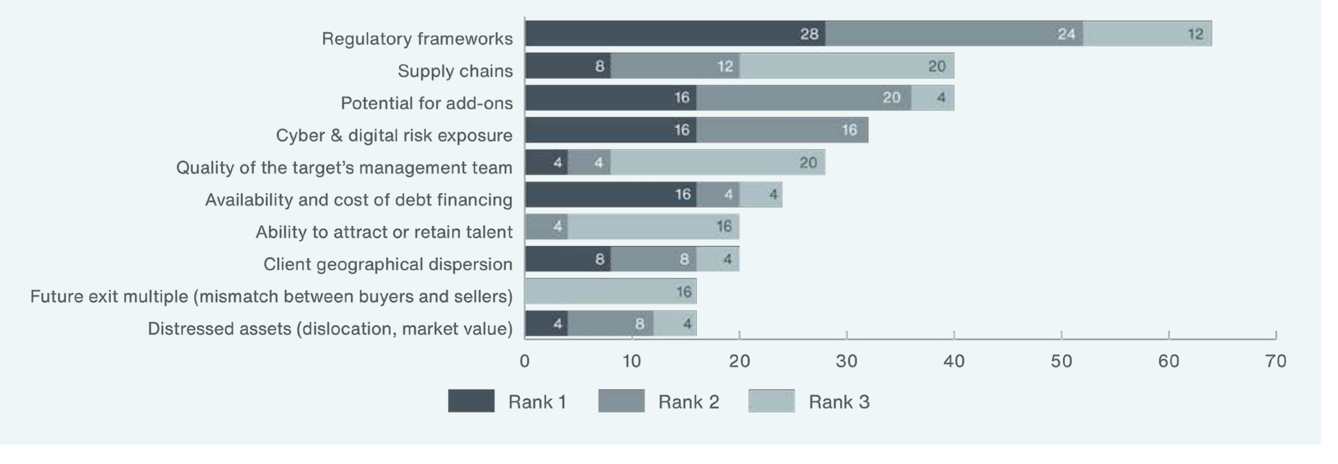
4. Of the following, what will be your organization's priority over the next 12 months? (Select one)



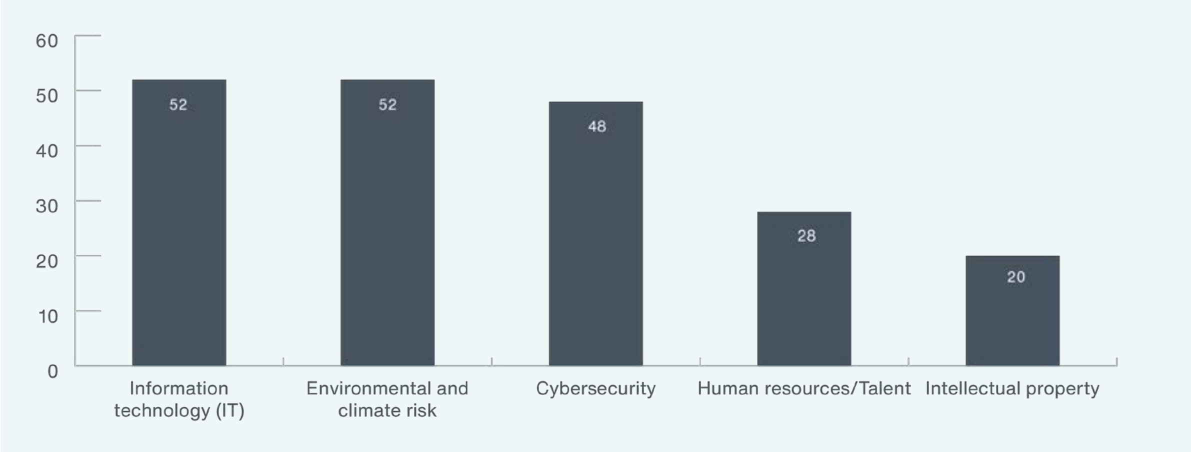
5. Taking into account valuation trends over the last six months, how do you expect valuations to change over the next six months? (Select one)



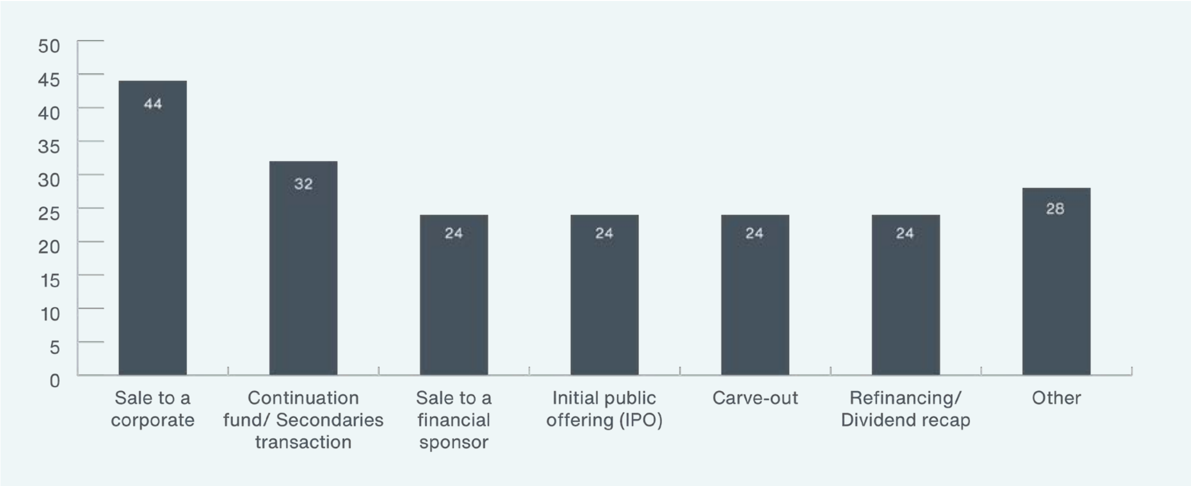
6. What are the most important factors to focus on when considering potential transactions?
(Select top three and rank 1-2-3, where 1 = the most important)



7. Over the last 12 months, which types of due diligence (besides legal, tax, financial and commercial) have become the most important when evaluating transactions? (Select top two)



8. What exit route structures do you expect to generate the largest volume of exits in the coming 12 months? (Select top two)



Part 3: Sponsors vs Strategics

A focus on PE and corporate sell-side strategy, with the sides driven by very different factors. Meanwhile, tech looms large as a motivator for sponsors on the buy-side.

Non-performing assets and the cost of refinancing are set to dominate sell-side M&A strategies for corporates in the coming year, showing the outsized impact that generationally high interest rates are having on dealmaking motivations.

Our survey shows that 67% of corporate respondents identify both of these factors as core drivers of their forthcoming sell-side activity. Today's higher borrowing costs are compelling firms to strategically streamline operations and shore up balance sheets, highlighting the critical role of financial prudence in achieving resilience.

The focus on divesting underperforming and otherwise non-core assets and managing debt costs underscores the priority corporates are placing on rationalizing their portfolios and maintaining financial flexibility in a challenging interest rate environment.

“We will be finalizing sell-side decisions based on the expected time taken to execute these divestments while also considering how financially viable refinancing terms are,” says the global director of M&A for a German corporate. “There are non-performing assets as well, which increases the need to sell them when the time is right.”

Financial sponsors are also preoccupied by today's higher cost of capital and the impact this is having on their existing portfolio companies' debt maturities. Nearly half of PE respondents (46%) say that refinancing costs will be a driver of sell-side decisions over the next year. However, sponsors also have unique considerations: 54% point to their fundraising plans as being the main factor shaping their sell-side strategies. Private equity is very much self-funding for investors. That's to say that LPs need to see capital returned from funds before they can recycle it back into new vehicles. This makes fundraising highly dependent on exits.

“Many of our companies have performed well financially and we are confident we'll see strong competition for these assets. Bids from private buyers will be high and this will help to kickstart our fundraising,” says the managing partner of a private equity firm in China.

All eyes on AI

Private equity firms are increasingly recognizing AI as a major buy-side opportunity, canalizing on its potential to generate strong returns. **More than three quarters (76%) of PE firms surveyed say that technology and AI-enabled acquisitions will have the largest bearing on their buy-side strategies.** These acquisitions promise to leverage cutting-edge innovations and enhance competitive positioning.

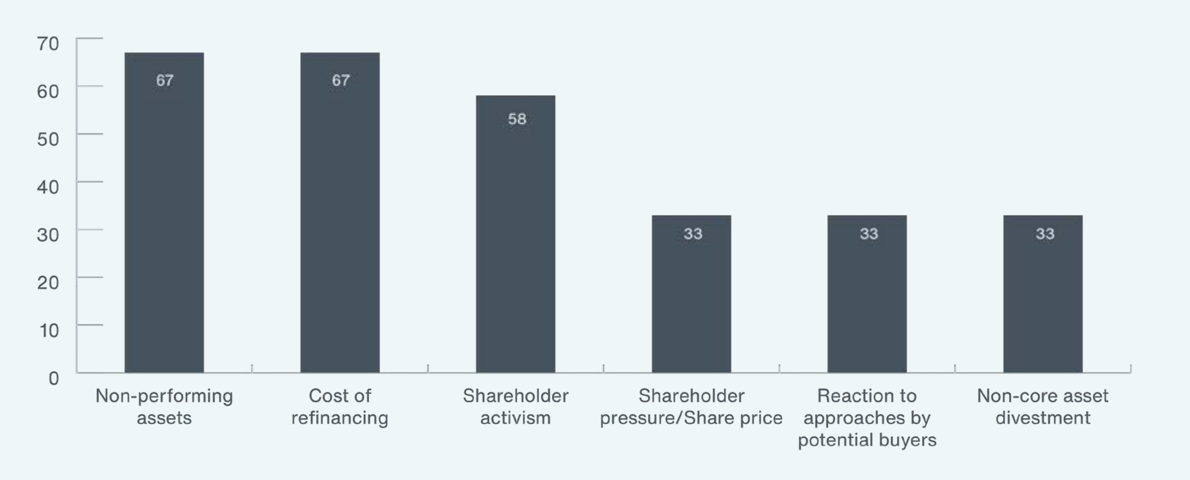
Add-on transactions to platform portfolio companies are also a priority, with 48% of PE respondents focusing on this strategy to achieve synergies and strengthen existing investments. Of course, the two are by no means mutually exclusive — where appropriate, sponsors will be scanning the market for AI and AI-adjacent bolt-on opportunities to maximize asset value.

Operationally, maintaining strong cyber health and posture, alongside thorough vulnerabilities assessments and enterprise risk management and governance, are crucial. **Both strategies are emphasized by 68% of respondents as vital for driving value at the portfolio company level.**

Robust cybersecurity measures and effective governance are essential for protecting assets and ensuring sustainable growth and resilience in a world increasingly defined by digital risks.

Questions directed at Corporate respondents

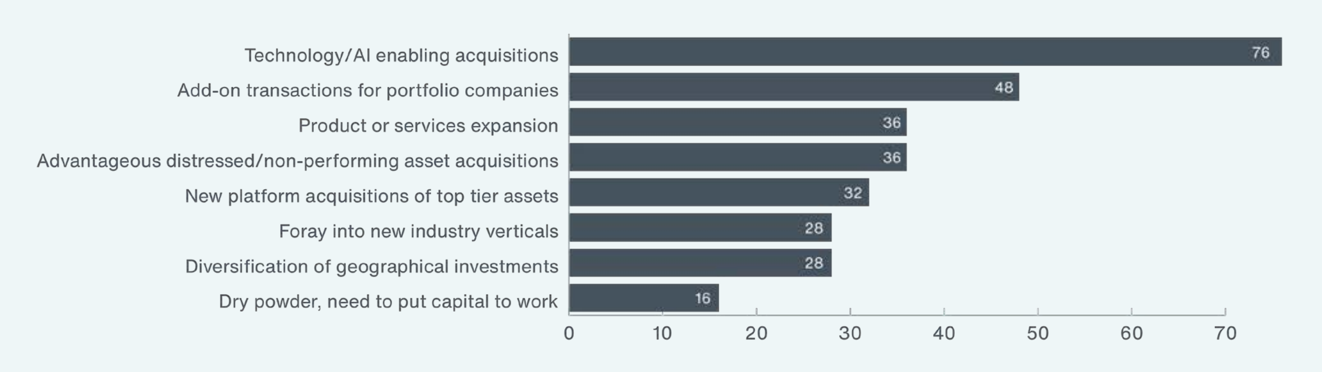
9. Which of the following factors are most likely to drive your organization's sell-side M&A strategy over the next 12 months? (Select top three)



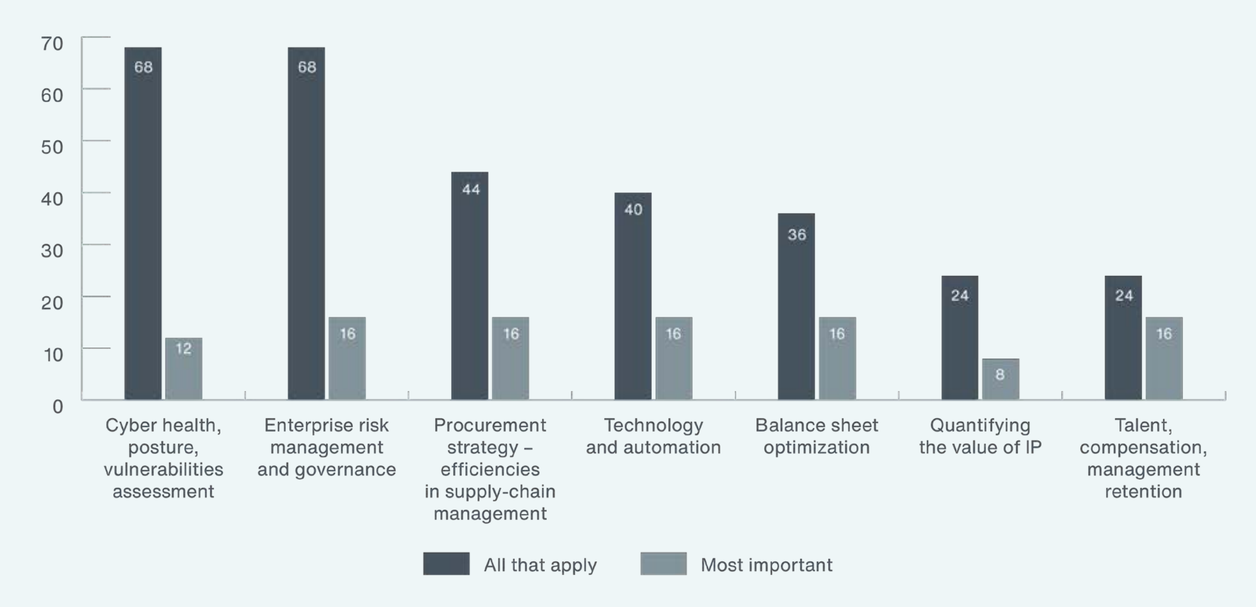
Questions directed at PE Firms

10. Which of the following factors are most likely to drive your firm's sell-side M&A strategy over the next 12 months? (Select top three)

11. Which of the following factors are most likely to drive your firm's buy-side M&A strategy over the next 12 months? (Select top three)



12. What are the most important strategies for driving value at the portfolio company operational level in the 12 months leading up to an exit? (Select all that apply and most important)



Conclusion: The ABC of M&A – AI, Big Tech and Climate Change

Dealmaking is likely to increase in the next 12 months with technology and ESG driving the market. But for PE, as always, a more benign environment for exits and fundraising will be vital.

The global M&A market has demonstrated impressive fortitude so far this year despite limited respite from central banks. Not only that, most investors now expect deal activity to rise over the next 12 months. Ample cash reserves on corporate balance sheets and private equity dry powder should continue to spur transactions.

Though from a buy-side perspective today's higher cost of capital is clearly weighing on financial sponsors more than their corporate counterparts. The biggest potential hurdle to this gathering momentum is the fractious geopolitical environment, the unpredictability of climate change and more stringent sustainability regulation and the second-order impact this is having on the integrity of supply chains.

Corporates and private equity firms face unique challenges and opportunities in the coming 12 months. On the buy-side, strategics are expected to prioritize acquisitions that deliver immediate synergies and competitive advantages. Non-performing assets and the cost of refinancing are set to dominate their sell-side strategies, as high interest rates compel companies to streamline operations and ballast balance sheets.

Private equity firms, meanwhile, are zeroing in on AI and AI-enabled acquisitions this year. Related stocks like Nvidia have surged over the past two years, and 'Big Tech' names such as Alphabet, Apple and Google are investing heavily into the technology. Private market participants are now actively looking to capitalize on this latest innovation cycle. PE funds are also prioritizing add-ons, which typically require smaller debt quanta and can tap the existing debt facilities of platform companies in some cases.

Fundraising, which has been challenging for the majority of PE firms over the past two years, remains a priority and is the deciding factor for near-term sell-side strategies. Exits are necessary to get fundraising off the ground, and with M&A having slowed since 2022, a large minority of GPs are actively considering secondary transactions as a means of returning cash to their investors.

Across the board, dealmakers are prioritizing environmental and climate risk due diligence, as well as navigating evolving regulations. Conducting thorough assessments of physical and transition risks, aligning with disclosure recommendations and maintaining strong cybersecurity measures are crucial for making informed decisions, and developing long-term value creation plans before making the final decision to execute on that next deal.

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