THE NEW VINTAGE?

Don't start popping the cork quite yet, but it looks like 2022 could be a classic year for dealmaking in the Midlands

Midland dealmakers believe that a combination of a fast-recovering economy, almost fabulous amounts of money ready to be lent and invested, pent-up demand, owner-managers looking to sell, corporates looking to buy, and huge interest from overseas buyers are making the prospects for mergers & acquisitions (M&A) in 2022 look excellent.

"The last year's been a manic one for M&A, full of giddy pricing, aggressive deals, and happy sellers," says Roger Buckley, corporate finance partner at BDO. "Those fundamental drivers for strong M&A activity in 2022 are still here. The wall of money looking for a good homes means high levels of activity, and high sale values. It'll be tough to be a buyer, but a great time to be a seller."

"The pipeline for 2022 looks strong, and I expect another bumper year for transactions," adds David M Jones, corporate finance advisory partner at Deloitte. "The primary motives for dealmaking remain unchanged for 2022. We saw a huge rally from late 2020 into 2021, and I expect this to continue into the New Year. All things considered, it's a year to look forward to."

"Dealmaking momentum for 2022 has been building since the summer: we've never spoken to so many privately-owned companies," says Paul Bevan, managing director at Breeze Corporate Finance. "For us next year will transcend all the years I've been advising on transactions."

There are solid grounds for this optimism. If we project the number of M&A deals involving Midlands-based businesses on current trends, 2021 should end with more than 800 transactions, up by about a fifth on 2020's total and in line with volumes last seen in 2018. And they look like quality transactions: the value of these 2021 deals, where the price tag is known, is £8.6bn, compared with £4.9bn in 2020.

The first three months of the coming year could follow 2021 in being the busiest quarter, driven by owner-managers looking to exit or de-risk before possible changes to Capital Gains Tax in March. In the year to December, there were 453 full or partial exits in the region.

"The pandemic has changed some owners' outlook on life," adds Paul Franks, managing partner at Beech Tree Private Equity. "We'll see an increase in businesses to market as owners either look for full or partial private equity exits, partly to facilitate growth, but also take some value off the table, to live life now, not at some future point when they sell the business. The pandemic has shifted the 'I'll do a deal next year' mentality to doing something now."

FUNDING

One of the most notable aspects of 2021 has been the increased role of private equity (PE) in dealmaking. It has been involved in more than 120 Midland transactions this year, compared with just under 80 in 2020. This has been partly due to PE houses launching buy and build strategies to shore up and expand their existing portfolio of business, and partly by the sheer 'wall' of international PE funds – valued at more than £1trn internationally – looking for investment opportunities.

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"I continue to be very bullish – apart from the Covid dip we've been in a bull market for the past decade," adds Khush Purewal, partner at KPMG. "This coupled, with a low interest environment and enormous piles of PE money, will keep all markets liquid for all manner of transactions in 2022. I can't imagine a scenario in 2022 where a sector receives no interest. Any business could have a Cinderella moment in the year ahead."

The other funding sectors to keep an eye on during 2022 will be debt funds and family offices, which have been growing in size and influence, but have thus far kept a low profile.

"Private equity is under pressure to invest, particularly in buy and build strategies," says Jamie Hope, managing director at GCA Altium. "It takes a lot of risk out of investment because it means backing a business and a management team that they already know and trust. In addition, there is a lot of debt funding coming through. We've spoken to something like 80 debt funds over the past few months, particularly from the US, and plenty of family offices are now coming to the fore."

EMPLOYEE OWNERSHIP TRUSTS

One growth area of note in dealmaking in 2021 has been the growth of Employee Ownership Trusts (EOTS), which hand over the business to staff through indirect ownership, similar to the John Lewis Partnership model. Businesses such as Nottingham-based Clegg Construction, Derby-based Pennine Healthcare, and Stourbidge law firm Talbots opted for EOTS during 2021. Market-watchers expect their number to increase in 2022 and become commonplace, alongside management buyouts.

Although the format was created in 2014, it is only in the past year that it has started to increase in popularity among exiting owner managers, partly as a way of handing on the company to the workforce, and partly because an EOT carries no Capital Gains Tax on the initial sale. This is even though EOTs are vendor-funded – meaning the seller has to wait a few years to be fully paid though earnings.

"There is growth in deals with EOT structures," says Victoria Tomlinson, senior associate at Browne Jacobson. "We're already advising on a number of these and, depending on what happens with tax in the upcoming budgets, these may be a popular option into 2022."

GROWTH SECTORS

Since the first introduction of lockdown in March 2020, much dealmaking activity has focused on specific sectors, such as medtech, digital, telecom, education, tech-enabled businesses services, home products, which are all seen as either Covid-proof or have actually benefited from the crisis.

Most experts believe these sectors will continue to be high value and in high demand.

However, it could be a third tough year for high street retailers who are dependent on footfall, as the consumer migration to online shopping continues. If fresh restrictions are imposed because of the new Omicron variant of Covid-19, then the outlook for traditional retail may be even bleaker.

However, many pundits believe 2022 will be the year that interest and activity in traditional sectors revives, particularly in manufacturing and leisure.

Jones believes the domestic leisure sector, which took a significant hit in the immediate wake of Covid-19, has proven resilient, and performed strongly on the back of staycations, glamping, caravan parks and spas. As restrictions in Europe tighten, it is likely to be another strong year for the sector."

"These hot sectors will stay hot, but we'll welcome back sectors that have been largely ignored by M&A markets since the pandemic, such as automotive, aerospace, as well as casual dining and leisure, where we're already seeing keen investor interest," says Buckley.

"The Midlands' stock of traditional and long-standing businesses are absolutely in vogue right now," adds Bevan. "Industrials, fulfilment, engineering, construction et al are all sectors attracting overseas interest. This is a seller's market."

PRICING

There are vast amounts of cash flowing through the dealmaking system from sources as varied as PE, alternative funders and corporates' own coffers. During 2022, that will be joined with funding from the main banks, as well as from debt funds, more peer-to-peer and family offices.

Sooth sayer

What transaction – flotations, buyouts, development capital, acquisitions – will dominate? What businesses will be doing deals? Will 2022 see opportunities to "buy and build", or will the year be dominated by investment in growth? Who's selling, who's buying and for how much?

The M&A market in 2021 is still very fizzy and this trend is expected to continue when investors look at the UK as a good place not just to start businesses but also find a skilled workforce with low barriers to business entry. This combination with innovative businesses scattered throughout the UK means the UK is a target for investors throughout the world. Interest rates are at record lows but inflation is knocking hard on the door. Foreign money is still flowing into the UK in the form of cash rich equity investors.

The Pandemic has led to many businesses transforming their digital capabilities however technology remains key in the year ahead as remote working, education and online shopping are here to stay. This will also mean the Logistics sector will see increased M&A activity in 2022. The digital innovation is already leading to changes in how work is done and it has given the opportunity for businesses to have a smaller bricks and mortar footprint.

The global commitments to greener and carbon neutral fuels will increase M&A activity in new emerging energy sectors as businesses form alliances and invest in technologies. Businesses are not just looking at how to be greener but also to work with greener customers/suppliers in order to develop their green credentials.

Valuations of businesses however will remain complex as past performance and closures during the pandemic will not reflect future price or targets.

The tax policy the UK is looking to adopt including investment in UK economy and the NHS coupled with the changes to the financial market (as the focus shifts from Europe to Asia/America) may mean Brexit is a distant memory in 2022.

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Valuations in prized sectors has been very high: multiples – many businesses are priced on their EBITDA (earnings before interest, tax, debt and amortisation) and a sector-specific multiple sectors such a digital and medtech have reached into the high teens.

The consensus is that every sector may see a high watermark for valuations in 2022, with a clear flight to quality and sector leaders. However, this may lead to many deals being aborted as businesses come to the market unprepared, and with unrealistic price expectations.

"One of the notable changes is that investors are so keen to get deals done that they are not spending time on uncertainties," say Hope. "If a transaction looks uncertain or may take a lot of time to sort, they are simply moving on to the next transaction. Investors want to make quick decisions."

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During 2021, about 30 per cent of deals involving Midland businesses were in manufacturing, compared with about 25 per cent in the professions and retail, and 20 per cent in IT and communications. Yet when you look at values – where we know the price tag – manufacturing accounted for more than half of the total, while professional and science accounted for well over a third.

However, while there may be an increase in value and volume, do not expect an increase in velocity: deals will still take time to be completed as buyers place even greater emphasis on the due diligence processes and ensure that their investments in uncertain markets are the right ones, with long-term prospects. Due diligence will have extra importance as many businesses' figures over the past two years have been artificially inflated or depressed by the pandemic, so give little indication on their prospects. That means buyers will insist on digging still deeper to discover the true nature of a business, while advisers will have do far more to demonstrate maintainable earnings for businesses they look to sell.

"In some ways it's going to be tough," says Bevan. "Due diligence and the armies of people it brings to check and verify will bring its challenges for us all. Nonetheless, deals, with proper planning, will be delivered."

SOCIALLY RESPONSIBLE DEALMAKING

The other big element of dealmaking in 2022 will be the growing importance of Environmental, Social, and Corporate Governance (ESG). Issues such as diversity, inclusivity, sustainability and social responsibility will increasingly be a key element in assessing the viability of businesses in transactions.

"The global commitments to greener and carbon neutral fuels will increase M&A activity in new, emerging energy sectors as businesses form alliances and invest in technologies," says Colin Rodrigues, partner at Hawkins Hatton Corporate Lawyer. "Businesses are not just looking at how to be greener but also to work with greener customers and suppliers in order to develop their green credentials."

"ESG has landed," adds Khush. "There will be a lot of focus is on environmental issues after COP 26.

"However, social, and corporate governance will become increasingly important. Indeed we expect the whole market, vendors, advisers, funders, and market commentators to be looking hard at how best they ride this wave." ■