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# Growth amid the uncertainty

## An outlook for M&A in the consumer sector

# Introduction

The pandemic has done more than disrupt lives—it has disrupted the consumer sector and accelerated the trends reshaping the space, namely digitalization and direct-to-consumer growth. In a way, this has created a stronger environment for mergers and acquisitions (M&A) activity, both in Canada and around the world, as companies sought to either capitalize on opportunities (through bold, transformational acquisitions and disruptive M&A) or find a partner to help weather the storm (through strategic portfolio optimization and the disposal of non-core assets).

The level of M&A activity in the second year of the pandemic backs this up. At the global level, the value of deals announced in the consumer sector reached US$757 billion in 2021, up 58.4% over 2020. The pace of M&A activity in North America the same year was even more pronounced, with Canada hitting US$9 billion (up by 73.4% over the previous year) and the United States reaching US$285 billion (up by 77.5%).

# The landscape remains healthy, but with some dark spots

On some levels, 2022 feels like a whole new environment compared to the past few years. Rising interest rates, soaring inflation, and heightened geopolitical tensions are but a few of the new elements acting on markets this year that dealmakers must factor into the M&A calculations. At the same time, the growing influence of environmental, social and governance (ESG) factors, a tightening regulatory environment, the growth of the direct-to-consumer market, and unsteady valuations are also weighing on potential deals.

The external factors weighing on the market will also do little to dissuade companies from looking to M&A as a source of non-organic growth or for ways to accelerate strategic transformation, digital transformation, diversify their portfolio, or optimize their portfolio value, either through acquisition or divestment.

## On another level, however, many of the factors that drove M&A activity in 2021 are still in play.

Interest rates are still low; while central banks have started to raise rates, they'll proceed cautiously. It's unlikely that the forecasted rate hikes in major markets will do much to cool M&A activity over the next year, as many companies and investors are still carrying high levels of dry powder, funds for deals already committed by private equity companies. Rising rates may increase the borrowing cost for potential acquisitions, but M&A could be seen as a less-risky alternative for deploying cash assets.

High levels of government spending and strong market performance over the past few years are continuing. This has given companies, private equity, and venture capital more dry powder to commit to deals, and has contributed to the growth of the number of special purpose acquisition companies (SPACs). As long as liquidity levels remain high, it will fuel interest in deals.

Indeed, a recent Deloitte survey of 1,300 corporate and private equity executives points to another strong year for M&A in 2022. The survey found that nearly 92% of respondents expect both deal volume and size to increase or remain at the same levels in the consumer sector in 2022 compared with 2021.

# Near-term pressures

## Despite all the uncertainty in the market, the new forces acting on it could help sustain the elevated level of M&A activity

**More attractive valuations**
Equity markets began the year sluggishly, and the valuations of many companies have fallen in tandem. Even with higher borrowing costs, falling share prices could tempt bargain-hunting investors.

**Geopolitical uncertainties**
After two years of pandemic pressures, geopolitical uncertainities could be a tipping point for some companies to close or look for a buyer. Stronger companies will take advantage of the lack of competition in several ways, including having better access to quality acquisition targets.

**Growing impact of environmental, social, and governance (ESG)**
The survey showed that 70% of companies now incorporate ESG metrics into target valuations and have re-evaluated their portfolios through an ESG lens. ESG is increasingly influencing the level of interest—or disinterest—in potential targets.

**The direct-to-consumer (D2C) trend**
While D2C was with us before 2020, the pandemic has accelerated its growth. Every mid-sized product-maker will need to consider how much D2C will shape their business model.

**New appetites for protectionism**
More than two-thirds (68%) of corporate and private equity executives expect to increase their interest in foreign companies in the coming year, which may give rise to protectionist issues. Typically, when governments have intervened to prevent foreign takeovers, the focus has been on industries such as resources, media, and defence. However, in early 2021, France blocked a major takeover in the supermarket space, citing food security as the reason for the intervention.

**Tightening regulations**
Pandemic spending led to unexpected debt loads that may persuade many governments to alter their tax codes in ways that could impact M&A activity. Our survey revealed that 54% of respondents believe the tightening regulatory environment will provoke more deal activity as companies rush to get ahead of more restrictive rules.

In short, while M&A will likely continue to be robust throughout 2022, the market is also growing more complex. Companies considering acquisitions have more to think about, including several factors mired in uncertainty. This only heightens the importance of defining and understanding the reasons for targeting a particular acquisition or selling off an asset, as well as post-deal strategies for the reshaped company.

# Long-term trends

Independent of the near-term forces, the long-term trends underway in the consumer sector will continue to be key drivers of M&A. The motives for buying, selling, merging, or forming alliances and partnerships have broadened as dealmakers consider a wider range of growth strategies. Among the most cited reasons for contemplating some form of deal are:

### Digital transformation
Pressure to initiate or accelerate digital transformation is spurring some organizations to acquire the capability rather than develop it internally. Our survey revealed that 63% of companies are turning to digital tools to help improve their diligence and monitoring functions, while 27% are considering adding these capabilities by means of a deal.

### To complement broader strategic transformation
Many companies are aiming for significant change through M&A. In one example from 2021, a large Canadian retailer sold part of its stake in the e-commerce operations of one of its subsidiaries as part of a broader program of reorganization. Bringing in external partners allowed the retailer to capture more value from its subsidiary.

### To divest underperforming assets
In our survey, 57% of corporate respondents reported "engaging in a divestiture in the past 12 months."

### To optimize the value of the portfolio
Some assets, even those not necessarily underperforming, are being divested to improve overall corporate value. The decision by a large Canadian food processing company to sell its bakery segment to focus on its retail and real estate businesses is one recent example.

### To satisfy activist shareholders
Stockholder influence is here to stay, at least for the foreseeable future. Pressure to reduce debt recently led a German food-maker to sell one of its North American units to a private equity firm.

### To diversify an existing portfolio
An instance of this occurred earlier this year when a large Canadian retailer, drug and grocer acquired a chain of physiotherapy clinics for $845 million. The Canadian giant wanted to diversify the health service offerings at its pharmacy chain.

### To secure supply chains
Companies may choose to acquire others to secure their supply chains. At the same time, they may divest themselves of less secure suppliers.

# Getting it right from the start

Companies consider M&A for a variety of reasons, whether as a means to reset and rebound, accelerate their growth, or disrupt the industry. This motive matters when deciding the best approach to making the deal.

Sometimes an offensive strategy is most suitable. A company may want to acquire another to fill gaps in product offerings, take advantage of attractively valued competitors, obtain technology, or accelerate its growth and expand its capabilities.

Other circumstances call for a more defensive strategy, such as when the priority is to preserve value and position. At those times, companies may choose to divest assets to optimize portfolio value or form partnerships to secure non-core capabilities.

In either case, the Deloitte survey of corporate and private equity executives showed that in the majority of successful M&A deals, the greatest attention was paid during the early, strategizing stages of the deal. Any neglect at this crucial juncture risks destroying deal value by misidentifying or underestimating risks, pursuing cost synergies at the expense of revenue synergies, or mismatching the integration strategy with the original deal's goal.

These hazards of dealmaking, especially at a time of growing economic, political, and regulatory uncertainty, aren't always easy to avoid. It's vital to have the right people in place to weigh all sides of strategic decisions, define the goals of a potential deal, and fully understand which path to take to achieve those goals.

As consumer-facing companies navigate their highly competitive market, they must consider M&A as a means to grow the business, acquire capabilities, or add value through acquisition or divestiture. When the time comes, successful executives need to follow three main principles: find the right deal, do the deal right, and see it through.

Let's talk.

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