An Inside-Out Study of UK Mid-Market M&A

2023

numis FOCUS

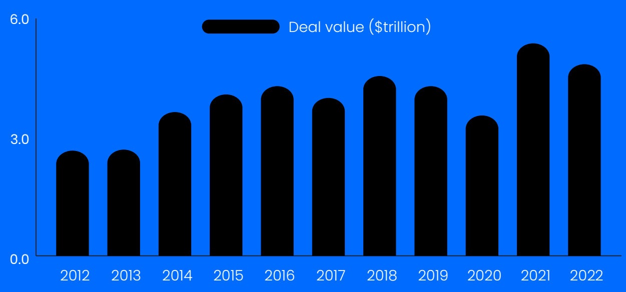
Subdued start belies optimistic outlook for M&A in 2023

After the very high volumes of M&A activity in 2021, last year started positively with good levels of M&A activity in H1 despite the impact of the Ukraine War. However, activity levels reduced post-summer given the economic and financing environments and Q4 was exceptionally quiet.

Globally, the total value of M&A fell by 13.7% year-on-year to $4.7 trillion. In North America, the aggregate deal value decreased by 21.6%, while in Europe the total decreased by 6.1%[1].

In the UK, M&A deal value totalled £183 billion – a 6% decrease on 2021 – while the 3,611 transactions involving UK-based companies completed in 2022 was down 11% versus prior year. Public M&A in the UK saw a total of 46 firm offers announced for companies listed on the Main Market and AIM index, down from 51 in 2021[2].

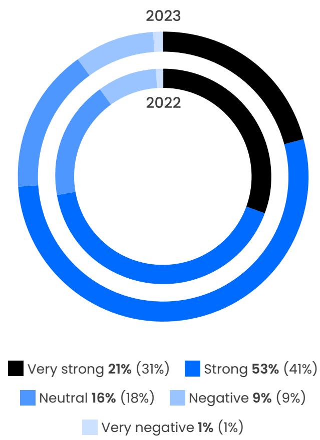
Global M&A activity[3]



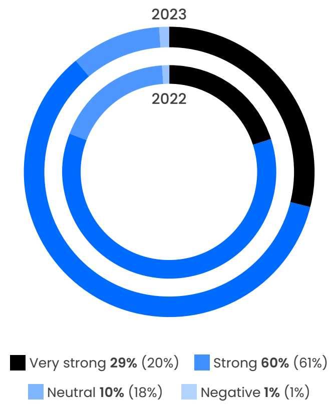
Despite the current economic and financing environments, our survey of FTSE 250 directors found that they are more positive about the UK M&A outlook for their company than they were at this time last year. Almost 90% have a positive view on M&A outlook, with 29% assessing the outlook as 'very strong'. Similarly, only 10% of investors have a negative view on the M&A outlook but their degree of positivity is slightly lower than amongst the corporates. Investors will welcome this positive outlook given that the survey highlighted the importance of M&A returns to the total performance of an investment portfolio, with only 10% of investors saying M&A returns were immaterial to their portfolio.

In addition, FTSE 250 directors are just as focused on new deals as they were the previous year (2023: 54%, 2022: 50%). However, 37% are 'highly focused' on new deals whereas no one was in the prior year. With 94% expecting their company to execute a M&A transaction in 2023, UK corporates are evidently motivated to act in 2023 despite the slower end to 2022 and unclear economic and financing conditions. This could well be driven by the outlook for the UK stock market which has certainly improved of late, with investors and FTSE 250 directors alike indicating increasing bullishness. 82% of FTSE 250 directors expect UK equities to outperform this year versus last year. 61% of investors are more positive on the outlook for UK stock market this year than they were in 2022, and just 19% are less positive.

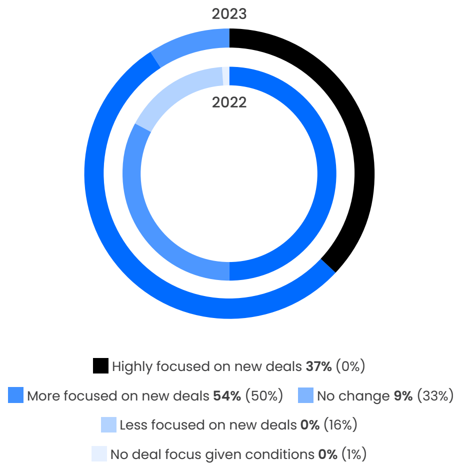
What is the view of investors on the outlook for M&A in 2023?



What is the view of corporates on the general outlook for M&A?



How has corporates' outlook for M&A been impacted in the past year in terms of pursuing new deals?

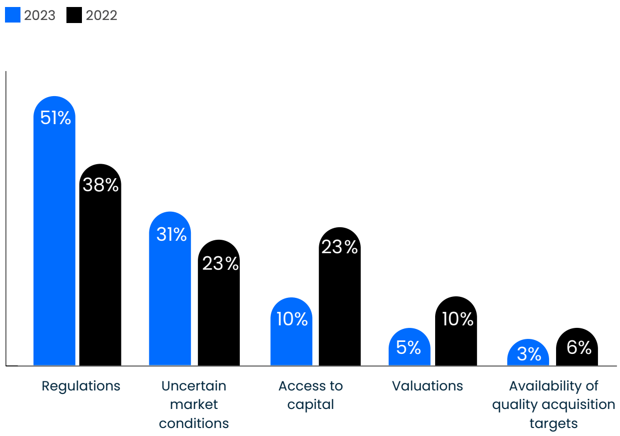


Note: Bracketed numbers reflect 2022 results.

1 Source: Pitchbook Global M&A report, 25 January 2023 2 Source: Pitchbook data 3 Source: Pitchbook Global M&A report, 25 January 2023

Improved economic and financing outlooks required to kick-start M&A

What is your company's biggest challenge to successful M&A in the current environment?



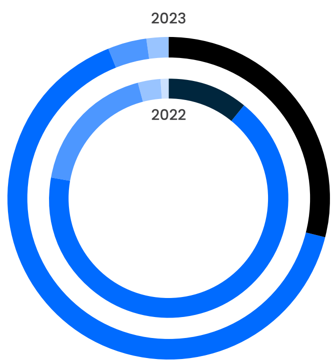
If our respondents' confidence in the outlook for M&A in 2023 is to be proven right, there are barriers to M&A identified by both investors and FTSE 250 directors which will need to be overcome. If the outlook improves through Q1 and deals are executed over the course of 2023, there remains the prospect of a reasonable year for UK M&A, albeit probably with lower volumes than 2022. However, if it takes until summer (or later), 2023 could prove to be much less positive than respondents anticipate.

Unsurprisingly, inflation, interest rates and the financing environment were cited by corporates as the issues positioned right at the top of the board agenda as 2023 starts. Interestingly, high leverage was not seen as an issue by corporates, reflecting that the balance sheets of many UK corporates are better capitalised than in previous downturns.

In terms of the biggest challenge to successful M&A in the current environment, regulation is once again viewed by corporates as the primary challenge, with 51% suggesting regulatory hurdles, such as anti- trust or national security, in the UK and/or elsewhere would be their biggest challenge this year, up from 38% in 2022. In second place, 31% see uncertain market conditions as the primary challenge (2022: 23%). Investors were broadly aligned with corporates as to the challenges facing dealmakers this year, with the financing environment, regulatory change and economic outlook cited as the top three challenges.

While the 2022 Autumn Statement undid some of the damage to confidence done by the 2022 mini-budget, the UK's economic outlook remains uncertain and Numis views that a pick-up in M&A activity will require a confidence boost from an improvement in the macro environment. This may be seen in Q1 through either the reported UK macroeconomic data or the corporate results announcements, which will detail recent operational and financial performance and comment on current and future trading outlook.

How do corporates expect financing market conditions to be YoY?

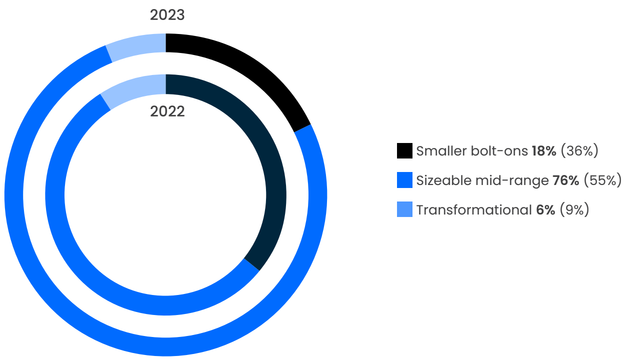


Significantly more favourable **29%** (11%)
More favourable **65%** (67%) No change **4%** (18%)
Less favourable **2%** (3%) Significantly less favourable **0%** (1%)

With the financing environment still strained and key to increased activity in the UK M&A market in 2023, it is refreshing that 94% of FTSE 250 directors said they expect financing market conditions to be more favourable or significantly more favourable this year compared to 2022 (78% - polled ahead of the Ukraine War). This is consistent with the view of corporates that their ability to access capital for M&A is much less of a challenge than last year.

UK corporates expect to pursue M&A on the front-foot in 2023

If corporates are considering acquisitions, what type of deals are they most likely to go after?



With 94% of FTSE 250 directors surveyed expecting their company to execute a M&A transaction in 2023, UK corporates are evidently motivated to act in 2023. Our survey shows that UK corporates are a bit more ambitious in terms of both deal size and target geography than they were at the outset of 2022.

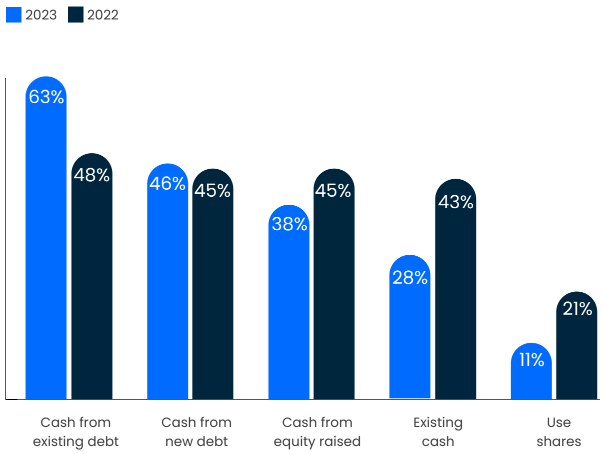
76% of corporates expect sizeable mid-range deals to be their most likely targets, which represents a growing confidence in the ability of corporates to fund and execute such deals. While this was also the area of largest focus in 2022, that number was only 55% and there was 36% expecting to pursue bolt-on transactions, whereas that is down to only 18% in this year's survey. This was at odds with the view (or desire) of investors that there will be a trend of more bolt-on acquisitions.

Geographically, last year's survey highlighted that UK corporates were most interested in staying close to home with the UK ranking as the most interesting geography for UK corporates. While the UK remained the most interesting geography in this year's survey, it scored less well and the confidence of UK corporates to look slightly further afield was demonstrated by the growth in appeal of M&A targets in the rest of EMEA.

While corporates expect financing conditions to improve this year and have less of a concern about access to capital, the financing environment is currently somewhat strained for many corporates.

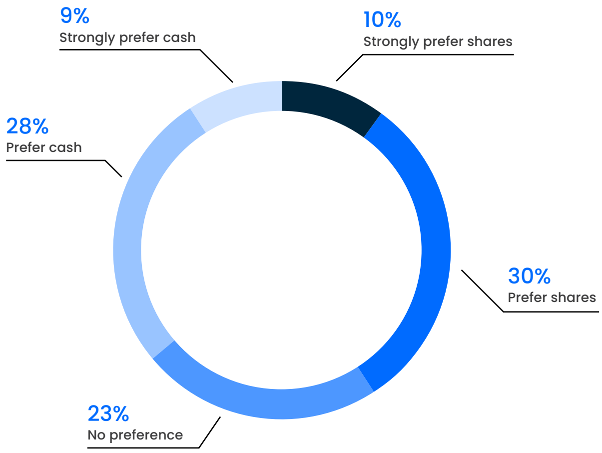
In terms of sources of funding for M&A, it is noteworthy that cash from existing debt facilities is once again the preferred source, although this year by a significant margin. The use of cash from new debt still ranks second but the use of existing cash is less likely this year, presumably as cash on last year's covid-19 funded corporate balance sheets has fallen. The use of shares as consideration to fund M&A remains the least likely source of funds for corporates but has almost halved, in likelihood reflecting a perception that paying in shares is an expensive currency when equity valuations are expected to rise this year.

How do corporates expect to fund M&A this year?



Given the trend of equity outflows amongst investors (£8.3bn in 2022[4]), it would be easy to assume that cash is king for investors but that is not the case. In fact, investors' preferences are finely balanced with 40% preferring share consideration, 37% preferring cash consideration and the remaining 23% having no preference.

What consideration do investors prefer in an M&A situation?



[4] Calastone data

Overseas corporates and private equity still have big role to play

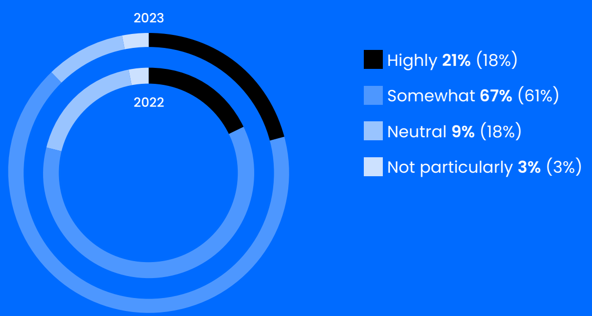
Overseas corporates and private equity firms have been a significant part of the UK M&A landscape for many years and that is unlikely to change this year.

It was no surprise to Numis that FTSE 250 directors assessed UK PLC's vulnerability to takeovers to be heightened, with 88% considering UK PLCs to be somewhat or highly vulnerable, versus 79% in prior year. While it was also unsurprising that 57% of UK corporates would expect the buyer of UK PLC to be an overseas corporate, it was indicative of their more bullish outlook that 40% would expect it to be a domestic corporate and extremely surprising that only 3% would expect the buyer to be private equity. We consider this to be a function of their perception of the near-term leveraged finance markets but note that private equity has significant funds to deploy and is actively screening opportunities, so it would be a mistake to underestimate the level of private equity activity in the UK this year.

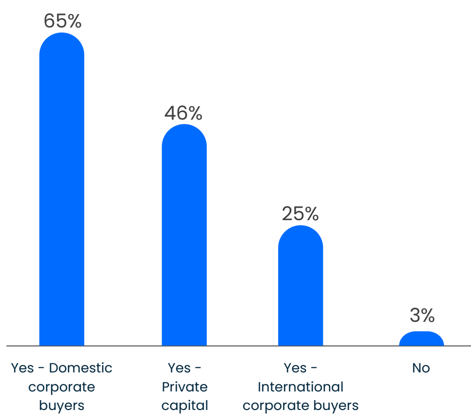
A recent Numis survey of 200 PE professionals in the UK[5] found that 73% of their pipeline was focused on UK listed companies, with 92% referencing the opportunity for public to private deals. Investors and corporates alike appear to be equally positive today with regards to the increased levels of private equity interest in the UK with 79% of investors and 84% of FTSE 250 directors having a positive view on private equity activity in the UK and not one of the 200 directors viewing it as negative.

Overseas corporate acquirers are attracted by quality UK corporates and often able to benefit from one or more of favourable exchange rates, valuation arbitrage and scale. This trend was observed during 2022, with bidders from US and EMEA (ex UK) accounting for 26% and 30% of firm offers respectively. There is no question that, particularly those from North America, will continue to be very active in 2023.

How do corporates view UK PLC's vulnerability to takeovers?



Are corporates expecting to see competition for assets increase in 2023 and if so, from where?



With international corporates, domestic corporates and private equity firms all motivated to be active in UK M&A this year, it is no surprise that all bar 3% of UK corporates expect to see increased competition for UK businesses and assets. The largest proportion of FTSE 250 directors think that domestic corporate buyers will be the source of increased competition, but private equity is seen as a significant secondary source of competition and much more likely than overseas corporates. Investors also expect activity from private equity with two of the top three trends they identified being more teaming up by private equity and strategics and more private equity co-investments.

[5] The UK Mid-Market Private Equity Outlook (October 2022)

Financial services tipped to be most active sector

Last year saw significant interest in sectors such as TMT, financial services and consumer.

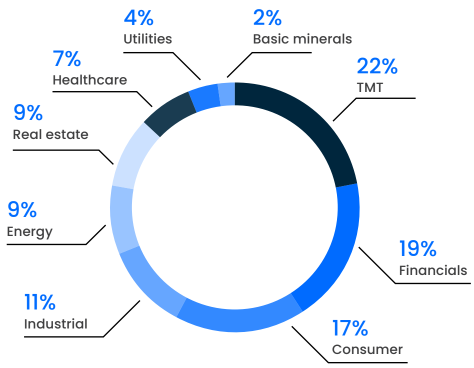
The financial services sector was again active in 2022, including RBC's acquisition of Brewin Dolphin in the wealth management space. The UK's transportation space also experienced a higher level of M&A activity than normal with bids completed during 2023 for each of Stagecoach, The Go-Ahead Group and Clipper Logistics.

Globally, TMT was a hotter sector for transactions than had been anticipated at the outset of 2022. The global hit sustained by TMT valuations contributed to a spate of technology takeovers, including some of the UK's tech majors.

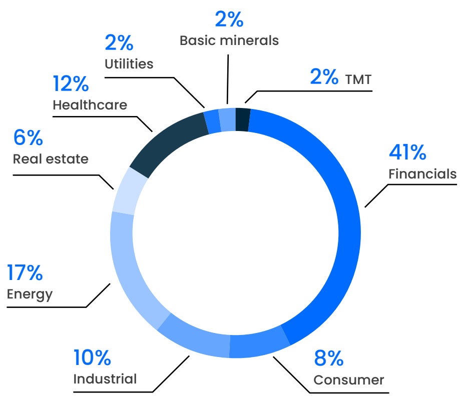
August saw Canada's OpenText agree to buy Micro Focus International in an all-cash deal at a c. 100% bid premium, and other notable deals included Hg's takeover of Ideagen and Schneider Electric's takeover of the remaining stake in Aveva it did not own.

About 40% of investors consider that the financial services sector will be the most active sector for M&A in the UK, more than twice the proportion for any other sector and further evidence of consolidation pressures across the industry. Energy was second, identified by 17% as likely to be the most active sector, followed by healthcare (12%).

Sectoral split of firm offers for UK-listed companies in 2022[6]



What sectors do investors view as being the most active for M&A in 2023?



[6] By volume of firm offers for UK-listed companies in 2022

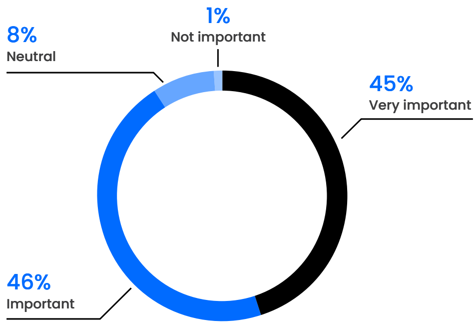
ESG on the agenda

Within the sphere of M&A activity, ESG and the related regulatory requirements remain a key consideration for UK PLC boardroom discussions this year. A significant majority of corporates (91%) consider ESG 'important' or 'very important' for their M&A strategy, reflecting their awareness of investor focus on issues such as a company's carbon footprint and net zero targets in their acquisitions.

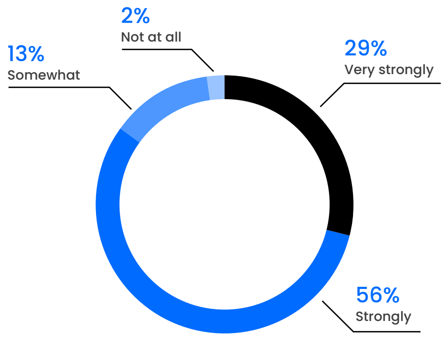
This focus is demonstrated by an almost unanimous position among investors to consider related issues when deciding whether to support an M&A transaction - just 2% say they do not consider ESG at all in such circumstances; 13% say they consider it 'somewhat'; and the remaining 85% say they consider ESG 'strongly' or 'very strongly'. Looking ahead, investors expect the scrutiny of ESG screening within deals to rise over the next three years, with 66% anticipating an increase.

79% of investors view the role of activists as a positive, and the most value-add areas were considered to be improving capital allocation, improving governance, and stimulating portfolio reviews. FTSE 250 directors also welcome corporate activism, with 86% viewing activist influence favourably, up from 73% in 2022.

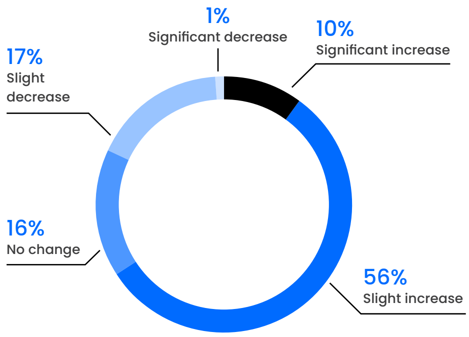
How important is ESG for corporates' M&A strategy?



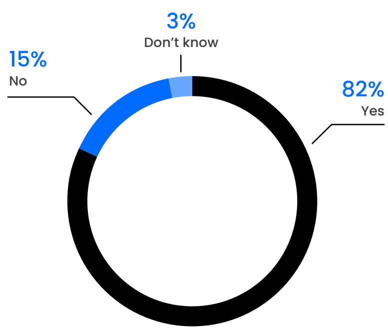
Do investors consider ESG issues in deciding whether to support management on a potential M&A transaction?



How do investors expect ESG scrutiny to change in deals in the next three years?



Do corporates believe that investors should look beyond simple valuation (ESG, culture etc) when assessing M&A opportunities?



Conclusion

The findings of the 2023 annual M&A survey point towards an improving outlook for UK deals compared to the second half of 2022 and increasing bullishness on UK equity outperformance, despite the expectation that overall UK M&A volumes will be lower this year than in 2022.

2022 was a challenging year for M&A activity, with global economic pressures, constrained debt markets and broad volatility all weighing on the appetite for deals. These forces continue to weigh on the market as this year starts, yet some corporates and even some private equity funds have shown themselves to be willing and able to transact and there seems to be an increased confidence in the boardrooms of UK PLCs with respect to pursuing M&A. The survey data is clear that UK corporates are becoming more proactive and constructive on M&A and expect to drive competition for assets. That said, compressed valuations mean that corporates should be increasingly mindful of their own bid vulnerability. Numis expects Q4 2022 trends to persist through Q1 2023 and overall UK M&A volumes for 2023 to be lower than 2022. However, we are seeing some positive signs and consider that improved economic and financing outlooks could drive bidder confidence in moving from deal consideration to deal execution leading to a welcome increase in activity in the second half.

At the same time, investors are positive on the outlook for UK M&A and remain keen on transactions that are well thought out and sensibly structured. Despite the environment and concerns over regulatory hurdles, they remain positive about the prospects of their portfolio companies and are willing to back attractive transactions as M&A is important to their performance.

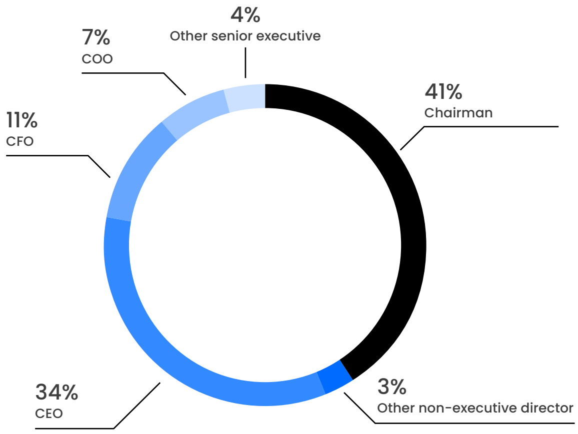
At Numis, we believe the UK M&A market can provide significant opportunities for both companies and investors in 2023. With one of the most experienced M&A teams in the UK, Numis stands ready to help you capture those opportunities.

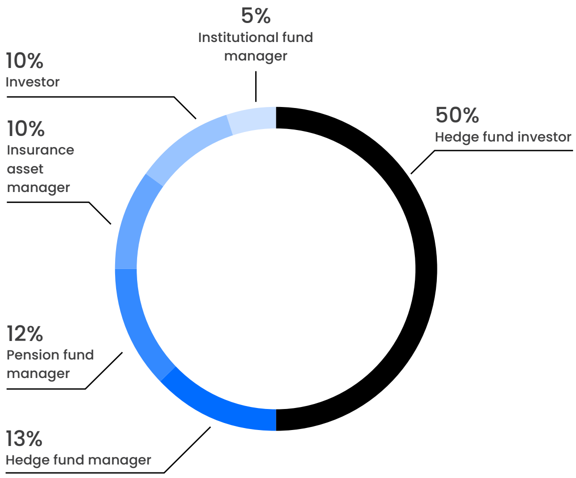
Background

Numis commissioned a survey with 80 board FTSE 250 directors to capture their views on the UK M&A market, and the investment opportunities in the sector. The survey was completed online in January 2023. This document provides an overview of the key findings, and a comparison with the results from a similar study we ran in January 2022.

Numis commissioned a survey amongst investors in the UK, US and Europe who invest in UK stocks, to capture their views on the UK M&A market and the investment opportunities in the sector. 200 investors completed the survey online in January 2023. This document provides an overview of the key findings, and a comparison with the results from a similar study we ran in January 2022.

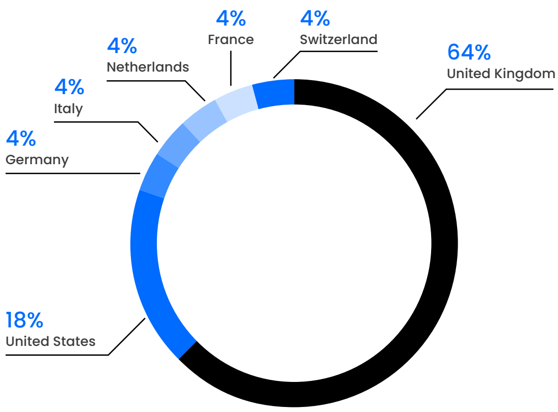
What is your role?





Geographical split of investor respondents

Investors surveyed were based in the UK (64%) or in the US (18%), with the remainder in Europe (ex UK)



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