Questions That Matter

Corporate M&A | Will Survival Pressure Lead To Consolidation?

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We expect to see a spike in M&A activity, not only because of excess liquidity and favorable financing conditions, but as a way for sectors hit hardest by the pandemic to survive.

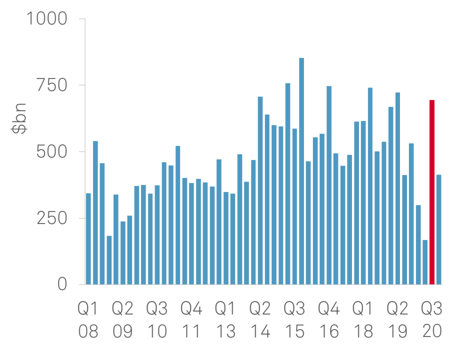
How this will shape 2021

Preparing for life after COVID-19. The pandemic has created profound disruptions in many industries, threatening carefully calibrated financial structures and strategies. Digital disruption has accelerated further, shifts in working patterns appear likely to persist, and ESG concerns have moved to the fore. M&A is likely to become a critical component of the corporate response to these pressures, either as a means to survival or to take advantage of favorable financial conditions.

Sectors hit hardest by the pandemic and economic slump could be forced into cost-focused rationalization. We expect continued mergers in depressed sectors such as energy, as operators look to gain scale under difficult operating conditions.

Liquidity choices. Record debt issuance this year has poured liquidity onto the balance sheets of companies operating in more resilient sectors. This, combined with historically low interest rates, has the potential to fuel M&A in 2021.

Q3 Saw A Resurgence In Deal Activity



Source: S&P Global Market Intelligence; Data as of Nov. 17, 2020.

What we think and why

M&A could reach or exceed pre-pandemic levels in 2021. Deal volumes were somewhat subdued for a number of years following the 2007-2008 financial crisis, but we suspect a different pattern is likely during the post-pandemic recovery, with 2021 volumes poised to return to pre-COVID-19 levels, if not surpass them. A surge in M&A deals in third-quarter 2020 indicates this potential trend (see chart).

Growth opportunities are fueling M&A in stable sectors. Much of the recent M&A has occurred in more resilient and stable sectors of technology, telecoms, and health care. While the largest cash deals in 2020 have been led by strategic buyers, we anticipate that the same drivers--excess liquidity and low borrowing costs--will also continue to support acquisitions by financial buyers.

The need to consolidate is emerging in depressed sectors. Not all sectors will enter 2021 on a firm footing, but could still contribute to higher merger volumes. For instance, there have already been a number of large mergers in the energy sector, including the Chevron Corp.-Noble Energy Inc. and ConocoPhillips-Concho Resources deals. We expect further consolidation among oil exploration and production companies.

Small and midsize firms will get in on the action. As many higher-quality names are snapped up, midsize players could merge, or smaller independents will become attractive value targets.

After a resurgence of deal activity in Q3 2020, M&A volumes look poised to reach or exceed pre-COVID-19 levels in 2021. This brings credit risks and could delay a post-pandemic recovery of credit quality

What could go wrong

Stretched valuations. The recent rally in equity markets, particularly in the technology sector, could inflate valuations into territory that could raise concerns about overpaying for assets and unrealistic synergy assumptions.

Credit-quality concerns. The leverage ratios of most firms we rate that have pursued acquisitions of over $10 billion since 2015 continue to hover well above the levels seen before the deal. Close to 15% of these entities have seen multi-notch downgrades. The credit health of firms that have pursued large deals could quickly deteriorate if growth slows for a prolonged period or access to debt markets becomes constrained.

This report is an extract from the S&P Global Ratings report, “Global Credit Outlook 2021: Back On Track?”

This report does not constitute a rating action

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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