2022 M&A REVIEW

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SECTOR OUTLOOK 2023

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2022/2023 Macro Outlook

2022 was quite a turbulent year. We saw global growth slowing due to a soup of fiscal and monetary tightening, China's Covid-19 restrictions and property slump and skyrocketing energy costs due to the Russia-Ukraine war. Global growth is expected to be at a below-trend pace of 1.8% in 2023, with various outcomes expected across each part of the world. Following the latest round of global interest rates rises, we have nearly reached the peak, with the UK rates not expected to exceed 4.5% and remaining at this level for 2023.

The US is expected to narrowly avoid a recession, with inflation forecast to reduce from 5% to 3%. China is predicted to grow slightly in H1 with an April relaxation of Covid-19 restrictions, followed by sharp growth in H2 with the reopening boost. The Euro area is expected to endure a mild recession due in part to the surge in energy bills, which will boost inflation to peaks of 12%.

In the UK, the issues we face this year will continue to be impacted as we suffer from that extra ingredient, Brexit. Rising costs, weaker trade, and increased uncertainty have already taken a toll on the economy and are expected to continue, with parliament in denial and no significant advance in any solution to our Brexit woes.

As always, however, there are silver linings to be found amongst the clouds. Private Equity (PE) activity is expected to continue, if not increase, throughout this year; history has shown that PE delivers stronger returns during tough times.

Whilst the increased cost of debt (and restricted access to debt) could slow deal activity in the short term, the demand for strategic capital will grow. PE firms will look for recession-resilient industries, such as business-critical enterprise software, defensive healthcare equipment & services, and strong tailwinds in defence and cybersecurity. With the transition to a low-carbon global economy, climate technology and environmental consulting will be a focus in venture capital and growth equity strategies.

Companies with resilient, recurring cashflows will be among the most attractive for PE this year, and the secondaries market will show strong momentum as limited partners and general partners seek liquidity options.

Source: HSBC, Goldman Sachs, KPMG

Key Themes for 2023

We see 5 key themes likely to influence values and deal making through 2023:

1. ESG

ESG will become increasingly important as governments seek to decarbonise their economies, stronger regulatory and reporting regimes drive compliance needs and social media platforms force corporates to put genuine focus on being a "Good global citizen". The recent COP27 summit concluded that $4-6 trillion needs to be invested in renewables and decarbonisation solutions every year until 2030 – including investments in technology and infrastructure – to allow us to reach net zero emissions by 2050. In America, the Inflation Reduction Act ("IRA") approved by lawmakers in August includes a record $369 billion in spending on climate and energy policies. There is plenty of opportunity to make great returns whilst doing good!

2. Data & AI

Data is undoubtedly increasingly at the heart of everything. It is relatively easy to acquire huge amounts of data so the value comes from those that can manage and distil it to drive value, either within your own business or deploying it through someone else's. The scale up in the capabilities of AI will accelerate exponentially as the data being processed builds and the technology learns from itself how to learn. Microsoft's recent extension of its partnership with OpenAI (ChatGPT), with a reported additional $10 billion investment, gives some idea of the value being placed on being at the cutting edge of AI. Smaller businesses need to think carefully about how and when they may need to adopt this rapidly advancing technology to remain competitive.

3. Healthtech

Volumes and activity remain strong as pandemic-forced changes in operating methods have gained traction. There is much, much further to go and we expect to see deal activity at the both the venture end of the market on the fundraising side and in consolidation, within different sub verticals as niche leaders emerge and their investors look to rapidly scale, all the way up as larger businesses look to protect their positions.

4. Operational Efficiency

With the pressures of Brexit and the recent pandemic both impacting on the availability of personnel, businesses able to support companies in transitioning to more automated, less-staff-intensive models will be well placed. We expect this to continue to support software and technology company valuations, as well as specialist professional services.

5. Telecoms & Interconnectivity

Telecoms will continue to see consolidation to drive value increases that come from scale, as larger players acquire customer bases. However, more significant will be the investment needed to upgrade the national telephone infrastructure with the roll out of fibre, picking up the so called "last mile" to the premises dominated by BT. With increasing bandwidth and speeds being demanded by businesses to remain competitive as well as by individuals, we see this investment, both in the UK and indeed elsewhere, will require scale. This is likely to result in opportunities across the supply chain as well as consolidation of those owning the cable in the ground. The investment is very long term, given the costs involved, will of course start with much latent capacity, with heavy investment in dark fibre. We expect to see Infrastructure Funds active in this area as installed networks reach scale.

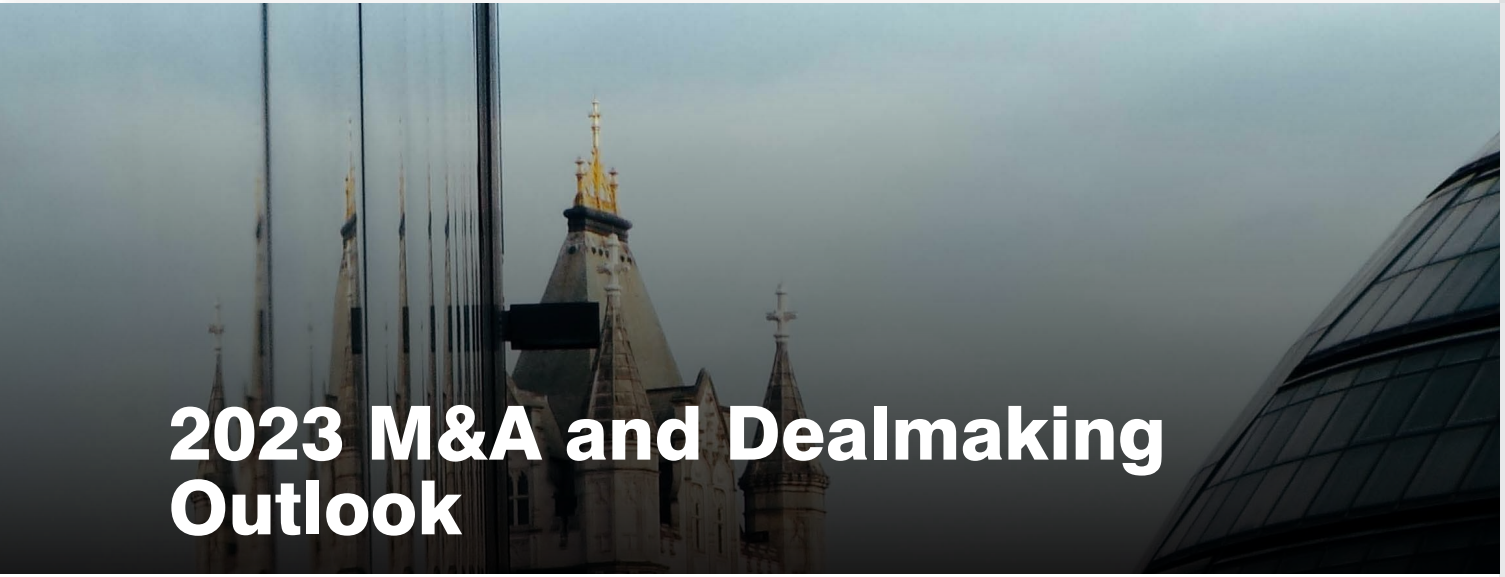
Public Market Outlook

The global equity market had a shaky end to 2022. Sell-offs last year resulted in losses on several indices greater than 20% for the first nine months of the year. Fortuitously, perhaps, the weak currency against the dollar meant sterling investors realised lower UK losses on their unhedged international equity exposures.

Despite this, however, opportunity in the equity market is more attractive than it was a year ago. This year's bear market has improved Vanguard's outlook for global equities and, even at the beginning of February, the FTSE managed to bounce back to an all-time high.

In the UK specifically, the VCMM calculates 10-year annualised return expectations for the UK equity market at around 4.6%-6.6%. Through their VCMM, projections suggest there are greater opportunities outside of the US.

Emerging markets are expected to perform attractively for the first time since the Covid-19 pandemic. This is due to steep selloffs in 2021 and 2022 amid concerns over elevated inflation, aggressive monetary policy tightening, slowing growth and political risks that had increased the emerging market risk premium.



2023 M&A and Dealmaking Outlook

M&A Outlook 2023

2022 was a year of two halves: the first half of the year piggybacked on the strength of the 2021 market with strong deal making activity and 1,821 deals completed by the end of June. Interest rate rises off the back of rising inflation numbers driven by fuel and energy price spikes in the summer swiftly curtailed deal activity while tempering the multiples and premiums from the highs of the year prior. However, even with the mid-year correction, businesses showed resilience and commitment to drive market demand, leading to only an 11% drop in the volumes to 1,621 in H2 2023.

Despite inflation, interest rate hikes, capital availability concerns, geopolitical tension, supply chain uncertainty and an ongoing consumer spending squeeze, M&A still remained central to the corporate strategies and a balanced mix of scope and scale evidenced the desire to invest in inorganic growth opportunities.

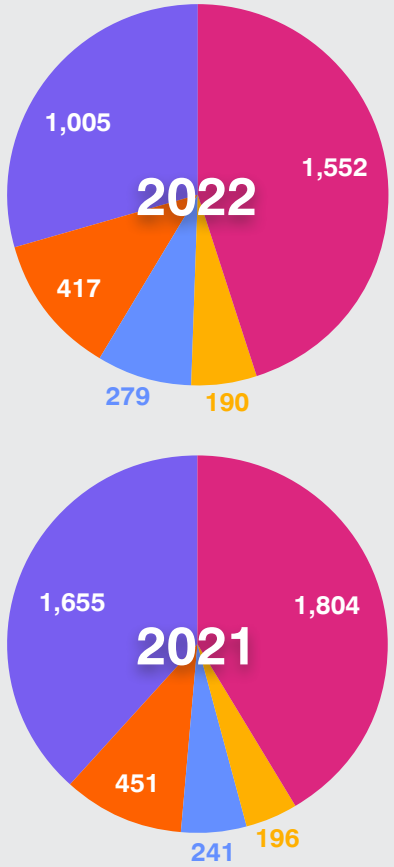
The market's ability to adapt will be paramount in the coming period and while value may be temporarily depressed by various macro factors, acquisitions, divestitures and alternative M&A strategies will provide growth pillars for businesses as we move on from the post-2008 cheap money economy.

Furthermore, in such an uncertain market, transformation is key and exercises such as changes to working capital policies, business reorganisation or cost reduction in favour of more tempered cash management strategies will secure the future of many businesses while inflation subsides over the next 12-18 months.

Source: Zephyr, Bain & Co, Deloitte

Deals Per Sector 2022 vs. 2021

The following chart shows the number of various transactions in each of Polestar's sectors over the past 12 months, compared to 2021



Sources: Zephyr, Bain & Co, Deloitte

Software & Technology Overview

2022 was a year of opportunity for the software and technology sector. The next-generation tech verticals, such as FinTech, HealthTech and ClimateTech, continued the pace of disruption along with DeepTech, AI, AR, machine learning and IoT. These innovations will continue to be an important aspect within corporations seeking competitive advantage and efficiency.

Solid growth for information, computing and technology services was driven by 5G wireless, fibre rollouts, cloud services, and demand for cybersecurity services and digital consultancy. New trends are emerging such as social commerce, gaming, next generation digital services, and eSports.

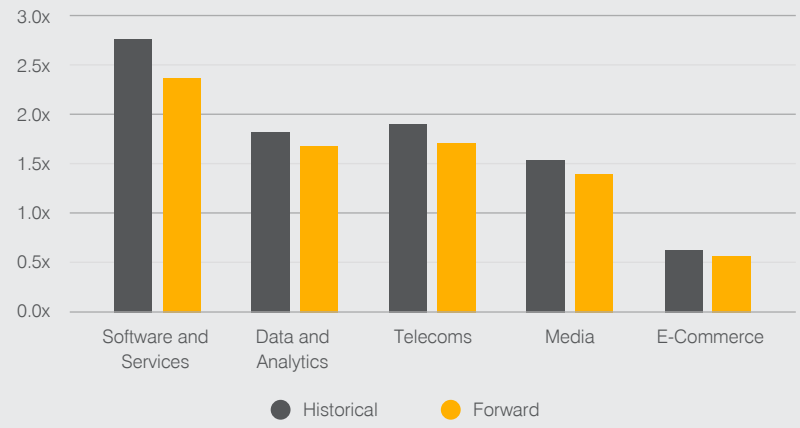
The war in Ukraine, geo-political tensions and the lingering impact of Covid-19 on supply chains (particularly in China) are all factors impacting this sector. Tightening monetary policies, inflation and a slowing growth outlook have created their fair share of challenges, leading to a global correction in valuations.

Despite the recession, underlying drivers of the sector productivity, efficiency, digitalisation, and sustainability, have a positive outlook and most companies will continue to attract interest from VCs and other investors, particularly those with SaaS business models.

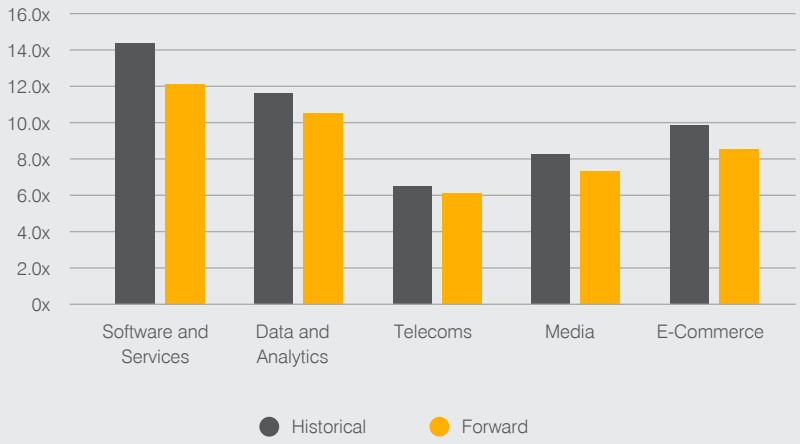
A key trend shaping the sector will be governments seeking to decarbonise their economies. The COP27 summit highlighted the need to invest in renewables and decarbonisation solutions, particularly in technology and infrastructure.

Although we might see a slight drop in valuations and the pace of activity in this sector, its innovativeness and creativity will let it ride out the wave.

Historical vs. Forward Revenue Multiples*



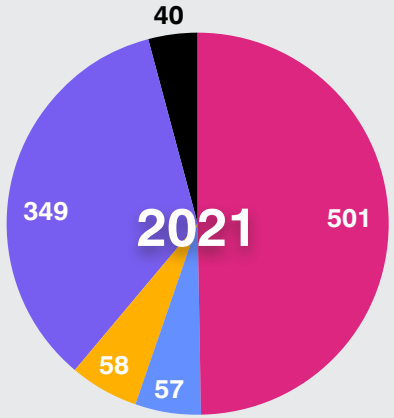
Historical vs. Forward EBITDA Multiples*

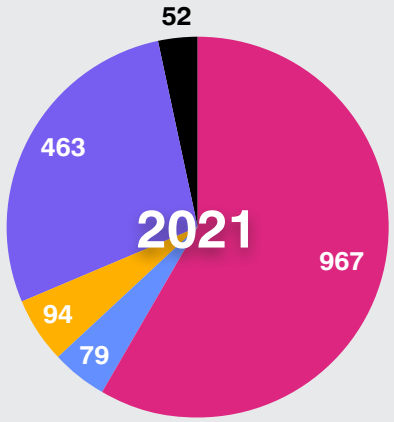


**Listed market information*

Source: Barclays

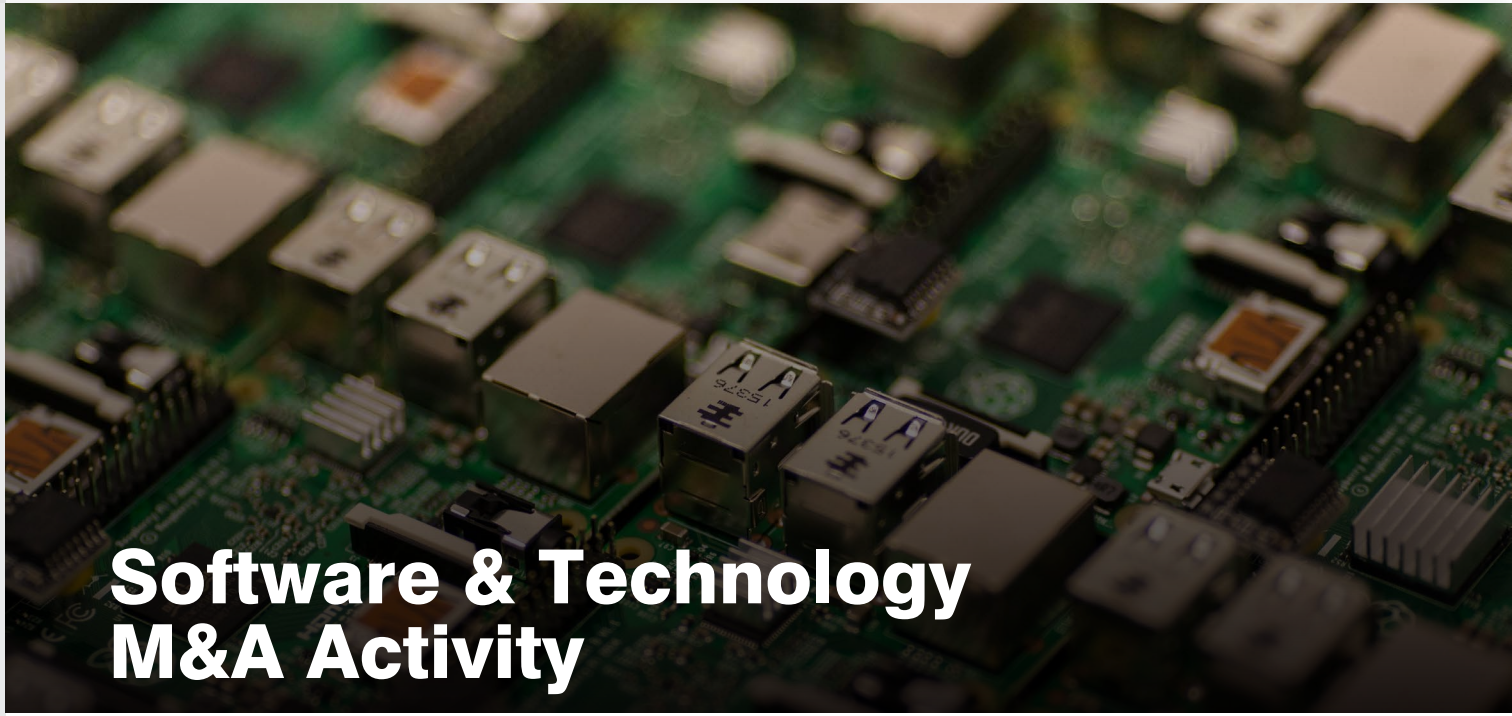
M&A Activity 2021





- Software & Services
- Telecommunications
- Consulting
- Data & Analytics
- E-Commerce

Zephyr



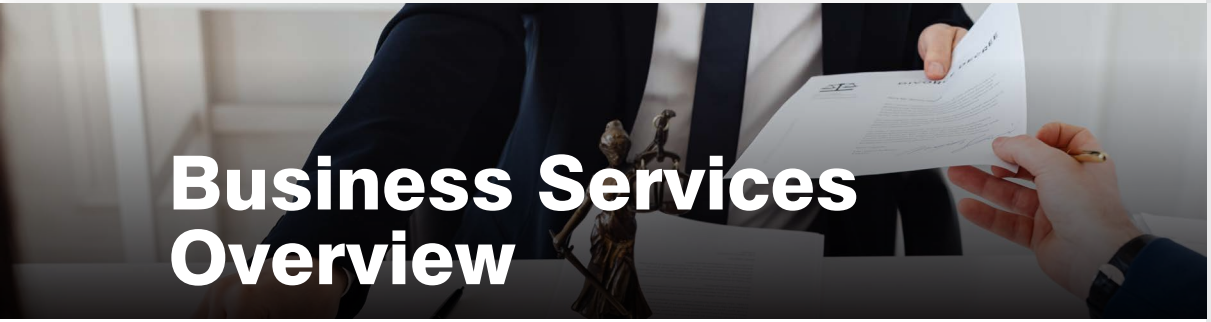
Software & Technology M&A Activity

The overall decline in M&A volumes can be seen across the software and technology spectrum with many financial and strategic acquirors seeking to reprioritise cash flow security through pursuing less transformative M&A strategies.

This retreat translated into the following number of deals per subsector:

- Software & Services – (H1 – 280, H2 – 221)
- Telecoms – (H1 – 22, H2 – 35)
- Consulting – (H1 – 24, H2 – 34)
- Data & Analytics – (H1 – 198, H2 – 151)
- E-commerce – (H1 – 28, H2 – 12)

Retreating from 1,650 deals last year, the sector produced 1,002 transactions in the UK during 2022. This should not, however, be interpreted as the end of the attractiveness of the space. Instead, it should be considered a market correction or consolidation from the record levels of activity seen throughout 2021 and the first half of 2022. Irrespective of consolidation, there are still large volumes of both private equity and trade dry powder available for businesses with well-developed value propositions.



Business Services Overview

In 2022, the business services sector was revived as the economy returned to a level of normality post-pandemic. The bounce of this sector was fuelled by a backlog of work caused by Covid-19. For example, the reoccupation and repurposing of commercial space benefitted the commercial renting and leasing sector.

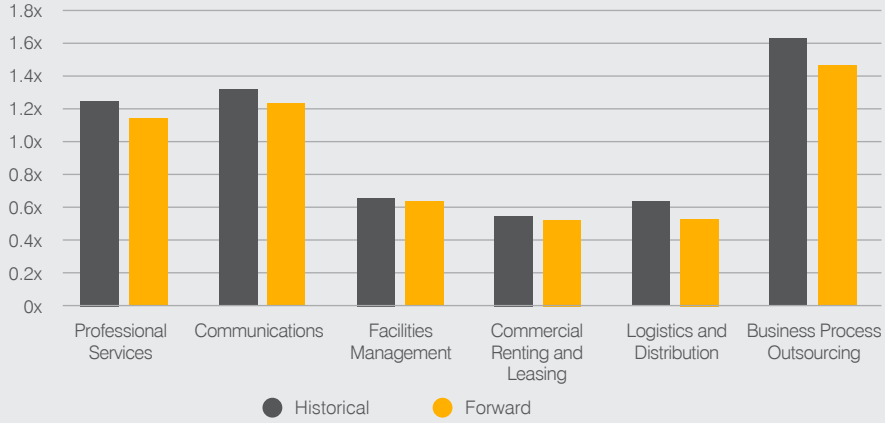
Consolidation is expected in the business services sector in 2023, with smaller companies being targeted by larger players due to economic pressures. Private equity has also taken a renewed interest in business services. Outsourcing non-core business activities continues to gain momentum, driving growth and M&A opportunities across professional services, business process outsourcing, and others.

Professional and tech-enabled services, such as accounting, consulting and legal services that provide core activities are appealing to investors seeking stability throughout the recession. Additionally, facilities management such as HVAC, building automation, and energy management specialists are seeing interest from ESG-focused investors to reduce carbon footprints and meet health and safety requirements.

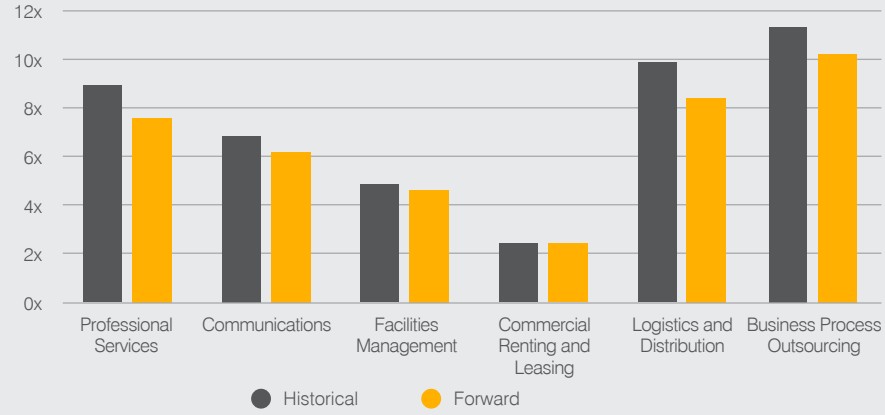
However, the business services sector will not be immune from the recession affecting the wider UK economy through inflation and the cost-of-living crisis. This may bring down UK valuations in the sector, but most firms should be able to ride the wave out.

A decline in the property market will impact the commercial renting and leasing sub-sector, although the professional services sub-sector should still see high demand as companies go through M&A processes, restructurings, insolvencies and liquidation.

Historical vs. Forward Revenue Multiples*



Historical vs. Forward EBITDA Multiples*



**Listed market information*

Sources: Barclays, Harris Williams

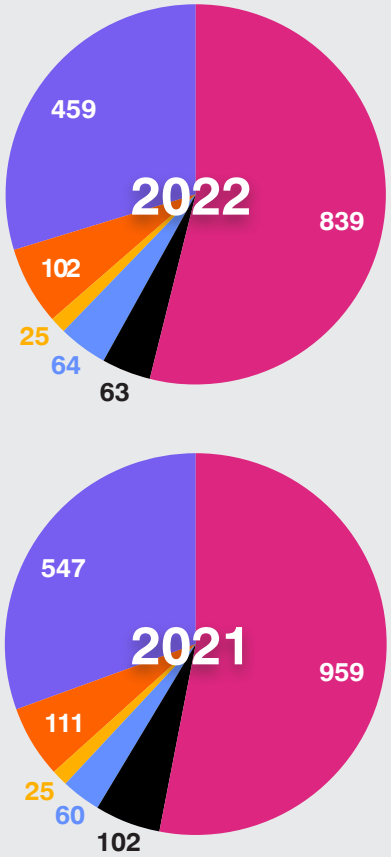
Business Services M&A Activity

The business services sector was active in 2022, completing 1,552 deals last year. However, this was quite a reduction compared to 1,804 deals in 2021. 31% of deals completed in 2022 were international companies investing into the UK, with 42% of that international interest coming from the US.

This has translated into the following number of deals per subsector:

- Professional Services (H1-435, H2-404)
- Communications (H1-28, H2-35)
- Facilities Management (H1-31, H2-33)
- Commercial Rental & Leasing (H1-11, H2-14)
- Logistics & Distribution (H1-44, H2-58)
- Business Process Outsourcing: (H1-252, H2-207)

M&A Activity 2022 vs. 2021



- Professional Services
- Communications
- Facilities Management
- Commercial Renting & Leasing
- Logistics & Distribution
- Business Process Outsourcing

Zephyr

Manufacturing & Industrial Overview

2022 masked issues we will be facing this year in the manufacturing and industrial sector. Whilst the growth rates of output and orders in the manufacturing and industrial sector were beginning to slow, activity remained strong due to the backlog from the Covid-19 pandemic. The domestic market delayed most of the growth in exports as supply chain disruptions were making domestic orders easier to fill compared to international ones.

MAKEUK Manufacturing Outlook suggests the sector will contract by 3.2% in 2023. Some key factors that will bring down valuation multiples throughout the sector will be supply chain issues, labour shortages, and the uncertain economic conditions.

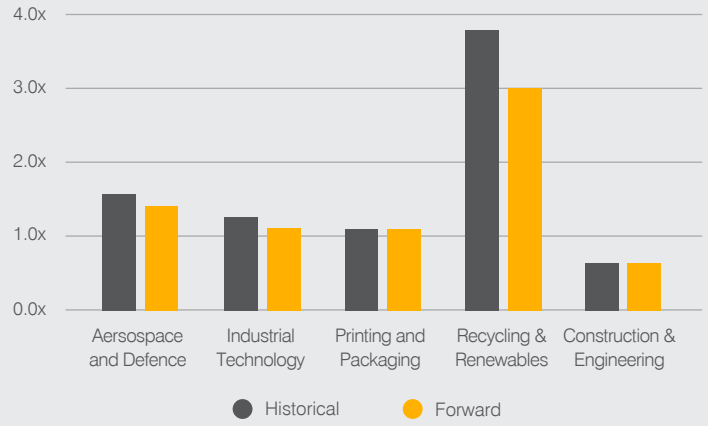
Semiconductor supplies continue to be disrupted by ongoing Covid-19 lockdowns causing disrupted levels of production, a problem likely to worsen as the US and UK step up trade sanctions against Chinese technology firms on national security grounds. This output gap is likely to continue until 2027.

A near record 86,000 job vacancies mean that skills shortages are costing the industry almost £20 million a day in potential lost output. Inflationary pressures and rising interest rates mean lower profit margins for most firms. Additionally, the weaker pound means it is, of course, more expensive for UK manufacturers to import raw materials or component parts.

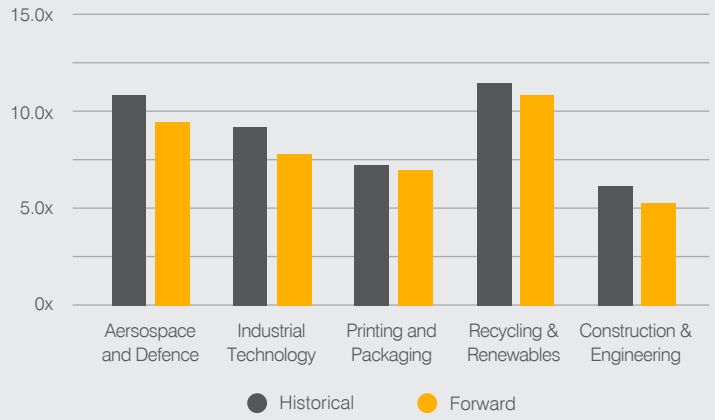
Going forward, manufacturing and industrial firms should consider five important trends for the year ahead: managing uncertainty; tackling workforce shortages; driving supply chain resiliency; scaling smart factory initiatives to the metaverse; and developing sustainability.

- Manufacturers have increased their digital investment over the past few years and accelerated the adoption of emerging technologies. Companies with higher digital maturity have shown greater resilience, as did those that accelerated digitalisation during the pandemic.
- Firms should consider a broad range of talent management strategies to reduce voluntary exits, such as pay increases, upskilling and reskilling, and flexible work arrangements.
- Implementing local capacity and digitising their supply chain.
- Manufacturers are progressing their ESG commitments by making operational changes across their value chains, such as managing waste, electrifying fleets, and elevating smart buildings.

Historical vs. Forward Revenue Multiples*



Historical vs. Forward EBITDA Multiples*



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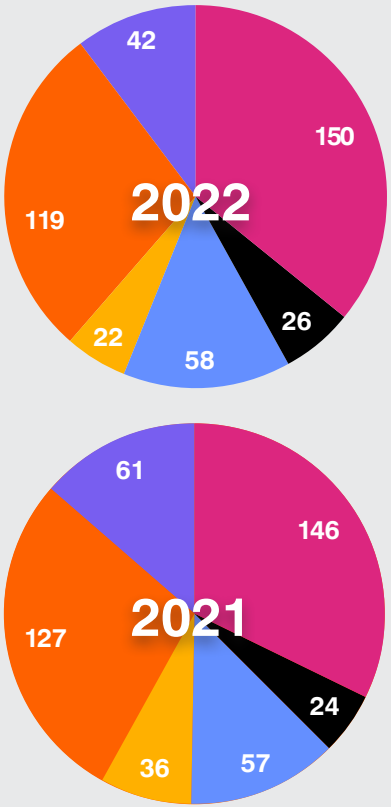
Source: BDO

M&A Activity 2022 vs. 2021



- Construction
- Printing & Packaging
- Recycling & Renewables
- Aerospace & Defence
- Industrial Technology
- Specialist Manufacturing

Zephyr

Manufacturing & Industrial M&A Activity

There was a slight slowdown in the manufacturing and industrial technology sector in 2022 (451 completed deals in 2021 vs. 417 deals completed in 2022). 54% of deals completed in 2022 were international companies investing into the UK. Although the interest was mixed in countries investing into the UK, the US made up a majority, especially in sectors such as aerospace and defence and industrial technology.

This has translated into the following number of deals per subsector:

- Construction (H1-82, H2-68)
- Printing & Packaging (H1-14, H2-12)
- Recycling & Renewables (H1-26, H2-32)
- Aerospace & Defence (H1-5, H2-17)
- Industrial Technology (H1-58, H2-61)
- Specialist Manufacturing (H1-22, H2-20)

Healthcare & Education Overview

Healthcare

The healthcare sector performed well in 2022, with growth fuelled by delayed treatments and backlogs from the covid-19 pandemic.

Healthcare firms seem generally optimistic for 2023 for two reasons: significant underlying opportunities for growth stemming from private hospitals directly taking on NHS-funded procedures, and continuous innovation in virtual healthcare.

Whilst inflationary pressures and rising costs have also affected this sector, there will be one key aspect that will either make or break this next year: the ability to source sufficient staff. Staff absenteeism due to Covid-19 added to the ongoing general labour shortage in healthcare, a problem exacerbated by Brexit, and the loss of social care workers who objected to mandatory Covid-19 vaccinations, a requirement which has since been dropped.

To tackle the staffing crisis, there have been two solutions so far. First, many businesses responded through overseas recruitment from countries such as India, the Philippines and Sri Lanka. The government's decision to extend a 12-month work visa scheme to cover foreign healthcare workers certainly helped in this regard.

Second, the pandemic demonstrated virtual offerings can provide remote interactions that can improve patient care and lower costs for providers. The virtual offerings, which range from technology that enhances care coordination and patient education to telehealth and care-at-home can tackle challenges confronting the health care ecosystem, including health equity, the rising cost of care, and workforce shortages. These capabilities have been transforming business models worldwide.

M&A activity in the healthcare sector was strong in 2022 before cooling off in Q4, due to falling confidence. It is predicted that there will be an acceleration in M&A activity for 2023 with both real estate funds and equity investors looking for deals. However, a key factor remains on whether sellers are willing to accept a lower valuation range.

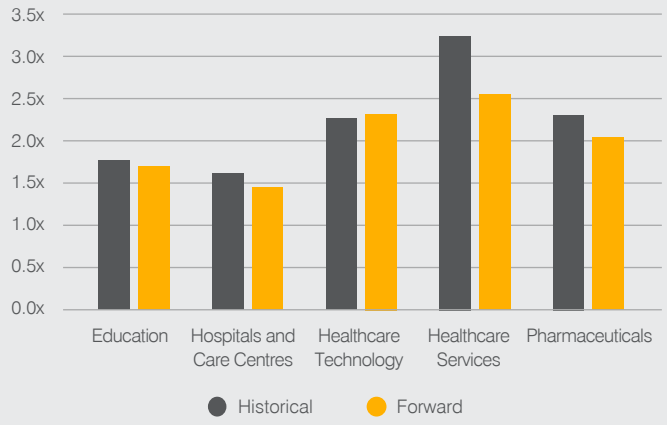
Education

Like healthcare, the education sector is expected to have the same positivity going forward in 2023. Last year brought some "normality" into the sector as students returned to campus and face-to-face learning. Higher education in the UK bounced back last year and, notwithstanding a 50% reduction in EU students accepting places in UK institutions, remains the destination of choice for international students, second only to the US.

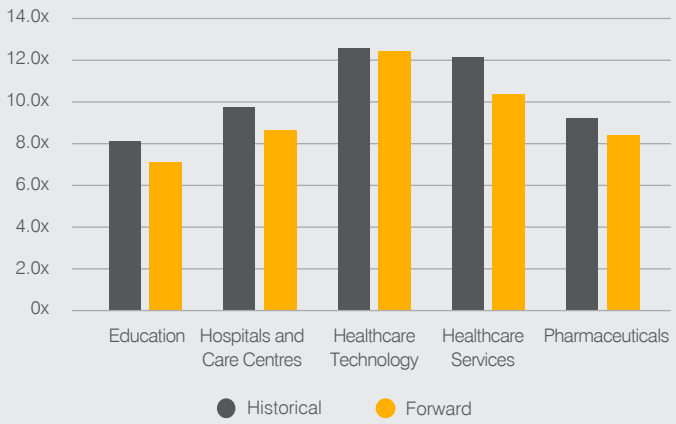
However, the pandemic transformed this sector. The pandemic demonstrated the need for online learning platforms and massively accelerated the rise of education technology. This will continue into the few years for edtech businesses as they enhance the learning that is delivered in the classroom or lecture theatre.

Source: Barclays

Historical vs. Forward Revenue Multiples*



Historical vs. Forward EBITDA Multiples*



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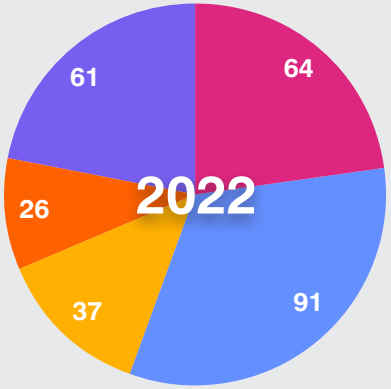
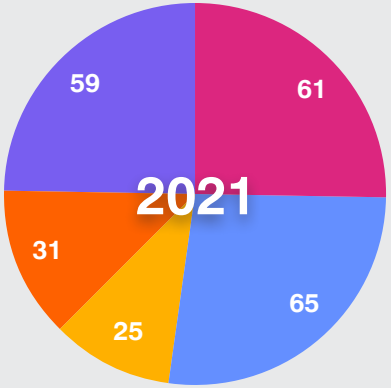
M&A Activity 2022 vs. 2021





- Education
- Healthcare Services
- Hospitals & Care Centres
- Healthcare Technology
- Pharmaceuticals

Zephyr

Healthcare & Education M&A Activity

Despite a challenging year in healthcare driven by staff shortages and various macro factors, volumes remained steady and even showed some growth from 241 deals in 2021 to 279 in 2022.

The deals from 2022 can be broken down as follows:

- Education – (H1 – 39, H2 – 25)
- Healthcare Services – (H1 – 47, H2 – 44)
- Hospitals & Care Centres – (H1 – 18, H2 – 19)
- Healthcare Technology – (H1 – 11, H2 – 15)
- Pharmaceuticals – (H1 – 32, H2 – 29)

With rising cost pressures, smaller players within the healthcare services, hospitals and care centres and Healthtech markets will have sought to join consolidation platforms, especially in the private hospital and nursing home space.

Such roll-up platforms that deliver cost-effective, high-quality care attract high levels of investor interest; the acquisition of smaller players can eliminate competition and be highly accretive.

We expect dealmaking volumes going forward to remain level during the first half of the year, before picking up in the late stages of Q2 into Q3 as private equity dry powder fuels activity and competition for innovative assets.

Food & Leisure Overview

After a long global lockdown, post-covid demand accelerated 2022 for restaurant operators, entertainment venues, and hotels. Barclay's review of 2022 consumer spending showed consumer card spending increased 10.6% year-on-year in 2022, as the lifting of all Covid-19 restrictions encouraged Brits to shop more in-store, eat and drink out and book holidays abroad. Additionally, festivals, outdoor events, premium events like F1 racing and international sports tournaments held place last year.

Although the UK had a great start in 2022, labour supply issues from Covid moves away from the sector augmented by Brexit (departures and a 50% reduction in EU students accepting study offers at UK universities) drove rising wage bills, with supply chain problems caused by the Russia-Ukraine war and soaring energy bills presenting tough challenges for the remainder of the year. These challenges brought valuations down across the sector and were driven by small operators selling to larger players.

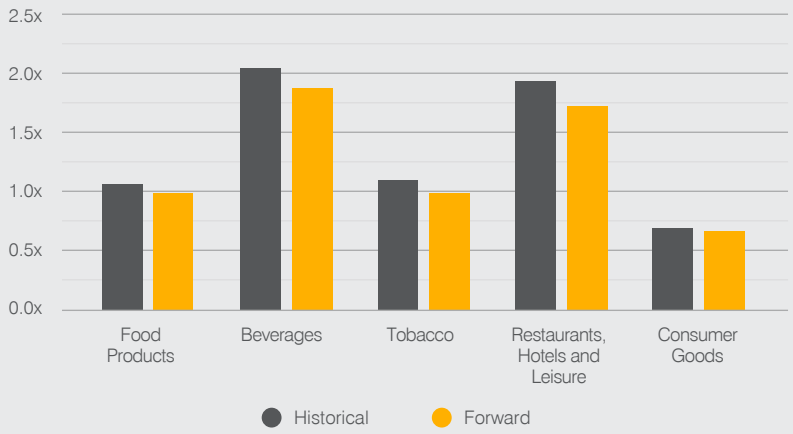
The silver lining for the sector this year will be holidays. Travel bookings overseas held up well in 2022, a trend that should continue through 2023, with some operators reporting record bookings for 2023 and others already issuing timetables for 2024. British residents looking to save money may forgo overseas holidays in favour of cheaper UK-based 'staycations'. The UK could also benefit from tourism both domestic and international, of which the relatively weaker pound should help play a part in attracting tourists.

There are also major events being held in the UK during 2023, namely King Charles III's coronation, which will draw international crowds, The British Open golf championship forecast to bring in around £100 million, and Eurovision which is expected to bring in £30 million.

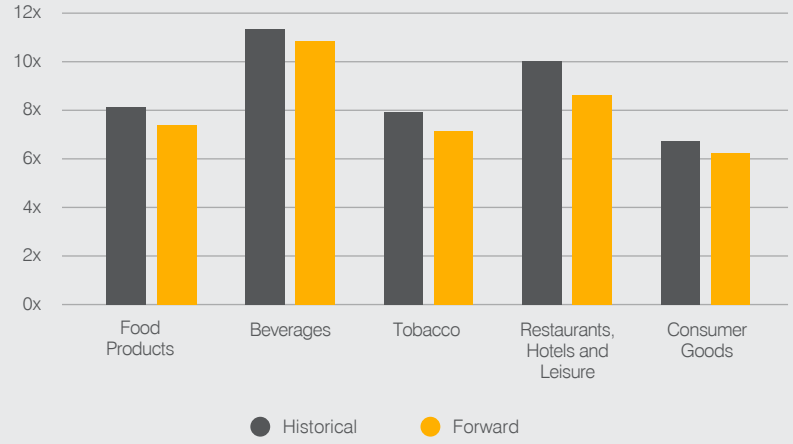
The key going forward will be whether airports can increase passenger activity and replace lost staff.

Source: Barclays, Avison Young

Historical vs. Forward Revenue Multiples*

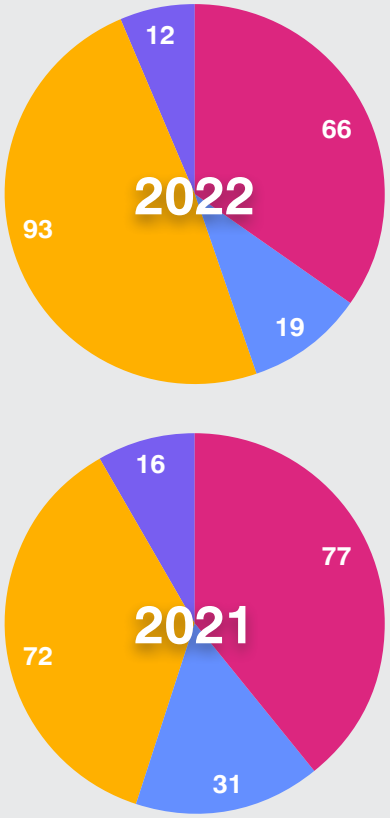


Historical vs. Forward EBITDA Multiples*



**Listed market information*

M&A Activity 2022 vs. 2021



- Food, Beverage and Tobacco
- Consumer Durables and Apparel
- Hotels and Restaurants
- Agricultural Business

Zephyr

Food and Leisure M&A Activity

The food and leisure sector maintained its activity in 2022, with transactions almost the same as last year (196 completed deals in 2021 vs. 190 deals completed in 2022). 60% of the deals were domestic, indicating interest amongst British businesses.

This has translated into the following number of deals per subsector:

- Food, Beverage, and Tobacco (H1-33, H2-33)
- Consumer Durables and Apparel (H1-12, H2-7)
- Hotels and Restaurants (H1-42, H2-51)
- Agricultural Business (H1-7, H2-5)