

Exchanges at Goldman Sachs

What's Next for M&A

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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

Today we're going to talk about the record wave of M and A activity that's showing no signs of stopping, even in the face of surging inflation and rising economic uncertainty. To do that I'm joined here heading into the end of year 2021 by Mark Sorrell and Stephan Feldgoise, the Co-Heads of the Global Mergers and Acquisitions Business in Goldman Sachs' Investment Banking Division.

Mark, Stephan, welcome back to the program.

Mark Sorrell: Thanks a lot Allison.

Stephan Feldgoise: Thanks for having us.

Allison Nathan: By almost any measure, M and A activity absolutely shattered records in 2021. Mark, can you start with the year in review? How did deal activity play out?

Mark Sorrell: So, thanks for the question, Allison. As you said, you know, it's been a remarkable year. And I think that the theme I would emphasize is really how broad and consistent activity has been. So, when you look at every region, every industry, every size of transaction, every type of transaction, it's really been a consistent surge in activity through the year.

I think the other thing that's been unusual about this year is how consistent it's been throughout the year. Often, we have an environment where there'll be one quarter of a pause when there's a macro blip or something, a geopolitical blip or something else happens. You know, we really have had a year of real consistency and real momentum. And we see that continuing.

So, for me, the takeaway here is real breadth and consistency of activity through the year.

Allison Nathan: But we have had some blips. We've had now we're living through omicron and the related growth concerns with that. Inflation is now a key concern. You know? So, the environment does feel a bit different than the last time we spoke to you all in July about the M and A outlook. What are you hearing in boardrooms about the impact of all of this on M and A going forward? Stephan, maybe you can start.

Stephan Feldgoise: You know, it's interesting, so, I was in a board meeting yesterday where this exact topic came up. And boards are concerned. Boards are asking the questions, as they should, around what is going to happen with a potential resurgence in COVID, what is going to happen with these inflation rates? I guess I would highlight a few things.

There are certainly a few things that are highlighting that some of these risks and issues are not just cyclical and short-term. You know? You think about labor rates. Labor

rates and inflation are here to stay for quite a period of time. The demand is driving it. But boards are really looking through these issues as we have looked through COVID in its prior waves, as we have looked through global instability to say what is my long-term strategic vision? And are there things that I want to do or have wanted to do that I should do now because the window exists, and I can get them done and position me in a consolidated world to be the winner? And that's what boards are really saying. It's what do I need to do to be the winner in five, ten, 20, 50 years?

And it's not about earning accretion day one. It's not about my leverage day one. Do I need to issue equity? Should I not do it because inflation is ramping, and my factories are running at 100 percent? It's what do I need to do to win? And that's really how boards are thinking. Which drives through a lot of these issues, which are not small, but really in the macro concept, people are thinking 50 years out.

Mark Sorrell: Maybe to add one point to what Stephan said, I think that notwithstanding the issues you

highlighted, it's remarkable how clients have remained focused on moving forward and initiating strategic activity. And I think one really good recent example is we've had a period of heightened equity market volatility but a few weeks ago. Right? And clients want to move forward, action things moves through. Of course, volatility is something that clients focus on and it's a tricky issue for execution. But there is a real desire to move forward. And I think that's one of the takeaways. Clients are focused on the risks. But do want to move forward.

Allison Nathan: So, with all that in mind, let's dig into the composition of deal activity. Mergers, both large and small, fueled volumes in 2021. What were the catalysts driving deal volumes? Did they differ by company size? And do you expect those same factors to continue to drive volumes in 2022?

Mark Sorrell: There are clearly some common themes that we can identify that I think cut across big and small. Right? I think in the corporate boardroom there are a few things that are in many, many transactions. One is technology, whether that is offensive or defensive. Another

is ESG, positioning portfolio for ESG themes, whether that is investing in certain areas or reducing exposure to certain areas. Another is focus. I think one of the interesting things we've seen is just renewed focus on capital allocation in the boardroom. As a client, you have to deal with lots of issues. And how you allocate your capital has become, I think, an even stronger boardroom topic. What's the implication of that? There's much more scrutiny of core versus noncore. And I think that's actually got more strong as a theme as the year goes on. And I personally think it will become even stronger.

And so, I think between technology and growth is the point that Stephan talked about and ESG and focus, these are all themes that are driving corporate boards to make decisions as we've been talking about and move forward. So, that's one comment.

I think in terms of size of activity, we have seen larger activity, both in the corporate side and the private capital side, in the private equity industry. So, more evidence of-- and I think it's quite possible we see a greater number of larger transactions. And I would drill into that one level

down, cross border transactions as well, which as we talked about in July, that's the one area where we had seen less activity, which has also started picking up. But I think those themes are actually very common across all clients.

Allison Nathan: Stephan, Mark just touched on the role that private equity is playing right now. Can you talk to us a little bit about what's driving that since it's been such a hallmark of the activity we've been seeing recently?

Stephan Feldgoise: Yeah. First off, the definition of private equity has broadened dramatically. So, sovereign funds, family offices all are directly doing private equity, not just in LP type roles, but in direct, controlling investment type transactions. So, the definition of private equity has broadened. And frankly, private equity has been if not the, one of the best returning asset classes in the last 20 years.

So, what happens? They garner more capital. How do they make money? By making investments. And so, the path to greater activity in the private equity universe is clear. The quantum is clear. Great returns garner more capital. But

additionally, the velocity at which they are executing transactions, you know, we mentioned previously think long term, think strategically, private equity knows they need to make investments to make returns. And so, their aggressiveness to enter the M and A market to put capital to work has been extraordinary. It's now, you know, somewhere mid 30s in terms of percentage of involvement in the M and A market that private equity has, again, on a broader definition of private equity. And that's only going to continue.

The capital raised, the capital allocated towards private equity by the big institutions, by the university endowments only continues to escalate. Again, driven by the returns. And the capital market has been extremely conducive.

Allison Nathan: We also saw the return of large leveraged buyout transactions. Mega LBOs are back. Mark, talk to us about some of the catalysts behind that activity.

Mark Sorrell: Yeah, maybe to pick out a couple of things, I think one is fund size. So, as we've seen a whole

bunch of funds raised by the larger private equity [UNINTEL], these fund sizes are growing very rapidly. As fund sizes grow, by definition, what can be done in terms of equity check in a single transaction grows. So, I think, one is fund size. And I think fund sizes will continue to grow. And therefore, the ability to do larger transactions will also increase.

I think the other thing that's driving bigger activity is I think you see increasingly, and it's hard to generalize, but increasingly more open mindedness from clients, both public companies and private companies, particularly in Europe around partnering with private equity. So, it's not just necessarily 100 percent transactions. You know, for example, you see more rollover transactions where the seller is rolling into the structure. Or more partnership transactions. And so, this sort of partnership between private capital and companies is, I think, an increasing feature of larger deals.

And I think, final comment, why is this happening? I think why it's happening is a bit what we were talking about a minute ago. What companies are trying to deal with at the

moment: technology, ESG, focus, capital allocation, some of these things, you know, private equity can be a very effective partner in addressing some of these issues in many situations. So, I think it is also a reflection of the reality of the world and the challenges of the world and the topics that need to be addressed.

Allison Nathan: We spoke a couple minutes ago about the recent market volatility. But at the end of the day, we've had rising stock markets in general in 2021, valuations are quite high. What are these high multiples doing in terms of changing deal structuring? How are they having an impact?

Stephan Feldgoise: When you think about high valuations, the first thing that comes to mind is should folks be using equity more in transactions? Use your high valued equity to accomplish what you want to accomplish. So, that's number one.

Number two, though, is that interest rates on debt still remain near historic lows. Maybe not as low as they were, but near historic lows. So, the efficiency and the cost to

debt is still extremely attractive as well.

The other thing I would focus on is one might say if multiples are so high, wouldn't that quell activity? Wouldn't buyers be concerned about paying such high multiples? But when you're trading at a high multiple, then you're looking at a business with a high multiple. Again, it shifts you towards using stock. But again, people are focused on the strategic positioning and, most importantly, investors are continuing to reward the strategic activity. It's not about did you pay one or two multiple turns too high. It's, are you going to be, again, the long-term winner? And that's what is driving stock prices. That's what intact institutional investors are applauding, this strategic repositioning. It's not, and we can see it on deal announcements, the first either criticism or comment from the market is not, "What's the return on invest to capital of that investment?" It's "Was that a good strategic move? And was the valuation reasonable in that context?" Not in the context of was it 4 percent or 7 percent or 10 percent or 12 percent return on invest to capital.

Now, markets shift. And at times, the markets are more

focused on returns on capital. And then that obviously has an impact on how boards think about M and A. But in a high multiple market, what we're seeing is people are still motivated by doing transactions that their shareholders are supporting. And right now, shareholders are supporting the strategic activity versus hyper focused on whether the multiple is one or two turns right.

Allison Nathan: So, we've talked about strategic transformation being a key driver of deal activity in 2021. But activist investors were also a driving force behind much of the activity we've seen. What's driving that? And what are the implications for companies and shareholders?

Mark Sorrell: So, I think, Allison, your right. When we talked in July, I think we talked about how activism generally had returned to pre-pandemic kind of levels, back to 2019 levels. Sitting here today, they're absolutely above pre-pandemic levels. So, we've seen momentum continue to build in the last few months. That's number one.

The second thing is we've seen activists attacking and focusing on larger companies in the past few months. So, I

think what's interesting is you've had more activity and more large cap activity.

I think what's driving it, which was the second part of your question, it's very difficult to generalize. Every case is specific. If there was one theme I would pick out, it's around portfolio and valuation in the market. And I think the one thing that we've seen is where activists are able to identify a gap in valuation between the share price and the intrinsic value of the company, and they see that gap widen, if it's a very large company where they can trade in and out easily, that's a place we've seen a lot of activist focus. And their approach is to identify that value gap, first of all, and then to propose actions to address the value gap. Often which have an aspect of portfolio-- you know, splitting the company, selling a business, changing a strategy, et cetera. So, that would be, I think, the theme very much around portfolio.

I think, you know, to make a comment around Europe. Post summer we have seen one mega cap campaign launched every two weeks in Europe. Which is an extraordinary level of activity when you consider the last 12

months. So, I think this is very, very much a theme. And it's very, very much on the mind of the corporate boardroom all around the world.

Allison Nathan: Stephan, you mentioned a moment ago the role that low interest rates are playing in all this. But the low-cost funding environment may be nearing an end if the Fed raises rates as is generally expected. As we certainly expect here at Goldman Sachs. What does that mean for the pace of deal making?

Stephan Feldgoise: It's one of many considerations when companies think about transactions. They think about, obviously, earnings accretion and the cost of debt certainly impacts that. It certainly impacts private equity as private equity thinks about returns. And obviously, they operate in a more leveraged environment than traditional corporates.

That being said, we're still at relative historical lows. Even if we move to a degree, we're at relative historical lows. But inflation is something we're all very focused on. And again, there's what the Fed does. But there's what also the

markets do. And the markets really drive what investors will pay for a given risk characterization piece of debt.

And so, when you think about corporate earnings and you think about growth, you think about the demand that we're seeing, that remains incredibly strong. Yes, it drives inflation. But again, debt investors think about the risk profile of the debt that they're buying for a given corporation. Yes, the Fed has an impact on that. But really, it comes down to perception of risk and do investors demand a higher rate of return for the debt that they're providing to various situations that drives the cost of debt?

Again, the Fed provides base rates that obviously impact things. But again, the risk quantum is what drives how much of a premium to the risk-free rate, so to speak, debt investors will acquire.

So, will it have an impact? Certainly. But I think we're still at such relative historic lows, even with some degree of a move, that I don't see it quelling deal activity. Maybe it might affect certain situations. But again, it's one of many things that I think boards and certainly private equity will

look through.

Allison Nathan: Mark, you mentioned the pace of cross border M and A slowing a bit. Can you give us a little bit more detail around that? We've obviously seen travel limitations and shifting regulatory and legislative landscapes globally. So, how have we seen that pace change? And what do you expect to see in 2022?

Mark Sorrell: So, I think you're your right, Allison. We have really seen this was the one part of activity that I think was subdued for a long period of time for obvious reasons. Post summer we really saw a surge in cross border activity. And you know, the post summer was one of the most active periods in history for cross border M and A.

I think that when we talk about cross border, there is cross border within a region. And then there's obviously, if you like, the most interesting part of market that's sort of sensitive to the ability to travel, which is transatlantic. And I think that when the travel restrictions in the US were loosened in November, that has been another big impetus for European clients to look more actively and participate

more actively on situations in the US and vice versa.

It's a very practical point-- and I think from my own experience of advising clients, European clients looking at transactions in the US, the travel restrictions were a very significant constraint on the ability to execute and be competitive. So, we're in a very competitive market where every little margin or difference can really count towards the outcome. And the inability to get key executives easily in and out of the US was an issue in a number of situations I worked on that made it that incrementally a little bit more challenging.

So, I think with the loosening of that, I see much more activity. And we could well see the return of large cross border. So, I think we're very optimistic about that.

Of course, if there were new travel restrictions, particularly in the US, that would be a significant dampener.

Allison Nathan: Stephan, we barely can have a conversation these days without talking about the digital transformation of companies across sectors. Such an

important theme. How has the prevalence of technology changed not only the way deals are conducted, but the pace of the transactions you've been seeing and expect to see?

Stephan Feldgoise: I think data digital technology is pervasive in everything we're doing. It's pervasive in recording this podcast. It's pervasive in the implementation technology of corporations. It's effective in driving transactions and how you execute transactions.

COVID has only accelerated that. It's forced people to embrace technology in ways that we thought would take many more years. But have now happened, you know, with relative immediacy. And that's impacting how boards think. It's impacting how boards think about something they may have thought about facing. Let's talk about the electrification of vehicles. It might have been a 20- or 30-year timeline. It's now a five-year timeline. Or even faster. And so, it's incredibly pervasive.

Look, many people are still remote. So, executing transactions is still largely done digitally and on Zoom calls

and digital recordings like we're doing today. Presentations of businesses for management presentations. Many of those things are here to stay.

And so, the timeline to executing transactions has gotten shorter. And that's something that Mark and I have spent a lot of time thinking about is the velocity at which you execute a merger transaction, you need to staff differently. You need to think differently. You need to advise differently. And so, that's really become pervasive in how we think about, not just the deals that are happening, but how do you do the deals? What's driving the deals? How are boards that operated in one paradigm of thinking about technology and digitization into the new paradigm?

Allison Nathan: So, hearing everything that you guys have said, lots of momentum, reasons to be optimistic about the M and A outlook in 2022. But what are some of the risks that you're both watching that could affect CEO confidence in doing M and A deals and just the pace and number of transactions we see next year?

Mark Sorrell: So, for me, the number one would be the

growth outlook. Our own economists are optimistic on world economic growth. But clearly the resurgence of the pandemic is going to impact growth to some extent. Maybe only in Q1. We have to wait and see. So, I think growth and the impact of the pandemic on growth, I would say, is my number one.

I think equity market volatility, I mentioned before, is a key risk. M and A is harder to execute in a volatile market environment for obvious reasons. And so, I think volatility is a very important factor.

And then the third thing I would just mention, because we've talked about it last time, is the regulatory environment. The regulatory environment around the world. Government scrutiny around transactions around the world. And that is something that we need to continue to watch. It clearly impacts some sectors more than others. So, I think that is another point. I would note on that particular point, so far, I think there is no evidence that that is impacting overall levels of activity. It might be impacting the type of transactions that are getting done. But in terms of the overall level of activity, I would say it's

not impacting it. But that's another one to watch. So, those three things.

Allison Nathan: Stephan, anything to add?

Stephan Feldgoise: Yeah, look, I think the world is incredibly connected still. COVID make it feel given the lack of travel, that we're disentangled to a greater deal. But we're not. What happens in Europe massively impacts the US. What happens in Asia massively impacts Europe. And the connectivity is still extraordinary.

And so, I worry about Goldman's stability. I worry about international relations. I worry about domestic unrest as well across various countries around the world.

Polarization. Political polarization, obviously, has an impact just on confidence. And confidence drives transactions.

There's one thing we can look across interest rates, you can look at equity markets, CEO confidence is the number one driver of M and A markets because it involves companies taking risks that they don't have in their normal operating business. And you have to have confidence in the

boardroom, and you have to have confidence in the executive office to do that. So, I worry about that.

But you know, certainly all the indicators now remain very strong. Our boards and CEOs have become steeled to global instability and recognize that's something, much like other risks, that need to be managed. So, I worry about those things.

And we're always practical. M and A has been economically cyclical over many years. And so, we recognize trees don't grow to the sky. But it's extraordinary. And again, the forward indicators we have in terms of new mandates and other things remain at all time high levels. And so, we feel optimistic, cautiously optimistic, as we look forward for the M and A market.

Allison Nathan: So, let's just end on that point. What do you expect for M and A in 2022?

Stephan Feldgoise: Look, will it reach and continue or exceed 2021 levels? We'll all see. But when you think about the foundational building blocks that we've talked about,

CEO confidence, board confidence, cost of financing equity markets, the amount of capital into private equity, into other sources, new mandate checks that we process through our system, it feels that we're operating at the highest levels we've seen in 2021 going into '22.

And you can look at the various accomplishments of Goldman Sachs year to date as announced on order of 400 transactions greater than 500 million dollars globally. We're operating at those levels or higher right now heading into 2022. So, again, we remain very optimistic about 2022, recognizing the risks and challenges around the world. But 2022 looks like it's on par or potentially at the highest rates that we've seen in 2021.

Mark Sorrell: Yeah. And to add to that, I agree with how Stephan characterized it, the diversity of activity that we're seeing, the breadth, the scope, I think, gives us the cautious optimism that next year will continue to be another very positive year for activity. So, we are cautiously optimistic.

Allison Nathan: Well, we are certainly looking forward to

seeing how the M and A market unfolds in 2022. Mark, Stephan, thank you so much for joining us again.

Stephan Feldgoise: Thank you, Allison. Much appreciated.

Mark Sorrell: Thanks Allison, appreciate it.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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