30 Second M&A Newsletter

Russia, recession, and economic impacts on M&A

Economic headwinds ahead. Steven Chiavarone, CFO and economist with Federated Hermes recently presented at the State of M&A conference held in Wisconsin. He shared a range of insights and economic predictors he expects to affect the business community and mergers and acquisitions in the years ahead. These were:

Geopolitical conflict: A whopping 40% of the world's palladium comes from Russia and the market could be impacted by Western sanctions as Russia-Ukraine tensions escalate. No palladium - no catalytic converters. No catalytic converters - no cars. Russia is a top producer of nickel, too, a key ingredient in steel and electric car batteries. While experts can't predict the exact impact of armed conflict in the former USSR, we know the fallout could have serious repercussions on supply chain, economic activity, and prices.

Labor force: The average American socked away thousands extra in savings over the last couple of years. Stimulus payments may have allowed some workers to take a temporary break from the workforce, but their eventual return won't be enough to solve our labor woes.

Middle America: On an uplifting note, Chiavarone suggested we could see a strong return to U.S. manufacturing as people rethink their supply chain. China's population is declining, and officials estimate they'll have a shortage of nearly 30 million workers in the manufacturing sector as soon as 2025. Chinese labor shortages, higher shipping costs, higher energy costs, no IP protection, geopolitical risks, and lack of transparency will all contribute to a shift in manufacturing. Meanwhile, he suggested the center of the U.S. would be "the next great emerging market." He pointed to an abundance of land and energy, easy shipping routes, ironclad IP protection, and one of the lowest interest rates in the world.

Supply chain shortages: Continuing shortages have a disproportionate impact on small and midsize businesses. When supplies are limited, market leaders go to their vendors and demand priority consideration on availability and shipping. Other businesses, left to take what they can get, will experience shrinking margins and lower ability to compete.

Inflation: When acquiring a business, buyers strongly consider the value on the future profits they expect to receive. Inflation, however, reduces the future-adjusted value of those profits. Buyers will likely trim their purchase price to adjust for inflationary scenarios.

Meanwhile, sellers could see their proceeds hit further by inflationary impacts on their working capital. As the price of goods and labor increases, it costs more to operate a business. That means sellers must leave more working capital behind in a sale.

Recession: With inflation come rate hikes. As Chiavarone pointed out, there have been 11 rate hike cycles since 1970 of three hikes or more. Of those, nine were followed by a recession. (The other two were followed by a stock market crash and the Mexican peso crisis.) With that, Chiavarone suggested we could see a recession in the backend of 2024, or sooner if rate hikes accelerate. Naturally, if we go into a recession, people pull back on purchasing. Businesses tied to discretionary consumer spending and those tied to business capital expenditures (e.g., big equipment, commercial construction) will feel the pinch in recessionary times.

All in all, Mr. Chiavarone's takeaway advice was this: **"If you are a seller - sell. For the moment the sun is shining, but we can't predict how rapidly a disruption is coming."**

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