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Private Equity Dry Powder Will Likely Spur M&A Opportunities

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Deal making got off to a slow start in 2023 with rising interest rates, persistent inflation and economic uncertainty continuing to weigh heavily on transactional activity. Private equity firms are sitting on approximately $2 trillion of dry powder for private equity transactions.[1]

Despite recent challenges, these available cash reserves and highly liquid securities make deal makers hungry for mergers and acquisitions.

This article will first examine the factors that created a record amount of dry powder, caused by private equity firms raising hordes of liquidity from their investors, even though such firms are still unable to invest the money into viable companies.

Second, it will discuss M&A opportunities for these firms, such as corporate valuations rising after the pandemic, distressed opportunities in cross-border transactions and all-cash deals.

Causes Behind the Surge

In May 2022, the U.S. Federal Reserve made the first of nine consecutive interest rate increases, citing rising inflation. The Fed has increased rates 11 times in the past 12 meetings.

The European Central Bank also increased interest rates in near unison with the U.S. Federal Reserve. Overall, the worldwide M&A market responded accordingly, reducing M&A deal making for the first quarter of 2023 to a 10-year low of just $559 billion.[2]

In contrast, there were, according to Bloomberg, 762 private equity buyouts in Europe last year, the highest since 2007.[3]

While high interest rates not only hampered access to credit, it also increased bank failures around the globe. The NRF M&A Trends Report revealed that the Europe and Middle East markets were especially harmed because private equity in those markets relied heavily on financing to fund their deals.

While other lagging economic indicators may still pop up as a result, fewer deals occurred in late 2022 and 2023, which further increased pent-up dry powder left uninvested by private equity firms.

Fewer Sellers on the Market

As of June 2023, many of the largest private equity firms have seen their portfolio companies' valuations fall, taking them off the market and forcing them to reinvest in internal restructurings instead of sales.

As discussed below, another indication of the limited sale inventory is that private founder-owned businesses as targets have spiked to 43.5% in total M&A value in the first quarter of 2023, increasing from 31.3% in the fourth quarter of 2020.[4]

Many of these private sellers are not backed by outside capital and are less affected by the increase in interest rates, resulting in 61.5% of all M&A deals being nonbacked in the first quarter of 2023.[5]

The Path Forward for M&A and Private Equity

Despite the overall M&A trend, things may not be as bad as they appear, with data biased by large equity sponsors. Indeed, whereas the overall transactional value of deals in the second quarter has fallen to 14.8% below the 2017-to-2019 quarterly average, the total deal count is still higher by 28.8%.[6]

While there are fewer large private equity deals in 2023 — i.e., $10 billion or larger — due to high interest rates, other smaller, private founder-owned deals sales have surged in the same time frame due to the universe of willing sellers shrinking and motivation of smaller size founder-owned business to sell given the current economic environment.[7]

Valuations at a Glance

The detached company valuations from fundamentals, resulting from the cash infusion of pandemic-related government incentives, will likely end as interest rate hikes taper off.[8]

With fewer global market swings going forward, improving valuation accuracy, there will be more attractive buying opportunities.

Indeed, it's not only prices paid on global M&A deals that are currently in correction mode — as the median enterprise value to earnings before interest, taxes, depreciation and amortization, or EBITDA, as a metric now stands at 8.8x for the 12 months ended in the second quarter of 2023, down from 8.9x in 2022 and 10.5x in 2021[9].

In addition, private equity portfolio companies also have been forced to undertake corporate restructurings over the last few quarters to deliver a more consistent track record of growth, feeding stronger EBITDA return potentials.

These separately are leading to a surge of M&A opportunities for corporate actors and private equity sponsors in the past few months.

Rising Cross-Border Activity

While private equity portfolio companies that have been loaded with additional debt will be susceptible, the higher interest rates will also create additional opportunities for private equity to target companies that are over-leveraged and discounted.

Highly leveraged companies in the Europe, Middle East and Asia markets may succumb to floating interest rate pressures and be acquired by cash-flush U.S. private equity funds.

As a result, an uptick in distressed cross-border opportunities may be on the short-term horizon, due in part to a relatively strong U.S. dollar.[10]

All-Cash Deals

Notwithstanding the potential growth in M&A, the ongoing dry powder surplus may finally drive more all-cash deals creating additional risks than ones featuring equity consideration.[11]

All-cash deals generally favor private equity with high amounts of pent-up dry powder, while nonprivate equity buyers may fall short due to the need to finance acquisitions at high interest rates.

Key Insights

Despite economic uncertainty and recent headwinds, private equity firms with excess dry powder holdings carry on high pressure from their investors to invest capital and maintain high returns.[12]

As the pandemic winds down and the supply chain returns to equilibrium, interest rates may fall, turning the second half of 2023 through 2024 into an opportunity for private equity.

Cash will remain king for the remainder of 2023, especially as investors are pushing to have their cash committed to investments by private equity firms.

More sellers that held back in 2022 may also soon enter the market, due to maturing internal operations that increased targets' profitability. While timing will remain a major factor in future deals, private equity funds may find new opportunities with distressed cross-border deals.

Taken as a whole, these factors indicate that M&A deal making is ripe for growth in the second half of 2023 through 2024 and pent-up dry powder may slowly be washed away.

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[1] See Norton Rose Fulbright, Global M&A Trends and Risk 2023.

[2] See Global Financial Magazine, https://www.gfmag.com/magazine/may-2023/private-equity-mergers-acquisitions.

[3] https://www.bloomberg.com/news/articles/2022-12-01/privateequity-backed-lbos-leave-european-companies-at-risk-of-default#xj4y7vzkg.

[4] https://files.pitchbook.com/website/files/pdf/Q2_2023_PitchBook_Analyst_Note_Founder-owned_Businesses_Are_AttrOactive_MA_Targets.pdf.

[5] https://files.pitchbook.com/website/files/pdf/Q2_2023_PitchBook_Analyst_Note_Founder-Owned_Businesses_Are_Attractive_MA_Targets.pdf.

[6] https://pitchbook.com/news/reports/q2-2023-global-ma-report.

[7] https://www.gfmag.com/magazine/may-2023/private-equity-mergers-acquisitions;https://files.pitchbook.com/website/files/pdf/Q2_2023_PitchBook_Analyst_Note_Founder-Owned_Businesses_Are_Attractive_MA_Targets.pdf.

[8] https://www.wilmerhale.com/insights/publications/2023-manda-report.

[9] https://pitchbook.com/news/reports/q2-2023-global-ma-report.

[10] See Norton Rose Fulbright, NRF Global M&A Trends and Risk 2023.

[11] https://windes.com/ma-deal-flow-rising-interest-rates/.

[12] See Norton Rose Fulbright, NRF Global M&A Trends and Risk 2023.