Will Lower Tech Valuations correspond to more M&A?

One topic has dominated the financial news recently: tech-stocks falling out of favor with investors. The pandemic-era dominance of tech has come to an end, with US value stocks outperforming growth by around 10% year to date. Most tech-stocks have collapsed over the last 3 months, with the average stock in the Nasdaq trading 40% below its 2021 peak. This raises the question of whether tech M&A activity will now accelerate, with buyers seeking to benefit from lower valuations, or whether there will be something holding this back.

Why are valuations going down?

To understand how tech M&A will change in this lower-valuation environment, we firstly must look at the drivers behind lower valuations. Naturally, the main factor that's harming technology valuations is higher interest rates. To combat inflation, central banks around the world have become hawkish, with markets now pricing in multiple rate hikes in 2022 for the major central banks. These higher rates harm growth firms' valuations disproportionately, as they have the bulk of their earnings in the future. When investors apply a higher discount rate to these future earnings, as the risk-free rate (in most cases the 10-year US Treasury yield) is higher, the valuation of growth firms drop more than of those which are profitable today. Simply expressed, as rates rise, future earnings are 'less valuable', meaning the valuations of stocks with large future earnings must fall. This explains the strong correlation between the relative performance of value and growth and the 10-year US Treasury yield.

Aside from abstract valuation theory, higher rates entail less liquidity in financial markets, meaning that there is less money available for the more speculative ventures. The relative decrease in risk-appetite over the last year has been shown by the SPAC boom fizzling out and the cryptocurrency bear market. As technology stocks, with their emphasis on future earnings, are inherently speculative, they have been hit by the lack of liquidity.

However, it is important to note that this evaluation of technology firms does not apply to the 'big tech' firms, as they are highly profitable today. That is also the reason why they have been less affected by the tech sell-off. Interestingly, however, inflation, the reason for which rates are being hiked in the first place, harms technology firms less than other sectors, due to mostly not relying on physical inputs in their production processes. This suggests that these firms' revenues and profits continue growing in the face of inflation, suggesting that they still may be attractive to buyers.

Another reason for the sell-off may be the very high valuations that tech firms had and still have. Even when doing the calculations with discount rates and future earnings, the valuations of many technology firms simply didn't make sense anymore. Notable examples are Lucid Motors, which hit a valuation of over $100bn without having sold a single car, or Joby aviation, which was valued at $10bn, even though the flying taxi it intends to produce is still in the development phase. As, especially in the last case, the size of the market and future revenues aren't predictable, the valuation was not driven by expectations of future revenues, but rather speculation.

Hence, valuations fell due to two main reasons. Firstly, excess liquidity and risk appetite in financial markets lead to high valuations, which had to fall when the two dried up. Secondly, higher interest rates lead to future earnings being less attractive, meaning the fundamental value of the shares also changed. It is very possible that these two factors will accelerate as central banks continue tightening monetary conditions. We must take this into consideration when trying to determine how M&A activity in tech will change in the future.

What will happen to M&A Volumes?

In general, higher interest rates should decrease tech M&A volumes because the debt which firms must take up to finance transactions becomes more costly. Also, the factors mentioned above merit lower valuations for growth companies. On the other hand, lower valuations entice buyers to make transactions that they previously found too expensive. In addition, we are at the beginning of a new economic cycle, making it unlikely that we will enter a recession soon that would halt M&A. Based off these two opposing arguments alone, it is hard to determine how M&A volumes will evolve in the future environment. Looking at history may help us.

Today's markets are most often compared to those of the dotcom bubble, which saw US M&A volume fall by 77% and global volume by 71% when it ultimately collapsed. Today's market and the dotcom bubble's most obvious similarity is valuation: 2022's Shiller PE ratio is 38.17, whilst it peaked at 42.88 during the dotcom bubble. The Shiller-PE adjusts price earnings ratio to smooth out the effect of the business cycle. Another similarity is rampant speculation, as evidenced by outperformance of non-profitable and even zero revenue firms both today and during the turn of the millennium, as well as today's SPAC and meme-stock phenomena.

The end of the dotcom bubble was also similar to what we are seeing today. Starting in 1999, Fed chair Alan Greenspan started hiking interest rates to contain US inflation, with the Fed funds rate rising from 4.5% to 6.5% in May 2000. Then, there was a rotation away from growth towards value, with the Nasdaq losing close to 39.3% of its value in 2000, with the S&P500 just losing 10.1%. Today, it is virtually certain that the Fed will raise interest rates at its next meeting. Further, the rotation from growth into value is already underway, with the Nasdaq losing 9.3% year-to-date and the S&P 500 only losing 3.8%. As these two scenarios appear similar, one could conclude that M&A volumes will collapse as higher interest rates harm valuations.

One game-changing difference to note, however, is that the dotcom bubble burst just as the world economy was entering a recession. The shock announcement of March 13th, 2000, that Japan had entered a recession led to an equity market sell-off that disproportionately affected US technology firms. As the economic fundamentals were worse after the stock-market crash than before, naturally M&A activity decreased. Arguably, the world economy today is at the start of a new cycle, as it is recovering from the covid pandemic. Thus, the dotcom bubble is no longer an apt comparison, meaning we must compare today's situation to a market crash after which there was no recession. This occurred in 1987.

1987 saw the same things we discussed above: speculation (Dow Jones up 69% year-to-date before the crash), an equity sell-off (black Monday), rising inflation (3.7% in 1987, 4.8% in 1989), rising interest rates (7% in '87 to 9% in '89) and importantly no recession. As a matter of fact, US economic growth actually rose from 3.5% '87, to 4.2% in '88. Indeed, in this situation which mirrors today, M&A volumes increased by 57% in the US and 54% globally in the year following the equity market sell-off. The peak of exuberance in that period was marked by RJR Nabisco's 1988 $25bn leveraged buyout led by KKR, the year after the equity sell-off. Hence, historical precedents would suggest that overall M&A volumes aren't set to collapse, due to the supportive effect of economic growth.

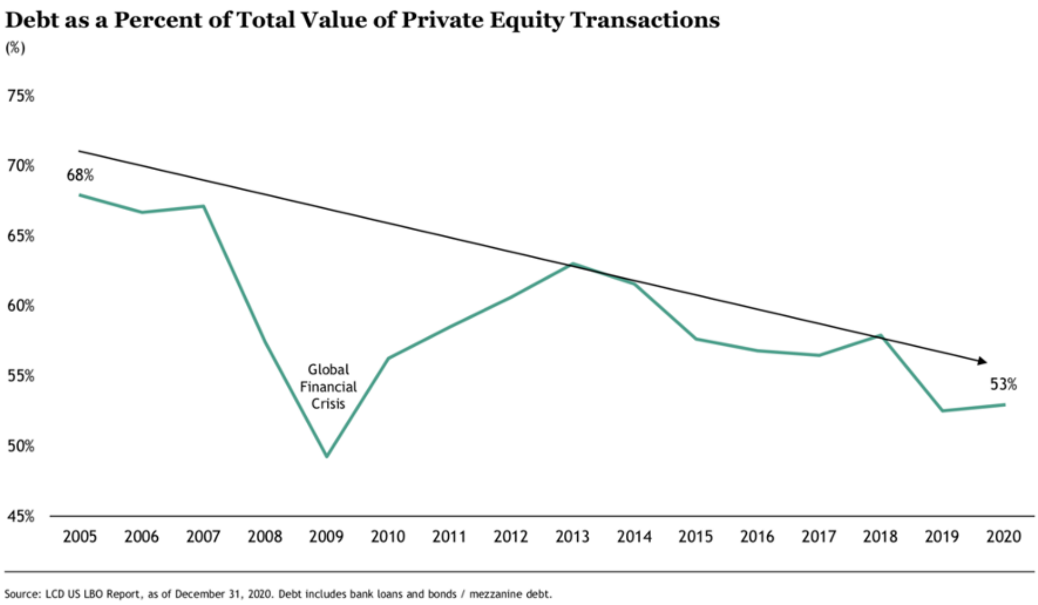
Who will be the buyers in this lower-valued tech market?

However, it is likely that the average buyer of tech firms will change. As tech firms usually pay for their transactions in stock, they will be less able to do this now, for example. One of the two standard acquirers in the M&A space is strategic buyers. They think of acquisitions in terms of an inequality, that two separate companies in the same or acutely similar industries integrating will be greater than the sum of their intrinsic values when they coexist individually. Their mandate is to pay a premium price over their financial buyer counterpart and use the combined synergies between the firms to help integrate the acquiring business and scale over the long term. As the valuations in the tech space fall and the threat of higher interest rates lingers, strategic buyers slowly become no longer poised to use their most readily available currency, their valuations, for partial or full stock-based M&A transactions. Realistically speaking, this leaves few strategic buyers in tech outside of the big 4 (Facebook, Apple, Amazon & Google) who have sufficient cash reserves to pay for acquisitions, as their financial buyer counterparts do. Especially now, with pending updates to federal corporate mergers guidelines from the US government set to cause an uptick in the outright rejection of mergers, described by a Wells Fargo analyst as an increasingly "more hostile regulatory environment", large strategic buyer tech firms are feeling the pressure to not make acquisitions. A recent omen of the new market sentiment is the collapse of the Nvidia-ARM acquisition due to "significant regulatory challenges" surrounding both US and UK anti-trust laws. This caused ARMs owner SoftBank to transition their sights back to an IPO during this turbulent time as even amongst the current sell-off, tech companies are still accorded higher valuations than other firms on U.S. equities markets. This caused ARM to move away from what would've been the largest M&A deal between chip manufacturers at a ~$40bn valuation with over $12bn in cash involved. While there has been significant stock appreciation since the deal was initially announced back in 2020, had such an acquisition been announced within the last few months its cost would've been substantial to Nvidia had they attempted to use the same combination of cash and stock, with their share price having dropped ~20% off its all-time highs achieved in December during our present valuation slump.

The financial buyer is in stark contrast to the strategic. Its best exemplification is found by way of private equity firms (PE). Their sole goal is to generate returns, always and in all ways. They do not have the innate limitation of being in one single industry unless they structure their firm that way. Further, they tend to be largely devoid of the effects of adverse market conditions since they leverage private as opposed to public equity and are considered an alternative investment vehicle. Most financial buyers in the market are looking to acquire a company firmly at or slightly below its market price (derived as a multiple of profits) with hopes of selling off the company for a profit within 3-5 years. Rarely are synergies a consideration of PE firms, at least from the perspective of the acquired company as PE firms may try to align their portfolio around a certain industry or sector but tend to stay away from individual firms merging or becoming absorbed. Due to this lack of synergy integration, we tend to see lower premiums paid in the space, despite some notable exceptions such as last year's joint takeover bid of Zooplus by EQT and Hellman & Friedman, wherein a bidding war transformed into a joint bid with an 85% premium. While this number and the 45% average premiums paid by fund managers internationally in 2021 seem astronomical, there exists an argument presented by many PE firms that mention that these companies are hugely undervalued in the market to begin with, especially when contrasted with their pre-pandemic valuations even before considering the current valuation slump. Thus, on the surface their deals are starting to look even more attractive than their strategic buyer counterparts, further tipping the scale towards financial buyers.

Private Equity investors' attention in recent years has shifted towards technology areas offering something "mission-critical." Many names that immediately come to mind such as the big 4 are considered "mission-critical" to almost every consumer on the planet, from phones and laptops to the rapid delivery of goods and more. However, the true commonality underscoring the backbone of all these companies' strategies is the cloud. Concepts involving the cloud such as the Internet of Things have become more critical than ever and perfect investments to weather the pandemic. Even with a fall in tech valuations, PE firms like Apax Partners still underscore the significance of cloud applications in other industries such as construction, which uses it for addressing labor and supply chain shortages in a traditionally offline business, and even in more central verticals such as cybersecurity. Pre-pandemic, cybersecurity might've been considered just a software investment opportunity, only making itself available to niche investment firms, however, since the rapid adoption of Work from Home mandates across the world, it has become a priority for all tech services making it highly valuable.

Despite the numerous attractive investment opportunities PE faces in the technology sector, they are in no way immune to the macroeconomic environment and especially interest rates. Since the beginning of the pandemic, the average loan-to-value ratio on PE deals has hovered around 50%. As interest rates rise, the debt that PE firms have taken up to finance their deals becomes more expensive, compressing margins and forcing PE firms to be more conservative in their financing. However, we must specify here that this relates mainly to leveraged buyouts that firms such as Thoma Bravo do in the SAAS sector, for instance. Growth investing on the other hand, which has recently been a hotbed of PE technology investing, will be less affected by higher rates, as little, if any, leverage is involved in these deals. Moreover, the leverage employed by PE is not at record levels, with the average loan-to-value ratio being 68% in 2005.



While it is uncertain as to whether private equity will continue its current streak of acquisitions, falling valuations have reduced strategic buyers investable assets while conversely setting up private equity firms to acquire companies at undervalued levels post-pandemic, meaning that it seems perfectly reasonable to expect an inverse relationship between falling tech valuations and the rate of PE acquisitions, and a continued direct relationship between strategic buying and their own valuations.

Conclusion

To answer the question posed in the title, M&A volume should hold steady. However, we can anticipate a shift of buyers away from strategists towards even more PE activity, due to the value of the strategic tech M&A' currency, stocks, plummeting in recent months. It is therefore fitting that Jon Gray, president of Blackstone, recently announced that his firm is looking into making more technology deals now with its record $100bn+ of 'dry powder', profiting off lower valuations. As long as economic growth doesn't abate, this sounds like a good idea.

TAGS: M&A, Technology, Interest Rates, Macroeconomics, Private Equity.