Goldman Sachs Exchanges

M&A in 2024: Navigating opportunities and challenges

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Date of Recording: November 30, 2023

Allison Nathan: After a slow start to M&A activity in 2023, deal-makers seem to be starting to return to the negotiating table. So, what's the outlook for deal activity for 2024?

Stephan Feldgoise: The level of dialogue is at the levels we saw, frankly, in 2021 and the first half of 2022, which were the most active M&A markets in history. It has not realized yet in the number of transactions. But the dialogue remains extremely robust right now.

Allison Nathan: Allison Nathan and this is Goldman Sachs Exchanges.

[MUSIC INTRO]

To walk us through the factors that have shaped M&A in 2023 and the drivers of activity going forward, I'm sitting down with Stephan Feldgoise and Mark Sorrell, the co-heads of the Global Mergers & Acquisitions business in Goldman Sachs's Global Banking & Markets division.

Stephan is joining me in the New York studio. And Mark is joining us remotely from London. Stephan, Mark, welcome back to the program.

Stephan Feldgoise: Thanks for having us.

Mark Sorrell: Thank you.

Allison Nathan: Stephan, when we last spoke about this same time last year, we were facing a lot of the same macro headwinds that we're facing today. We had just seen a year of dramatic interest rate increases. We had recession fears. Geopolitical concerns. So, start by explaining to us how that macro backdrop affected strategic M&A activity this year.

Stephan Feldgoise: It's been interesting, it feels since

Mark and I took over the M&A business in 2020, there's been a series of, whether they be macro, political, COVID headwinds that have challenged the M&A market, I'd say. And we're now at a point where I would say there's a number of new factors. Obviously, geopolitical has risen to the top of the list currently. Which has caused global instability. And you've certainly seen a dearth of cross border activity.

That being said, interest rates now are, I won't say stable, but they're being better understood by the market. Over the last year and a half we just saw a rapid escalation in interest rates. And it's really that change in rates that led to difficulties for private equity to execute deals. It led to difficulties for boards to price deals. And it led to difficulty for investment banks to be able to price debt, underwrite debt with confidence that rates weren't going to move so dramatically that it would cause dislocation, which is what you saw over the last year or two.

Valuations are still challenged in terms of do boards have views where values meet where buyers are? And that's why I think we remain with a challenged M&A market.

That being said, the level of dialogue, the level of activity, we've seen some very large transactions, particularly in and around energy and related sectors over the last couple months, the level of dialogue is at the levels we saw, frankly, in 2021 and the first half of 2022, which were the most active M&A markets in history. [It] has not realized yet in the number of transactions. But the dialogue remains extremely robust right now.

Allison Nathan: And is it really just the macro environment potentially getting a bit more friendly that's driving that increase in dialogue? Or are there other factors at work too?

Stephan Feldgoise: There's definitely other factors. And if you look at M&A cycles over time, whenever there's been a material shift in fundamental value, whether that be technology valuations coming down, whether that be interest rates, and therefore the discount rates at which people think about cash flows, therefore lowering valuations happen, there's a psychological period of time where founders, owners, board members, management teams need to come to a realization of a new paradigm. And that takes time.

And here, it's particularly unique because we saw a move in interest rates, while earnings and cash flows for companies remain quite strong. So, many boards of directors would say, "My company's performing. My shares are good. My earnings are good. My sales are good. Why should I be worth less just because the Federal Reserve decided to raise interest rates?" And so, you actually have seen a more protracted period than typical. It's usually a six to nine month realization period, as I'll call it, to when people recognize a new valuation paradigm. Here it's taking longer because, particularly in North America, we can talk about the global nature in a second, but particularly in North America, earnings, macro economic drivers, sales, customer demand has actually been quite good. Now, if that changes, it could lead to a different perspective because confidence is the number driver of M&A. If the confidence in earnings and underlying performance falters, then you'll see a different timeline on the valuation paradigm. But right now, it's taken longer for those reasons.

Allison Nathan: And Mark, how would you describe the CEO sentiment today as we head into 2024? Does it match what Stephan just laid out for us?

Mark Sorrell: I agree with Stephan's comments. And I think CEOs, whilst they have a number of challenges in their business: dealing with inflation, margins, geopolitical risk, they are keen to advance their own strategic agenda. And I think that for the vast majority of our clients, they want to push forward with their strategic objectives. Their portfolio moves are growing their businesses, number one.

I'd also say that I think as we move towards the end of this year, I think there is great consensus around what the macro-outlook will be next year with inflation coming down and rates normalizing in the second half of next year. A lot more along the lines of our own views. And I think that gives CEOs a little more confidence with which to plan their moves for next year. So, I share Stephan's optimism.

And I think all through this year, from my own perspective, what's interesting all through this year is despite all the geopolitical events and other events that clients have had to deal with, they are still keen to push on with their strategic agenda when conditions permit.

Allison Nathan: And Stephan, you mentioned some areas where we have seen a substantial amount of M&A activity. Talk to us a little bit more about which sectors have seen the most activity and which sectors, you think, will see more activity in 2024.

Stephan Feldgoise: Hands down, natural resources has been torrid. And that has led to some of the largest transactions we've seen, particularly in energy. We define natural resources as energy, power, chemicals, and metals, and mining. All very global, other than power is more regional. But certainly, energy, chemicals and metals and mining, extremely global. Very high cash flow businesses. And very much long macro demand growth.

And so, we have seen tremendous confidence in those companies. And we've also seen those companies recognize the benefits of scale. And so, you've seen an accumulation of what I call the accumulation of molecules, whether that be in energy. Whether that be in chemicals. And based on the dialogues we're seeing as well as the macro, we do not expect that to slow down.

Healthcare, also extraordinarily active. You have possibly the period in time with the greatest cash balances in capitalization of the large pharmaceutical companies around the world. You've also seen tremendous development of new molecules that they view as attractive. And so, you've seen large biotech and healthcare-based M&A. Expect that to continue.

I will say technology is particularly interesting. The desire to execute and do things in technology, I'd say we've seen a rebound over the last several months. And we would expect to see a resumption in '24 of more technology M&A than relative to what we have seen. But it was a very substantial valuation shift.

And industrials has really never seen a dip. All the way from prior to 2020 through COVID into now, industrials continues to move along. Sponsors remains challenged across all industries. And that really is the cost of financing is just so much higher that the returns have been challenged. And therefore, you haven't seen the fingers meet on valuation. But sponsors remains challenged.

Allison Nathan: I do want to ask you about that a little bit more because we have seen a big change among the buyers and sellers involved in these transactions. Private equity, in particular, which had been hugely active in M&A has, obviously, become much less active. Stephan, you mentioned you think that may continue. But what could bring activity back in the private equity space?

Stephan Feldgoise: So, there are a number of drivers. So, private equity, just from a numerical perspective represented, call it at the peak, 35 to 40 percent of the M&A market. It's now much, much smaller. What will cause it to return? There are well over 1,000 substantial portfolio companies already in the portfolios of private equity. So, obviously, private equity are not only buyers but sellers. The demands from their limited partners to return capital, and so, the forcing function for them to sell assets is very high. I think there's a recognition in the interest rate environment that is higher for longer, that the ability to refinance at much lower rates is probably further off. And therefore, the pressure to monetize will continue. So, I would expect that to drive this.

The other factor is what I mentioned before, which is just the valuation paradigms, and sellers, non private equity, recognizing that the valuation paradigm has changed and,

therefore, being willing to transact at potential lower valuations than they were a number of years ago.
The other major factor is if you look at corporate M&A now relative to 2019 or 2018, it's actually at quite similar levels. And so, corporate M&A has remained relatively robust. You just saw a huge part of the private equity universe shrink. And you saw technology M&A, which was also 30 to 40 percent of the M&A market at the peak shrink, also, dramatically. And that's where you saw natural resources rise, technology decline from an M&A volume perspective, and private equity decline, and corporates stay relatively consistent.

Go back to the financial crisis, after the financial crisis when it was very difficult for private equity to execute transactions, you saw a similar resurgence of corporate M&A activity in filling in that vacuum that private equity represented. And then private equity slowly over time resumed, which is what we would expect to see here.

Allison Nathan: A bright spot has been mega deals. So, deals that are very large, exceeding $10 billion. Why has the market for these large deals remained resilient?

Stephan Feldgoise: We certainly have seen a resurgence in some of the largest transactions. And I think a lot of that has to do with the industries that we're talking about have extraordinarily large companies that have accumulated massive cash piles.

When you think about pharmaceuticals coming out of COVID, you saw tremendous cash accumulation by companies. And the bottom line is that large pharma has always looked at startups and new companies as companies to acquire to bring in new molecules or bring in new compounds. And you've seen some new compounds in new areas, whether that be in cancer research or other areas, that have tremendously valuable small companies. And so, by definition, some of those are going to be very large transactions.

The other is in energy. And you saw the creation of some very large global energy companies and the accumulation, as we've seen of, I call, molecules and assets and scale has proven to be beneficial. And given just the sheer size of those companies, you've seen some very large transactions in energy.

The other thing is that we've just seen confidence return to some of the largest companies and the recognition and the benefits of scale, whether it be on capital structure, whether it be in weathering a pandemic with a global face are very clear. And so, we've seen markets that have been supportive and conducive in some of these industries for some of the largest players. And that's why we've seen the return of large transactions.

Mark Sorrell: I would just add, I agree that large transactions have actually been very resilient over the past year. And they're quite concentrated or tend to be quite concentrated in certain sectors. Where have we seen less mega activity than before is in tech, which be one place of note than previous cycles.

I also think on the private equity side, the place we've seen resilience in large transactions is in public to private transactions. So, private equity buying public companies. And this year we've seen record activity in that type of transaction. And actually, a good number of very large public to private transactions, both by traditional private equity and infrastructure funds.

So, I agree with Stephan is where we've seen certain transaction types, certain industries, it's really been resilient. And I just think it shows that where clients want to move their portfolio forward, if it's a large transaction that makes the greatest sense, size is not an obstacle.

Allison Nathan: We also recently spoke to one of your colleagues, David Dubner, about the trend toward corporate simplification and spin-offs. And that really being a driver of M&A activity. Do you expect to see that type of activity continuing in 2024?

Stephan Feldgoise: No doubt. Spin-offs have been very robust. A number of drivers. Number one, activism continues. And boards have recognized if a simplification or a separation makes sense, either they can choose to proactively do it, or if it is very stark and very clear, activists and their shareholders are going to push them to do it. So, you've seen proactive portfolio simplification done by boards.

The other thing is a spin-off is a singular decision. If a board decides that they want to spin a business off, you don't need a buyer. You don't need an IPO market. You're going to hand that to your shareholders. And so, if the simplification makes sense, it is a unilateral decision of the company to execute that. And therefore, they recognize the certainty is 100 percent because they're going to be able to execute it.

And so, that's why you've seen, again, a shift where you don't depend on a private equity universe to buy it. You don't necessarily depend on a successful IPO. You make a decision that simplification is the right thing to do, and this is the execution path that you pursue. And given that we're going to remain in not the most robust, but certainly, hopefully, more robust but challenged markets, I would expect to see that type of unilateral decision making continue for simplifications.

Allison Nathan: And Mark, what are you seeing in terms of deal making outside of the US?

Mark Sorrell: So, I would say, Allison, that outside the US we see very similar trends to in the US in terms of what clients want to talk about and advance. I think what's different outside the US is I think there are a couple of things. First of all, that the macro picture is weaker in

Europe, in particular, versus the US. So, if you look at our own forecasts for next year for growth, European growth we expect to be meaningfully weaker than US growth. So, the macro is not as favorable. And, obviously, a number of geopolitical events that we've seen have taken place closer to Europe than they have closer to the US.

So, I think for those reasons, I would say corporate sentiment outside the US is a little bit more risk averse than in the US. But I think the underlying themes are the same. And my view is as we've seen in past cycles, the M&A cycle in Europe and in Asia will lag the US. But probably lag it by maybe six to nine months, not longer than that.

Allison Nathan: So overall, I feel like there's some optimism coming through both your comments, Stephan and Mark. What are you really looking at to gauge where you think activity will be in 2024? And again, you had measured optimism, I would characterize it. Not overly so. But what do you really watch to think about the next six and 12 months ahead?

Stephan Feldgoise: I would say we're very balanced. But I think Mark and I, and Mark will comment, we're very balanced about it.

What do I look at? I look at percentage of M&A of GDP, which is at, probably last decade or two decades, as a percentage of GDP a record low level. And so, low single digit percentages where historically it's been closer to the mid single digits. That's a fundamental driver.

I look at the extraordinary amount of private capital, both to buy businesses, but also the number of portfolio companies that sit inside private equity companies who make money by transacting and doing transactions. I look at that as a forcing function.

And the other, the third piece I would mention, is that what we saw coming out of COVID was that the desire to do strategic repositioning, whether it's to do M&A to diversify supply chains or products or geographies, was extraordinary strong. And what COVID showed us is that there will be windows where you can't get things done. And what boards said and what shareholders of companies have said is that if there's something that makes sense for you to do and there's a window to do it, you should do it and not wait for the perfect time. There's never a perfect time. But there will be times that you can't do things. And so, that forcing function of companies to seize opportunities when there are windows when they can get things done remains.

So, when you put those three factors together, we're not sitting here saying that's going to be necessarily the first quarter of 2024. And we think in long-term cycles in our business. I'm not smart enough to sit here and say whether that's first quarter, second quarter, whatever it might be. But the underlying forcing functions remain very strong.

Allison Nathan: Mark, do you have anything to add?

Mark Sorrell: Yeah. I would say, Allison, if you think back to 12 months ago, what we saw when we first started to see a bit of a surge in corporate activity we've been talking about in this session, we really saw across all sectors globally, corporate clients coming to us and saying, "We want to push forward and look seriously at buying specific targets and sizable targets."

And so, for me, the best measure of corporate sentiment that Stephan and I look at really carefully is we see all the activity that our clients are pursuing. And when large corporate clients are calling us up saying, "We want to move on a meaningful sized target," that is a really strong indication of how risk appetite is shifting amongst our corporate client base.

I think for private equity clients, it's a little bit different. I think for private equity clients, they obviously have a business model which is to deploy, to buy, and to exit, to sell. And I think with private equity, on the buying side, I think right now there is still some hesitation to deploy. And that is uncertainty about valuation that Stephan talked about. I think it is greater in certain sectors, particularly cyclical sectors there's more uncertainty around valuation.

I think on the sell side, I think what we're looking at is that private equity own assets of all sizes. I think my view of what will happen in the next 12 months is the first part of that market that will come back is on smaller and mid-sized assets. And then we will see larger and larger exits come through.

And so, what I'm looking at, particularly on the private equity side of the business, I think, is the recovery and the ability for private equity to exit large portfolio assets where they obviously hold very large single equity positions. So, we have lots of different ways to look at the corporate, the private equity activity we have and see how the desire of our clients to push forward is shifting.

What I would also highlight, back to your first question to me is there's a huge impact of sentiment around the M&A business. So, one of the things that I think has been interesting in the post COVID period is how quickly activity can ramp up when conditions are conducive and when clients are in a risk-on mode.

One of the things I find most interesting about pre COVID versus today is I think today clients, when they see the window of opportunity, to Stephan's point, really push forward because they know that window may not be there forever. And so, what we're seeing when clients move risk on, activity ramps up very quickly. Clients push forward. Off the back of that, other clients push forward. And you can move quite quickly into an upswing of activity.

Allison Nathan: And so, what could derail an outlook where we have some measure of optimism?

Stephan Feldgoise: There are always many things that can derail confidence. Historically, election years have been down M&A markets. Obviously, there's a big election coming up in the United States. Geopolitical. Interest rate moves that none of us can predict that may be in response to substantial changes in inflation data one way or the other. So, any of those things will impact confidence.

And by far, and we've said it every year and I'm sure it will be true next year as well, CEO confidence and board confidence is the driver of M&A. M&A decisions are never 95/5. They're always difficult decisions based on expectations for the future and forecasts, synergies, and opportunities in combinations that are difficult and hard to execute. And yeah, we've never minimized integration. And once the deals are done, getting companies to work together and get put together always takes forward leading confidence.

So, interest rate moves. Macro. Pandemics. Any of these things can derail confidence. That being said, again, we focus long-term. There will be volatility. That's certain. As we have seen. But the underlying drivers are really over long cycles what we have seen drive the M&A market.

Allison Nathan: Stephan, Mark, thanks so much for joining us.

Stephan Feldgoise: Thank you for having us.

Mark Sorrell: Thank you.

Allison Nathan: Thanks for listening to this episode of Goldman Sachs Exchanges, recorded on Thursday, November 30th, 2023.

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