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ANATOMY OF A FALL: M&A IN 2023 AND WHAT TO EXPECT IN 2024

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While predictions of a recession did not pan out in 2023, ongoing economic uncertainty, rising interest rates, regulatory scrutiny and geopolitical tensions contributed to a second year of falling activity levels in global M&A following 2021's record-breaking year. Worldwide M&A activity in 2023 through November totaled $2.56 trillion, a decrease of 21% compared to the same period in 2022, and the slowest first 11 months for M&A in a decade. Deal volumes declined by 9% during the same period, although they remained at a historically high level.

Financing conditions remained challenging in 2023 as central banks around the world continued raising their policy rates at the steepest pace in recent decades in an effort to battle inflation, with average increases of approximately 400 basis points in advanced economies and 650 basis points in emerging market economies from late 2021 to October 2023. In the U.S., inflation remained elevated early in the year, with the Consumer Price Index for All Urban Consumers ("CPI") up 6.4% over 12 months to January 2023. To bring inflation down towards a long-run average of 2%, the U.S. Federal Reserve increased its federal funds target range by 25 basis points at each of its February, March, May, and July meetings, tapering off its aggressive pace from 2022 as the benchmark rate reached the highest level in more than two decades.

M&A activity backed by private equity funds ("PE"), which have traditionally relied on debt financing, was particularly affected by the rise in interest rates. PE-backed M&A deal value in the first 11 months of 2023 saw a year-over-year decrease of 33%, while deal volumes increased by 1%, reflecting smaller average deal sizes. Compounding the effect of higher rates set by central banks, credit supply was also constrained by tightening bank lending standards in light of ongoing economic uncertainty and in the aftermath of the high-profile issues at Credit Suisse, Silicon Valley Bank, Signature Bank and First Republic Bank and related turmoil in the industry. This

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further supported demand for private credit, or direct lending by institutions such as private funds, insurance companies and family offices, rather than banks, bank-led syndicates or public markets. In the first three quarters of 2023, private credit provided 86% of loans for the leveraged buyout market, up from 65% in 2021.

Meanwhile, M&A deals continued to face scrutiny from antitrust and foreign investment regulators in the U.S. and globally. In 2023, the Federal Trade Commission and the U.S. Department of Justice proposed changes to the Hart-Scott-Rodino ("HSR") Form and Instructions that would substantially increase the time to prepare an HSR notification filing and issued Draft Merger Guidelines setting forth an expanded scope of transactions that may be challenged by the agencies. Overall, the long duration of merger investigations globally, greater risk of litigation, and uncertainties of merger enforcement have contributed to increased time and costs for completing deals.

All of these headwinds have resulted in fewer large deals, with only 19 mega deals (deals valued at over $10 billion) announced during the first nine months of 2023, a 42% decrease from 2022 and the lowest level of mega deal value since 2013. The mega deals included Johnson & Johnson's spinoff of its consumer health business Kenvue, valued at over $40 billion, which generated cash proceeds of $13.2 billion for Johnson & Johnson. This was the most prominent example of a general increase in divestiture activity driven by portfolio realignment needs, liquidity needs and antitrust remedies, among other catalysts, with U.S. disclosed divestiture deal value up 53% year over year to $115 billion in the first half of 2023.

Markets and commentators are optimistic that central banks may achieve a "soft landing" with inflation under control and slower growth in 2024. If this indeed comes to pass, it ought to help mitigate the volatility in valuations and lack of confidence in inorganic growth opportunities that have plagued the M&A markets over the past year. As interest rates stabilize and start to ease downwards, we can look forward to a rebound in global M&A activity across the board.

Full Time: Heightened Antitrust and Foreign Investment Scrutiny

Regulators continued to tighten controls on mergers this past year based on competition and foreign investment considerations. While most deals are still being cleared, resolutions are typically coming after

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more extensive review processes with a greater likelihood of litigation for higher-profile deals. As one example, Broadcom's $69 billion acquisition of VMware involved receiving merger clearance from 11 jurisdictions as well as additional foreign investment clearances, and closed 18 months after signing. The increased risks and costs of antitrust and foreign investment review have served to deter some deals from being pursued at all.

In June 2023, the Federal Trade Commission ("FTC"), in collaboration with the U.S. Department of Justice ("DoJ"), issued a Notice of Proposed Rulemaking setting forth the first major proposed changes to the HSR Form and Instructions since 1978. The proposal would create significantly greater work for parties required to file the HSR form, with the FTC itself estimating that the proposed changes would increase the time to prepare an HSR filing by 290% on average. HSR filings are required for transactions where either party is engaged in U.S. commerce or an activity affecting U.S. commerce and certain size thresholds are met—in 2023, filings were required for many transactions valued at as little as $111.4 million. Considering these thresholds and the fact that U.S. activity continues to account for much of global M&A activity (44% in the first nine months of 2023), changes to the HSR form would affect a substantial portion of M&A deals. Moreover, HSR filing fees have also increased significantly, with fees on larger transactions now as high as $2.25 million.

Weeks after announcing the proposed changes to the HSR form, in July 2023, the DoJ and FTC issued Draft Merger Guidelines that reflect a marked departure from the agencies' prior guidelines and case law, towards a focus on transactions by allegedly "dominant" firms, vertical mergers and lower concentration thresholds, among other circumstances. The draft guidelines are consistent with President Biden's July 2021 "Executive Order on Promoting Competition in the American Economy" which encouraged the agencies "to review the horizontal and vertical merger guidelines and consider whether to revise those guidelines" and the agencies' subsequent launch of a public inquiry "aimed at strengthening enforcement against illegal mergers" in January 2022. The guidelines, as drafted, present uncertainty in terms of their application by the U.S. antitrust agencies themselves as well as by courts that may be called to adjudicate challenges, and further reflect a potential divergence between the stance of the regulators and the courts.

Parties looking to complete larger deals in the current regulatory environment need to be prepared for litigation by the U.S. agencies, which have brought a historically high number of cases consistent with the expressed preference of FTC Chair Lina Khan and DOJ Assistant Attorney General Jonathan Kanter to sue rather than settle with merging parties. However, the agencies have continued to face mixed success in court. Notably, the FTC's request for a preliminary injunction of Microsoft's $69 billion acquisition of Activision Blizzard was denied in July 2023 by a U.S. District Court judge in the Northern District of California, and its motion for injunctive relief was further denied by the Ninth Circuit Court of Appeals. While FTC proceedings remain ongoing, the deal closed on October 13, 2023, after receiving clearance from the UK Competition and Markets Authority ("CMA"), which had also initially blocked the acquisition but granted clearance after parties agreed to divest Activision's cloud gaming rights over the next 15 years to Ubisoft.

Through negotiating with regulators while responding to investigations and defending litigation, parties have been able to reach settlements after the commencement of litigation. For example, the FTC and six states resolved their suit to block Amgen's $27.8 billion acquisition of Horizon Therapeutics with a consent order in September 2023, nine months after the deal was announced. The FTC also reached a settlement with respect to ICE's $13.1 billion acquisition of Black Knight, under which the parties agreed to divest two mortgage origination services businesses

to a third party in August 2023, approximately 16 months after the deal was announced. Along the spectrum, the 21-month interim period from the signing of the Microsoft/Activision Blizzard deal in January 2022 to its clearance by the CMA and closing is one of the more extreme examples of the extended process that deal parties face for clearing regulatory hurdles. These extended timeframes have significant implications for the extent to which targets can agree to restrictive interim operating covenants and the market, competitive, and operational risk that buyers assume when they lock in a purchase price for the target a year or two before they can actually own and operate the business.

Dealmakers are well-advised to engage thoughtfully with the regulatory approvals process, as illustrated by the fallout from Illumina's closing of its $7.1 billion acquisition of cancer test developer GRAIL in August 2021, one month after the European Commission ("EC") announced it had opened an in-depth investigation and the FTC's review was also ongoing. The case involved several notable developments in EC merger regulation, including the EC's first interim measures against integration in October 2021, the first prohibition of an acquisition which fell below the notification thresholds under the EU Merger Regulation or in any member state in September 2022 and a record-breaking gun-jumping fine of €432 million imposed on Illumina as well as a symbolic first-time fine on GRAIL in July 2023. Illumina was ordered to divest itself of GRAIL by the FTC in April 2023, and by the EC in October 2023. Illumina's acquisition of GRAIL became a touchstone of Carl Ichan's proxy contest earlier in 2023 that led to the ouster of the company's chair and its CEO's resignation, and the basis for his lawsuit filed later in the year against the board and ex-CEO of Illumina asserting breaches of their fiduciary duties in connection with their decision to move forward with the GRAIL acquisition in the face of regulatory opposition.

Beyond antitrust and competition, regulators have continued to increase their scrutiny over M&A through foreign investment regulation. In the U.S., the Biden administration signed an "Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern" in August 2023. The executive order implements a "reverse CFIUS" policy that authorizes the Treasury Secretary to regulate certain U.S. investments into China in entities engaged in activities involving sensitive technologies in the semiconductors and microelectronics, quantum information technologies and AI sectors.

Meanwhile, EU member states continued to adopt and refine foreign direct investment ("FDI") screening mechanisms, with Belgium, Estonia, Luxembourg and Slovakia among the countries adopting new regimes in 2023. These developments are in line with the EU's FDI Screening Regulation that went into effect in October 2020, which does not mandate that member states adopt national screening mechanisms, but calls on member states without comprehensive FDI screening mechanisms to urgently set one up and provides key requirements for the same.

The EU also tightened regulation of inbound investment with the EU Foreign Subsidies Regulation ("FSR") entered into force in July 2023. The FSR imposes notice filing requirements for acquisitions of control of targets with at least €500 million in EU turnover, where the parties received over €50 million in financial contributions from non-EU countries in the three years prior to signing. For a deal noticed to it, the EC may conduct an investigation and may prohibit or clear the transaction, with or without conditions (such as divestitures of subsidized assets or repayment of foreign subsidies). These new regulations thus necessitate additional diligence by parties as to financial contributions from non-EU countries both during and before engaging in a merger process and impose additional filing, informational and timing requirements on parties to M&A.

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The Holdovers: Private Equity Remains Resilient as Credit Markets Adapt

Private equity-backed M&A activity, which skyrocketed to over $1 trillion during the blockbuster year for deal-making of 2021, has fallen off against a backdrop of rising rates and economic uncertainty to pre-pandemic levels. Private equity firms continued to seek to do deals and support their portfolio companies based on their judgment of valuations, while adapting to headwinds with an increased number of smaller deals, partnerships with other funds and companies, a broader set of funding options and expansion into adjacent areas.

PE investors seized buyout opportunities where public market valuations appeared attractive relative to the valuations of private companies. Global PE public-to-private deals reached 96 for the year through October 25, 2023, already representing the greatest annual total in over 16 years. Deal sizes were smaller on average, with two of the largest deals being Silver Lake and CPP Investments' $12.5 billion take-private of Qualtrics and Japan Industrial Partners' $14 billion buyout of Toshiba. Many of the public-to-private deals resulted in recently de-SPAC'd companies being taken private again. In many cases, we saw a return to "clubbing" whereby multiple PE sponsors aggregated their equity checks to complete the acquisition.

Boosted by banks shifting away from certain types of lending, a trend towards private markets and sustained demand for credit, private credit has rapidly expanded over the past two decades, growing from approximately $280 billion assets under management in 2007 to over $1.75 trillion as of September 30, 2023. While some have predicted that rising interest rates would lead to a contraction in the private credit market, this was not borne out in 2023. Buoyed by a greater ability to pass along increased rates through variable-rate loans and a more stable capital base of pension funds and insurers rather than depositors, private credit funds have worked with borrowers on flexible financing solutions to fund acquisitions, portfolio company operations and distributions.

The rise of private credit has attracted market entry by PE firms such as KKR and Apollo, as well as BlackRock, Fidelity and PGIM (owned by Prudential). Traditional banks are also forming private credit funds, such as Wells Fargo's partnership with Centerbridge which has received $2.5 billion in equity commitments from the Abu Dhabi Investment Authority and British Columbia Investment Management Corporation. Beyond private credit, PE firms have steadily expanded into other asset classes including venture capital, infrastructure, real estate and public markets through adding hedge fund capabilities. There is also some indication that PE may broaden its fundraising base through a "retailization" of the market, expanding beyond institutional investors, family offices and high net worth individuals to retail investors seeking returns and diversification through alternative investments.

Despite a slowdown in fundraising, PE firms boasted significant undrawn capital commitments as they deployed capital at a smaller scale during the year. Private equity asset sales also reached a decade low in 2023, contributing to mounting investor pressures for return of capital. A more stable economic environment with interest rates leveling off and starting to come down will support more constructive dynamics in M&A markets overall, and facilitate exits and entries by PE sellers and other financial buyers that have been sidelined over the past two years.

Ferrari: M&A Drives Ahead in Natural Resources

On October 11, 2023, ExxonMobil announced the largest oil-and-gas deal in two decades: an all-stock acquisition of Pioneer Natural Resources for $59.5 billion. The acquisition would more than double Exxon's footprint in the Permian basin, a region which accounts for more than 40% of U.S. crude oil production, to become the largest producer in the region with

1.3 million barrels of oil equivalent per day. Less than two weeks later, Chevron announced a $53 billion all-stock deal to acquire Hess, a deal that Chevron says would upgrade and diversify its portfolio, as it would enter into an Exxon-led partnership offshore Guyana and add U.S. shale assets primarily in North Dakota. The proposed deals remain subject to regulatory review. Shortly after their announcement, a group of Democratic senators wrote to FTC Chair Khan expressing concern that the deals would likely harm competition, and Exxon and Pioneer as well as Chevron and Hess have received second requests from the FTC. In the face of potential regulatory scrutiny, the acquirors have highlighted that their proposed deals would strengthen U.S. energy security.

The acquisitions reflect a focus on securing low-cost production and managing geopolitical risk in light of ongoing wars and related fallout. By buying established operations in profitable oil and gas regions, acquirors avoid the need to explore and develop unproven reserves. Recent conflicts have also focused attention on geographic location as a critical consideration. In addition to being devastating humanitarian crises, geopolitical conflicts around Russia and the Middle East have had significant implications for the energy sector. Following decades of investment, Exxon promised to withdraw from Russia after the February 2022 invasion of Ukraine; subsequently, in October 2022, its stake in a major oil and gas project was expropriated by the Russian government. More recently, during the first month of the Israel-Hamas conflict starting in October 2023, Chevron was ordered by the Israeli government to shut down natural-gas production at a major offshore platform.

The two headlining deals illustrate a broader persistence of investment in traditional oil and gas, despite calls to "end fossil fuels," transition to renewable energy sources and keep climate change in check through goals such as net zero greenhouse gas emissions by 2050. Earlier in 2023, Hess' CEO expressed the view that "oil and gas are needed for decades to come." On the other hand, the International Energy Agency has projected that demand for oil, gas and other fossil fuels would peak by 2030. In any case, we can expect to see further consolidation in the oil and gas sector around stable, low-cost assets. As oil and gas prices remain volatile, stock consideration could continue to help bridge valuation gaps as in deals this past year.

Energy transition and emissions reductions efforts remain highly relevant even while they have been challenged by macroeconomic conditions and geopolitics. Stabilizing inflation and interest rates will help to support the renewable energy sector, though infrastructure as well as solutions for trade restrictions on minerals required for scaling the adoption of renewables will take time to build out. Financial sponsors will continue to be driven to investment in renewables by specific mandates, the promise of returns and government incentives such as under the U.S. Inflation Reduction Act of 2022. Meanwhile, oil and gas companies have pursued a range of M&A towards reaching emissions reduction targets and staying relevant through the energy transition. Shell and BP have made significant acquisitions in renewable natural gas ("RNG"), with Shell closing its $2 billion acquisition of Nature Energy, Europe's largest producer of RNG, last year. In balancing its continued investments in oil and gas and climate commitments, Exxon completed a $4.9 billion acquisition of Denbury, a developer of carbon capture, utilization and storage solutions.

Geopolitics and the energy transition are likewise key drivers for the mining sector. The scaling of renewable energy imposes intensive requirements for metals and minerals including copper, nickel, lithium, and cobalt. Developments in securing and mining reserves of copper, which is key to electrification, bear parallels to those we have observed in oil. As the average capital required to develop new copper mines has increased by approximately 50% to $3-$4 billion in recent years, M&A activity has been driven by ac-

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quirors seeking large, high-quality reserves and strategic partnerships to diffuse risk. In another take on the energy transition, Glencore's $6.9 billion acquisition of 77% of Teck's steelmaking coal business as part of the CEO's broader strategy to spin off the company's coal business reflects a view both of the continued relevance of coal and the shift to a cleaner but metal-intensive future for energy.

The Zone of Interest: Cross-Border M&A Opportunities

Cross-border M&A activity remained significant at $707 billion during the first nine months of 2023, but was down 21% compared to a year ago, and represented the slowest first nine months since 2013. Geopolitics, sanctions and foreign investment and competition regulation explain some of the trends in cross-border M&A, as investment pivots to align with countries' political affiliations. Acquirors' quest for stability, growth and profitability at attractive valuations also have been and will continue to be drivers of cross-border M&A activity.

U.S. to Europe M&A accounted for some of 2023's largest cross-border deals, including Tapestry's $8.5 billion acquisition of Capri Holdings and Bunge's acquisition of Viterra to form a combined agribusiness company valued at $34 billion. Muted M&A activity in Europe over the last two years, with a 34% year over year decline to $521 billion in the first 11 months of 2023, could present additional buying opportunities. For example, Bloomberg reported on a series of deals for UK small and mid-cap companies in late 2023, observing in November that small-cap companies were trading at a 64% discount to the FTSE 100 on a price-to-sales basis compared to a premium of 40% five years prior. Considering broader economic conditions, we also expect to see cross-border M&A from Europe into the U.S. While the EU economy was 10% larger than the U.S. economy in 2008, from 2008 to 2022, U.S. real GDP grew 72.4%, far surpassing growth rates of 2.1% for the EU and 4.8% for the UK (in U.S. dollar terms, *i.e.*, adjusted for foreign exchange rates). The OECD has forecasted U.S. real GDP growth will slow in 2024-2025 to 0.9%-2.0% per year, but remain above real GDP growth in the Euro Area, forecasted to be 0.7%-1.6% per year.

As an example of the impact of geopolitics on cross-border M&A, U.S. outbound M&A has pivoted sharply away from China and towards Japan and South Korea, countries with which it has closer political ties. Japan stands out globally as an active geographic market for M&A in 2023, having posted an 18% year over year increase in M&A activity through November 2023. In recent years, Japan's economy has emerged from decades of low growth and low inflation, recording core consumer inflation in Tokyo in November 2023 of 2.3%, slightly above the central bank's 2% target. Considering in part the importance of Japanese equities to the country's aging population, with approximately 25% of the $1.5 trillion Government Pension Investment Fund invested in domestic equities, recent corporate governance reforms have supported improved performance of Japanese stocks. Such reforms include new guidelines for corporate takeovers released by the Ministry of Economy, Trade and Industry in August 2023, which were developed as "fair rules" to facilitate the objective of "encouraging acquisitions that are favorable for the economy and society." Earlier in 2023, the Tokyo Stock Exchange pressed listed companies trading below their book value to come up with a plan for increasing their market value, noting that around half of the issuers on its main board were trading below book value. Along with the buyout of Toshiba, notable deals in 2023 included a $6.4 billion buyout of JSR Corp, a manufacturer of semiconductor materials, by Japan Investment Corp., a public-private partnership. Interest rates in Japan remain some of the lowest in the world, even as the Bank of Japan is preparing for the end of negative rates with inflation's uptick. For foreigners, a historically weak yen is another factor attracting investment into Japan.

Wish: Looking Ahead to 2024

Aggressive monetary policy measures implemented over the past two years appear to be tempering inflation from 2022 highs. In the U.S., inflation has slowed over the course of 2023 to 3.2% in October, leading bond markets to price in a cut in interest rates in the first half of 2024. While other major central banks are expected to check inflation by keeping rates higher for longer, this is consistent with greater optimism that the global economy will avoid a recession in 2024, and instead attain a "soft landing" of slower growth. A pivot from rising to stable and decreasing rates should provide a boost to deal-making in 2024. In particular, we expect improved macroeconomic conditions to support private equity exits and their deployment of cash into new investments. While dealmakers need to give due regard to evolving antitrust and foreign investment regimes in structuring and proceeding with relevant transactions, recent examples suggest that deals can be completed by parties that are willing to take on litigation risk and are able to engage with regulators on resolving their concerns. We also anticipate continued consolidation in the energy and mining sectors, with transactions motivated by perspectives on the future of the sectors and geopolitics. Technology will be another sector to watch, particularly intersected with healthcare (biotech) and the advancement of artificial intelligence, which could be a driver of M&A activity in sectors such as media and consumer/retail. Acquirors may also identify attractive investment opportunities across borders when considering fundamentals, growth potential, economic backdrop and political environment relative to prices.

Overall, M&A appears poised for a recovery in 2024.

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