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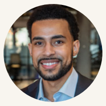

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M&A and CVC in an Economic Downturn

Despite challenging market conditions, not all corporations are affected equally by, or react equally to, a downturn

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- The GFC, much like present day, was a period of noticeable decline for both public and private markets. There was less exit value in 2008 and 2009 combined than there was in 2007—$36.4 billion versus $57.4 billion—while the total number of public listings fell by nearly two-thirds during the same period. However, corporate M&A and investment activity remained relatively resilient due to a number of factors, such as record levels of capital on corporate balance sheets and an evolving venture ecosystem that has attracted growing numbers of nontraditional participants.

- Despite the rapid growth observed in financial markets in the years since the GFC, 2022—particularly the second half of the year—was marked by several declining economic factors. Despite this, corporates have remained somewhat resilient. 26.2% of all US VC rounds in 2022 included a CVC investor—the highest proportion of overall US VC deal count ever observed for CVC deals.

- While the future is uncertain given ongoing market volatility, there are several opportunities and potential benefits of corporate dealmaking during an economic downturn. Widespread valuation declines have lowered the “entry cost” for capable corporate acquirers and investors, allowing many to make bold, strategic plays that may have been previously out of reach. Additionally, this current economic period may be competitively advantageous as corporations with more favorable capital structures—relative to their competitors—may be able to pursue innovation and synergies at a quicker pace.

Introduction

The pursuit of inorganic growth and innovation are ubiquitous objectives for corporate leaders and stakeholders, remaining top of mind even in the advent of one of the worst economic declines since the global financial crisis (GFC). While many corporations are struggling amid turbulent market conditions and economic headwinds, there are enterprises with favorable capital structures and strong recent performance that are advantageously positioned to pursue investment and M&A opportunities. Unlike their more cautious counterparts, these organizations may view the current environment as an auspicious period to execute upon impactful, value-add strategies and initiatives to achieve long-term success.

Rising interest rates and major geopolitical tensions, among other factors, largely contributed to declines in public market performance throughout 2022. Consequently, companies within the private sector, which often look to public enterprises as valuation proxies, have seen substantial valuation declines and a fundraising environment that is becoming increasingly investor friendly. Our 2022 Annual US VC Valuations Report shows downward-trending pre-money valuation figures for nearly all stages of VC and an increase in the frequency of deal terms and downside protections that favor investors.

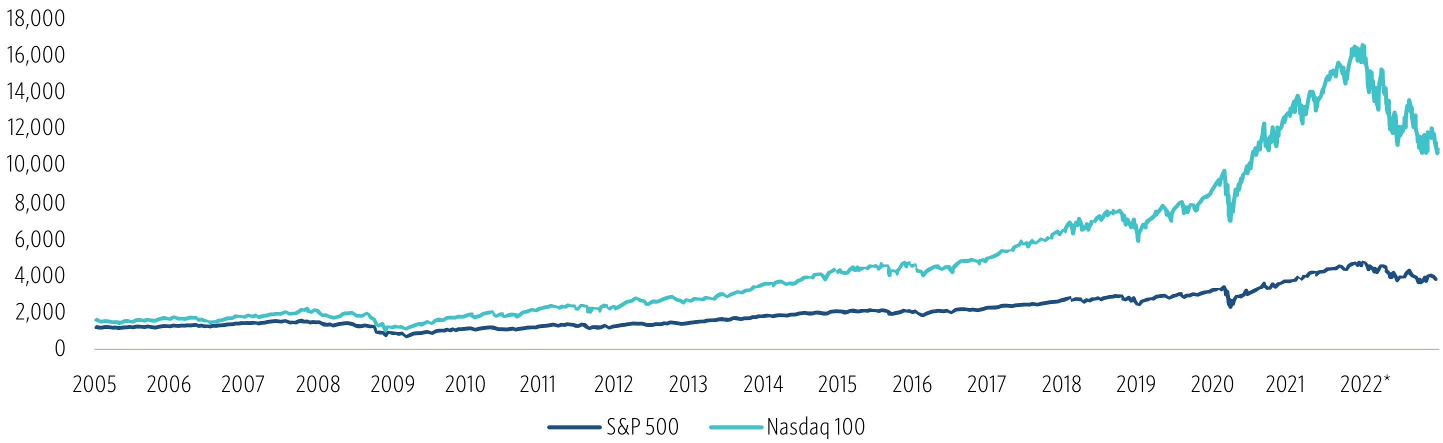
While valuation declines—among other symptoms of a slowing economy—may suppress the appetites of some investors, they should serve as a conducive factor for corporations in a strong financial position to capitalize on "discounted" acquisition and investment opportunities. Doing so would allow organizations to pursue targets or strategic synergies that may have been previously passed on or out of reach entirely due to high costs. Ideally, these targets will help corporations satisfy strategic needs and fill geographic, skill, or product gaps; from a financial perspective, lower valuations for targets during a slowing economic cycle can improve the chances for acquirers and investors to see higher returns.

While predicting the future is impractical, this note looks at historical corporate acquisition and investment activity, as well as recent corporate dealmaking trends, to form a basis for what the future may hold. Additionally, this note discusses several opportunities that may arise from the current market conditions and why capable corporate entities may benefit from pursuing them.

Takeaways from the global financial crisis

Although the GFC is not a perfect comparison to the present-day downturn, primarily due to it being limited to the financial services and real estate sectors, it is the best modern example to examine as we look to understand the environmental factors that influence M&A and corporate venture capital (CVC) activity. Much like it is now, the economy faced substantial declines in the public markets from December 2007 to June 2009, with the S&P 500 and the Nasdaq falling 37.6% and 31.0%, respectively.

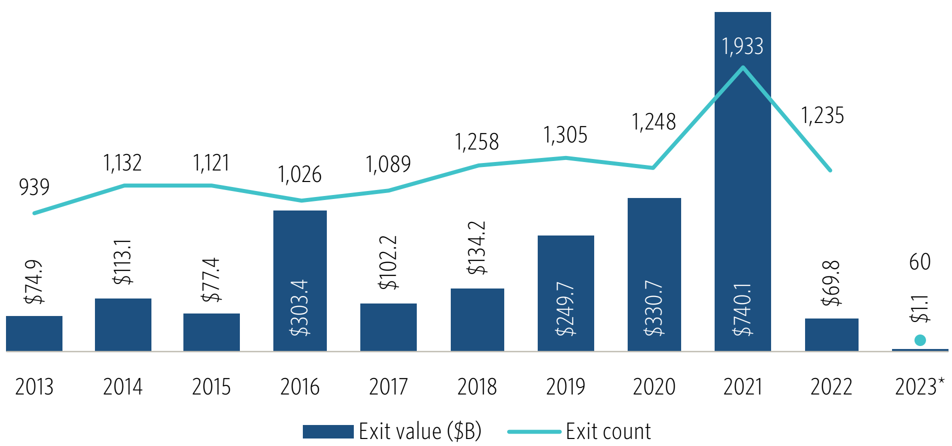
Historical S&P 500 and Nasdaq daily close price



Source: PitchBook | Geography: US
*As of December 31, 2022

This led to declines in deal volume and valuations in private markets, including a sizable drop in exit activity for VC-backed companies. Indeed, despite a record $57.4 billion in total exit value in 2007, only $36.4 billion in exit value was recorded in 2008 and 2009 combined. Notably, public listing activity was hit the hardest with just 34 public exits in 2008 and 2009, totaling roughly $5.3 billion—down from the 94 exits totaling $24.5 billion in 2007.

VC exit activity



Source: PitchBook | Geography: US
*As of January 19, 2023

Acquisition activity remained somewhat more resilient; 872 acquisitions occurred during the 2008-2009 period, just 6.6% less than the 934 that took place during 2006 and 2007. Historically speaking, this was a very active period for M&A and illustrates the importance of pursuing synergies even in a downturn. This activity was buoyed by many large corporate acquirers, including Cisco Systems, Microsoft, IBM, and Alphabet, which made a combined 46 acquisitions during the GFC. Leading up to this period, there was a sharp increase in the amount of cash reserves possessed by US firms; corporations within the S&P 1500 held nearly $750 billion in cash reserves, and their cash holdings—as a percentage of assets—doubled from 1980 to 2008. This increase is partially attributed to tightening credit markets over the same period, leading many corporations to gradually increase cash reserves to safely hedge against refinancing or rollover risk. This excess liquidity allowed some companies to pursue M&A opportunities and maintain competitive investment activity even through an economic downturn.

While there is no one measure to perfectly assess the impact that M&A activity has on the performance of an acquirer—due to several external factors that may influence success or failure—there is anecdotal evidence that suggests that corporate acquirers that remain active during downturns may outperform less active companies in terms of total shareholder return (TSR). To clarify, “active acquirers” would be companies that made acquisitions totaling at least 10% of their market cap from 2008 through 2010; in these instances, these active companies had an average TSR of 10.5% over a three-year period ending January 2010, compared with 3.3% for less active companies during the same period.[1]

Top acquirers from 2007 to 2008*

Acquirer name	Acquired count
Cisco Systems	14
Microsoft	12
IBM	10
Alphabet	10
Oracle	9
Yahoo (New York)	9
Hewlett-Packard	8
Comcast	6
Dell EMC	5
eBay	5
Dell Technologies	5
Yahoo	4
Motorola Solutions	4
Cadence Design Systems	4
Intersil	4

Acquirer name	Acquired count
Gen Digital	4
VMware	3
Thomson Reuters	3
Quest Software	3
LiveUniverse	3
Novell	3
SAP	3
Ignite Technologies	3
Citrix Systems	3
Adobe	3
BMC Software	3
First Data	3
Broadcom (acquired 2016)	3
AT&T	3
Agilent Technologies	3

Source: PitchBook | Geography: US
*As of December 31, 2022

1: “The Case for M&A in a Downturn,” Harvard Business Review, Brian Salsberg, May 17, 2020.

CVC activity also remained relatively strong during the GFC; in fact, more CVC-led deals (123) took place in 2008 than any year prior. Additionally, 2008 and 2009 were the fourth and fifth consecutive years on record that CVC-led deal activity surpassed $1.5 billion. Considering the minimal impact that stock market crashes have on cash and given that balance sheet cash is the primary source of funding for CVC programs, it makes sense that corporate investing remained resilient throughout the GFC. Still, not all CVCs are the same; the natural inclination to conserve capital, wait out market volatility, and avoid risky expenditures remains prevalent among many enterprises, and we will likely see many companies slow deal activity as we move through an uncertain 2023.

Current environment and recent corporate activity

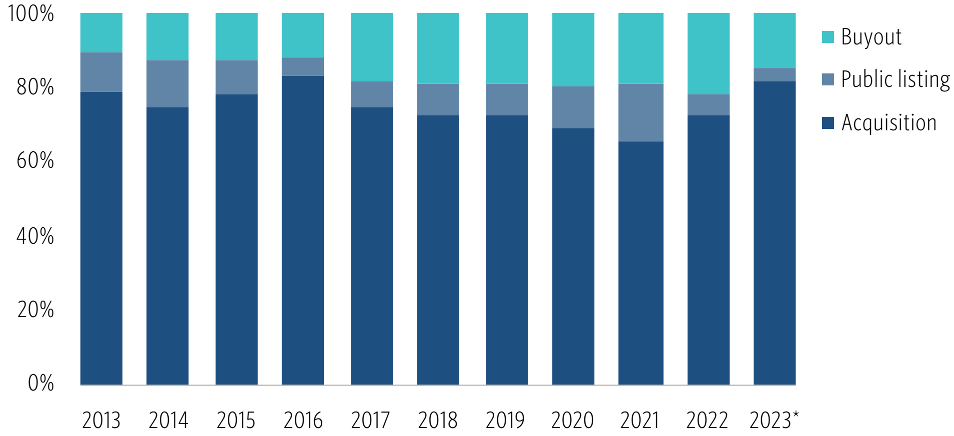
In the 15 years following the GFC, we have observed a rapid evolution of the economy, the financial markets, and market participants. In 2022, the S&P 500 reached a record high of 4,796.6—nearly four times greater than 2008's average trading price of 1,220.0. The aggregate amount of US venture deal value in the last five years—$1.1 trillion—is greater than the total deal value from the preceding 20 years. As of Q2 2022, the combined cash balance held by the S&P 1500 is nearly $2 trillion—nearly three times greater than the total cash holdings recorded in Q2 2008.[2]

Despite this record growth, the narrative surrounding 2022 and 2023 has been one imbued with recessionary fears. Rising interest rates, geopolitical tensions, and other factors have led to massive equity sell-offs and valuation declines in public and private markets, which have challenged growth expectations and rendered the prospect of dealmaking in such an uncertain economic time a daunting task. Indeed, total US VC deal value declined 30.9% YoY to $238.3 billion in 2022, while the total number of deals completed across all stages of VC fell 14.4% to roughly 16,000.

Arguably, the biggest headline of 2022 was the frozen liquidity environment for US-based VC-backed startups. Just $69.8 billion in exit value was recorded in 2022—the lowest since 2011—as startups, particularly those in the later stages of the VC lifecycle, struggled to find a suitable path to liquidity. This drop was largely due to the lack of public listings throughout the year, trapping tremendous amounts of return potential within late-stage and venture-growth startups on the cusp of an IPO. 76 public listings totaling just $32.5 billion occurred in 2022, down from 304 public exits totaling $624.4 billion the year prior.

2: "US Corporate Cash Balances Unlikely to Match Pandemic Peak," Fitch Ratings, October 25, 2022.

VC exit count by type

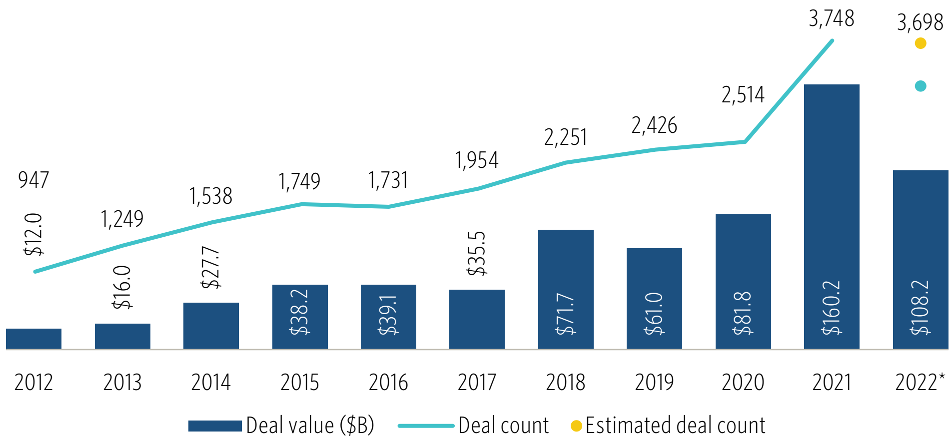


Source: PitchBook | Geography: US
*As of January 19, 2023

This marked decline in exits heavily impacted nontraditional investor participation, which waned steadily throughout 2022 amid declining market conditions. Nontraditional investors, which include PE funds, crossover investors, corporations, CVCs, and others, participated in approximately 20.5% fewer deals YoY in 2022, and total US VC deal activity involving nontraditional investors fell 36.4% to $176.5 billion. This makes sense, as limited paths to liquidity for larger, mature startups trap substantial amounts of value and return potential within the top of the venture lifecycle, significantly altering the risk/return profile of potential investments. This is especially true for crossover investors that have assets in both public and private markets; a dramatic swing in public equity valuations can ultimately lead to an inclination to slow or halt capital deployment to risky private assets such as VC. Indeed, just 488 US VC deals were led by crossover investors in 2022, down from 718 the year prior—a 32.0% decline. Given the ongoing volatility observed in public markets, we expect crossover investors to continue their cautious approach in 2023 as they reassess the fluctuating risk profiles across various asset classes.

CVC deal activity has been much more robust relative to the broader population of nontraditional investors. Total US VC deal value involving CVC participation totaled $108.2 billion in 2022; given the total US VC deal value of $238.3 billion, this means that nearly half can be attributed to CVC participants. Much of this CVC deal value is concentrated in larger rounds; of the $108.2 billion mentioned above, $103.0 billion was attributed to equity financing rounds larger than $10 million. In fact, of the 1,060 US VC deals exceeding $50 million, 50% involved a CVC investor. Given record levels of cash sitting on US corporate balance sheets, it makes sense that these enterprises frequently write large checks to participate in outsize funding rounds. Whether the investment is purely financial, purely strategic, or a hybrid of the two, having the capital to pursue deals of all sizes is invaluable.

VC deal activity with CVC participation



Source: PitchBook-NVCA Venture Monitor | Geography: US
*As of December 31, 2022

When looking at deal counts for 2022, our data shows that 26.2% of all US VC rounds included a CVC investor—the highest proportion of overall US VC deal count ever observed for CVC participants. Moreover, 2022 was a record year for CVC-led deals in the US; 634 CVC-led rounds totaling roughly $22.4 billion in value occurred throughout the year, which is significantly higher than the previous record of $17.6 billion across 596 deals in 2021. Considering more CVC-led deals occurred in 2022 than the period from 2002 to 2009, it is clear that these investors are becoming increasingly more active in their pursuit of venture opportunities. In fact, more than 2,070 unique CVCs invested in US-headquartered companies in 2022—nearly four times greater than the number of unique CVCs observed just a decade ago.

Additionally, these record figures illustrate not only a growing number of active CVC investors within the venture ecosystem but also a growing willingness and desire from startups to take on CVC capital. As a founder, having a CVC investor on your cap table can be beneficial for a variety of reasons: having access to a credible brand, leveraging the technology or expertise of the parent company to garner customer engagement, or accessing new markets via parent subsidiaries.

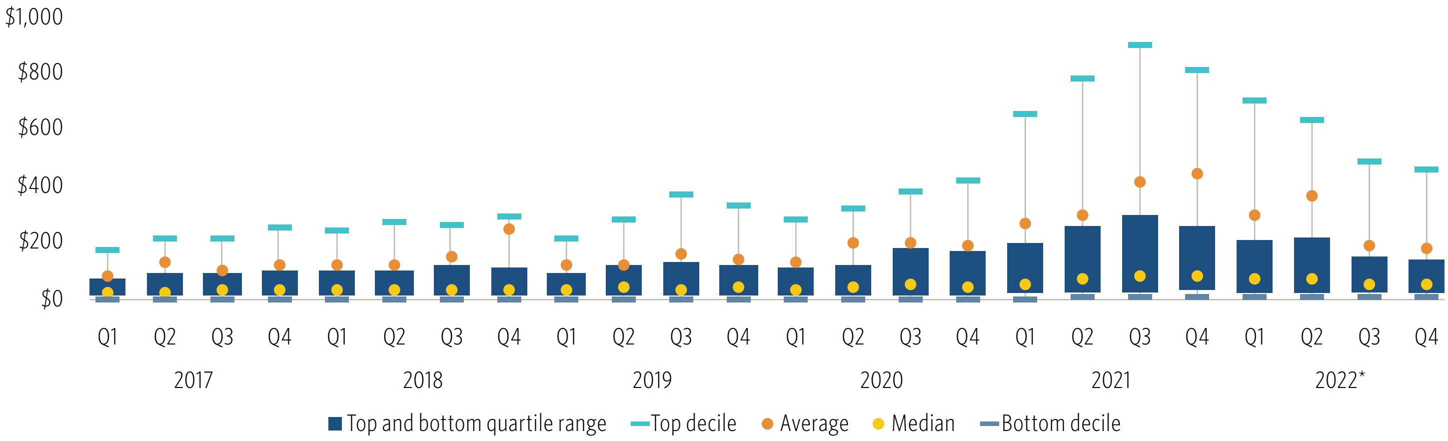
Our data also shows an increase in VC deal valuations involving a CVC investor, while valuations for VC deals involving a PE investor, asset manager (AM), or government/sovereign wealth fund (SWF) showed a decrease. In 2022, the median pre-money valuation for deals involving a CVC was $61.0 million, which is 10.9% higher than the year prior and the highest-ever median valuation for CVC-involved deals. Conversely, CVC investors often demand a larger stake than other nontraditional investors, as the median equity stake acquired by CVCs in 2022 was 23.0%—which is over 2% greater than PE investors, AMs, and SWFs. Despite this, median CVC equity stakes have been trending downward in recent years; between 2016 and 2020, median CVC equity stakes were 25% or greater, while in both 2021 and 2022, we see the median share acquired decreasing roughly 2 percentage points. Declining CVC stakes over the last two years are likely attributed to increasing competitive pressure from other investors, both traditional and nontraditional, that were pursuing deals in a funding environment in which founders held considerable leverage. Now, as the venture market becomes more investor friendly and the total capital available to startups decreases amid cooling nontraditional investor participation, it is probable that CVCs will look to acquire larger equity stakes in return for their investment.

Opportunities for corporate dealmaking

As mentioned above, marked valuation declines in private markets have created opportunities for active corporate investors and acquirers to pursue deals in an otherwise challenging environment. Notably, given both the propensity for corporates to write large checks and the fact that valuation declines have been most pronounced in late-stage and venture-growth-stage private enterprises, there may be a plethora of discounted opportunities at the top of the venture market across several sectors.

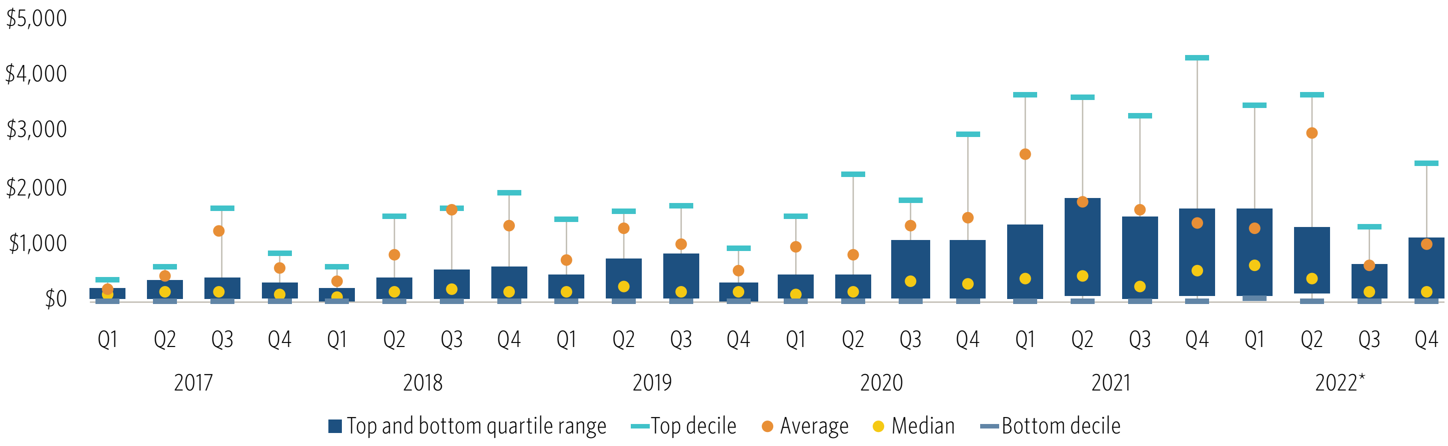
Indeed, while valuation declines are likely to become more prevalent across nearly all stages of venture amid ongoing market volatility, late-stage and venture-growth-stage markets have already seen a significant drop-off. In 2022, the median late-stage pre-money valuation fell 13.0% YoY to $65.3 million, while venture growth fell 17.1% YoY to $290.0 million. It should be noted that these declines are somewhat buoyed by the first half of 2022, which was notably more active and robust relative to the following six months. For example, the median pre-money valuation for venture-growth-stage companies in Q3 2022 and Q4 2022 was $155.0 million and $132.0 million, respectively. The proximity of these enterprises to public markets makes them especially susceptible to broader market volatility; thus, recent declines seen in public markets have had a much stronger influence on later-stage valuations compared with more nascent stages of venture.

Late-stage VC pre-money valuation ($M) dispersion by quarter



Source: PitchBook | Geography: US
*As of December 31, 2022

Venture-growth pre-money valuation ($M) dispersion by quarter



Source: PitchBook | Geography: US
*As of December 31, 2022

Intuitively, we would expect valuation figures to continue their descent in the new year, which would theoretically lower the "entry price" for active corporate investors and acquirers. This is especially advantageous if a corporate acquirer/investor has had to pass on a particular deal in recent years due to an expensive price tag; the ability to revisit these opportunities at a lower cost, and with potentially more leverage over deal terms, is a huge bonus. In any market downturn, there are discontinuities—situations in which solid, fundamental enterprises are dragged down by the dwindling performance of the overall market and/or by weaker businesses in their industry/sector.

Said differently, declining valuations are not necessarily an indicator of declining quality among prospects; various value drivers within these organizations, such as customer or revenue growth, may not be as negatively affected as market valuation suggests. Being able to identify and act upon these discontinuities is a major opportunity for corporate acquirers and investors heading into the new year.

This is not only true for prospects that fit a corporation's existing investment thesis, but also for those that may be a bolder, more strategic play. It is very likely that lower valuations could lead to more explorative dealmaking outside the bounds of a corporate's norm; after all, these organizations greatly understand the need for innovation, and many have the structural capability to invest for longevity rather than focusing on maximizing return in the short term.

Another opportunity present during this downturn is an evolving competitive dynamic. Inherently, not all corporations are affected equally by, or react equally to, a market downturn; companies with less favorable capital structures and financial positions during this period will simply not be able to pursue dealmaking in the near term, while others that are better positioned financially will remain capable of pursuing opportunities. Assuming this dynamic occurs among competitors within a particular industry, it is likely that some corporations will use this period to get an edge over peers by capitalizing on the best targets to fuel growth and innovation.

Whether the goal is to support the growth and stability of a parent organization or maximize the financial return on an investment, being able to pursue deals while your competitors sit on the sidelines is a major advantage not afforded to all. Additionally, less competitive pressure within dealmaking can lead to lower investment and acquisition costs since there are fewer companies bidding up the price.

Looking forward

The current economic environment is challenging for enterprises of all sizes, and the duration of this market turmoil remains unclear. While 48% of CEOs expect current economic conditions to worsen over the next six months, only 7% are preparing for a deep recession in the US.[3] This illustrates that while volatility is likely to persist, not all corporate leaders are viewing the future through a pessimistic lens. The benefits of a corporate acquisition or investment are invaluable, and being able to pursue either of these strategies at a discount is rare. By capitalizing on attractive buying opportunities within the current economic climate, capable and willing enterprises can become even more powerful and competitive within their industries. These organizations, assuming they can successfully acquire and integrate targets, stand to position themselves to achieve strong performance in the immediate future, as well as upon the arrival of a broader economic recovery.

3: "US CEO Confidence," The Conference Board, February 9, 2023.