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M&A Hesitation: Banker Fears 'Rose-Colored Glasses' Syndrome

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Opportunities for mergers and acquisitions in Los Angeles have seldom been more ripe, but many may end up spoiling on the vine while dealmakers hold out for a better alternative.

There was a significant decline in M&A activity last year, with some reports indicating a year-over-year decline of around 50% nationwide by the close of last year's second quarter. Despite that fact – and the lack of any significant recovery in the year's back half – dealmakers are optimistic in the New Year, according to Aaron Solganick, chief executive of El Segundo-based investment bank Solganick & Co., which also has offices in downtown Los Angeles.

"A lot of people went on hold and weren't ready to run a process for all the obvious reasons" in M&A, said Solganick, including rising inflation and interest rates and an ongoing lack of liquidity.

"What we're seeing now is that people are looking at their year-end and realizing, 'Hey, we're only growing 10% because of how slow this year has been, when we used to be growing 30% year over year.' And they're realizing they need to do an M&A transaction,'" he added.

Too optimistic?

But the biggest threat to these deals may be rose-colored glasses, Solganick said, as potential M&A targets refuse to budge for anything short of the kind of offer they would have gotten two or three years ago, when the market was far more favorable and liquidity was abundant.

"A lot of these companies that did end up going to market were still trying to lock down valuations from two years ago, from the 2021 glory days where they might get nearly double what they would now," said Solganick.

Chris Manderson, a partner at Beverly Hills-based law firm Ervin Cohen & Jessup LLP specializing in mergers and acquisitions, venture capital, and debt and equity financing, said the mismatch of expectations in value between buyer and seller was a primary cause for faltered deals in 2023.

"Simply put, the sellers wanted too much money. If you're selling your house, and you're getting offered half what your neighbor got a year or two ago, despite the fact that you've got a nicer property and a better home, that's going to bother you," said Manderson, who also serves as co-chair of the firm's business, corporate and tax department. "These companies were hoping to get offers based on old valuation data that no longer really had any relevance."

Understanding the market

As these companies come to terms with the likely economics of a deal in the current market, Manderson said, the Los Angeles market will see increased deal activity.

"Those gaps are beginning to close, and sellers may finally get the reality check they need to make a deal," Manderson said.

Lloyd Greif, founder of downtown-based middle-market investment bank Greif & Co., said that while most dealmakers were celebrating the notion of a return to form for the M&A markets, many are still grappling with the ghost of 2021. Greif noted that M&A transaction volume in 2021 was up 25% over 2020, and the dollar value of those deals was up 57%.

"That's a very healthy situation. Now – compared to 2021 – the number of transactions completed in 2023 was down 45%, and the dollar value has gone down 60 percent," Greif said. "It's a totally opposite environment, thanks to the impact of a four-headed Hydra – economic uncertainty, rising inflation, high interest rates and geopolitical crises – that has plagued dealmaking."

Jay Langan, a regional manager and partner at Deloitte & Touche LLP specializing in M&A, said the primary cause of 2023's M&A downturn was the

Aaron Solganick, chief executive of Solganick & Co., in his El Segundo office. (David Sprague/LABJ)

lack of debt financing and its increasing expense.

Sensible deals ahead

Middle-market deals will likely carry M&A dealmaking this year, according to Solganick, especially in the year's first half. As a global leader for middle-market companies, Southern California is well positioned to reap the benefits. Solganick noted that technology companies – a leading industry for Los Angeles – have held up comparatively well in the M&A market, with roughly a third of all M&A deals made in 2023 originating from tech.

"You're not going to see too many big flashy deals. It's going to be deals where you don't have to raise debt, and don't have to worry about the interest rates too much while funding the transaction," said Solganick.

But Greif said the city's middle-market niche is not without its Achilles' heel and has suffered in particular from the shrinking availability of private equity and venture capital.

"Venture capital has been mostly on the sidelines throughout 2023, and that's a major blow to young companies. The lack of private equity has a similar effect on entrepreneurially owned and operated companies," said Greif. "Los Angeles is not insulated from that. We have more entrepreneur-led companies here, more middle-market companies here that are younger and less mature because of the Southern California ecosystem that welcomes and supports innovation and entrepreneurship. LA's a meritocracy, not an aristocracy."

Another reason L.A. skews to middle-market companies, Greif said, is the "flight of Fortune 500 companies from California due to high income taxes, greater government regulation and a higher cost of living for employees."

For the area's largest companies, the biggest threat to M&A dealmaking in 2024 could be regulatory threats, Greif said. He noted that Lina Khan, who heads the Federal Trade Commission under the Biden Administration, hasn't shied away from attempting to shut down high profile deals, notably the now completed merger between Microsoft and Santa Monica-based game-maker Activision Blizzard, Inc.

"Lina Khan is a bad word for dealmakers. Her aggressive enforcement policies and actions make major companies think long and hard before doing any big deals, because they may end up wasting a lot of time and money putting deals together only to have the transaction blocked on antitrust grounds by the Feds," said Greif.

Manderson seconded the difficulty of dealmaking under the current FTC, adding that the regulatory threats to M&A may be foreign as well as domestic. He noted the planned $20 billion merger between Adobe and Figma, which officially fell through in December. In a press release, Adobe claimed the deal's failure was the result of having "no clear path" for antitrust approvals in Europe and the UK.

But for Solganick, who specializes in middle market M&A deals in the technology and IT services space, the future looks bright. Solganick said concerns about overregulation from the FTC and UK aren't a problem for the companies they're targeting for dealmaking. He said his boutique investment bank is in full-on hiring mode in order to keep up with the current dealmaking demand, with a likely uptick on the horizon.

"At the end of the day, if your company has good revenues, good profits and you're growing at a reasonable pace, if you've got good financials and a good product, you'll be able to sell your company regardless," said Solganick. "It will be telling, when the money starts to really come back, what companies the market will be focusing on."