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In this mergers and acquisitions market, the strong eat the weak

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Bay Street’s summer vacation plans are in jeopardy.

Bankers and lawyers are bracing for a second consecutive year of record-breaking merger and acquisition activity, fuelled in part by a recent tech stock sell-off that dramatically lowered the price tag on growth-focused businesses.

In recent months, M&A activity has exploded in sectors such as software, IT services and logistics. The Canadian tech industry’s serial acquirers – companies such as Constellation Software Inc, CGI Inc. and Descartes Systems Group Inc. – tapped their cash reserves to stage a string of foreign takeovers.

Waterloo, Ont.-based Descartes made its third acquisition of the year on Monday, acquiring XPS Technologies, a Utah-based shipping software firm, for an initial US$65-million. (Performance payments of up to US$10-million more are tied to certain revenue targets in the first two years after the acquisition.) “All the numbers in this business got crazy because of the pandemic, and now they’re back down to, maybe, the old normal levels,” Descartes chief executive Edward Ryan told The Globe and Mail.

As interest rates continue to rise and inflation fears continue to haunt investors, corporate financiers predict more deals are coming in perceived safe havens as well. That includes sectors such as banking, gold mining, real estate and restaurants.

“We expect to see continued robust M&A activity going forward as many of the strong fundamentals remain intact, including access to capital and strong demand from both strategic players and financial sponsors,” Richard Betsalel, managing director at investment bank Crosbie & Co., said in a report last week.

Investment bankers point to one major distinction between last year’s M&A activity, which came as equity markets hit historic highs – and what’s now playing out. In the past, growth-focused companies such as Shopify Inc. or Nuvei Corp. used their lofty valuations to pay for takeovers, either swapping stock or selling shares to finance acquisitions.

Now, cash is king. The strongest companies – those with cash in the bank, relatively resilient stock valuations and untapped credit lines – are going to pick off rivals who face limited access to capital markets.

Constellation, for example, spent more than US$1-billion on acquisitions in the most recent quarter, a new record for the value of businesses acquired by the

Toronto-based tech company, and four times what analysts predicted. Yet Constellation still has more than US$900-million of cash and no debt. "With the continued pullback in software valuations, we believe there is a higher probability Constellation deploys more capital on large acquisitions," Paul Treiber, an analyst at RBC Capital Markets, said in a recent report.

Bay Street is also predicting companies that spent the past two years playing defence through the pandemic will get back on offence.

Recipe Unlimited Corp., parent of the Keg, Swiss Chalet and 17 other brands, grew through a series of takeovers, but the deal-making stopped with COVID lockdowns early in 2020. Scotiabank analyst George Doumet said in a recent note that Recipe is coming out of the pandemic with one of the industry's strongest balance sheets, with "ample room" for share buybacks or M&A, with targets that could include weaker Canadian and U.S. chains.

Private equity activity is also expected to heat up with the weather. Mr. Betsalel said the industry "took a bit of a breather in the first quarter of 2022″ but is now aggressively hunting for deals, as most fund managers are flush with cash.

PE funds are shopping at the upscale end of the market. Funds managers are targeting what they see as quality companies – those that increased revenue and earnings before interest, taxes, depreciation and amortization (EBITDA) by 10 per cent or more in recent years, according to Crosbie & Co.

These high-growth businesses are being purchased at a 30-per-cent premium to the average valuation for similar-sized companies, well above the historical 15-per-cent gap. Mr. Betsalel said the wide premiums "confirm that private equity buyers continue to compete aggressively for the top performers."

Last year set records for global M&A activity, with US$5.9-trillion committed to more than 63,000 takeovers, according to Refinitiv, including US$349-billion spent on 4,558 Canadian deals. While a slow start to the year means those high watermarks may not be breached, Bay Street expects takeovers to continue to run hot this summer.