The Road Ahead for Private Equity: Reflections and Predictions

Akin®

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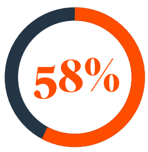
Executive Summary

The year 2023 will be remembered as a challenging one for private equity (PE), with complexities to navigate on many fronts. Traditional debt financing was expensive and scarce, expectations on valuations were tricky to navigate, portfolio companies required additional attention, fundraising was not easy and regulators continued to scale up their scrutiny of the industry and its transactions. Although overall transaction volume was significantly down, private equity funds still found opportunities to do deals even in the face of these stiff headwinds.

A Slow Deal Environment

With high inflation and rising interest rates, the past 12 months have seen a continuation of the valuation uncertainty that characterized a large part of 2022, and as such, deal volumes have remained depressed.

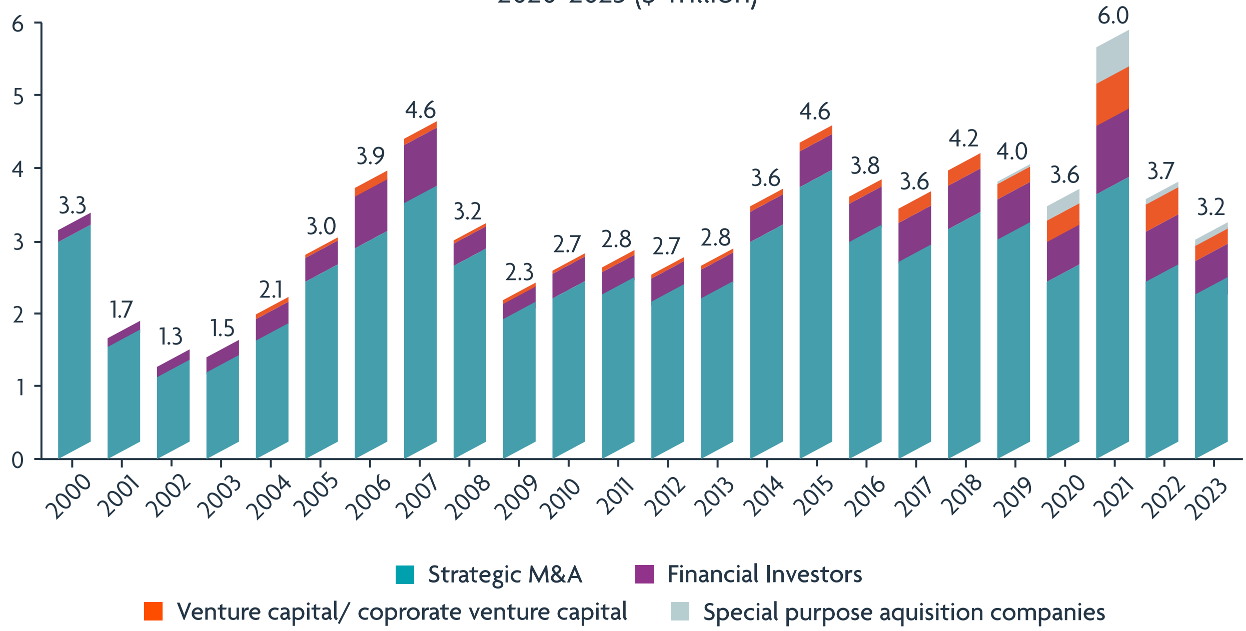
According to Bain & Co., global M&A for private equity firms fell 58% in value in the first three quarters of 2023 compared with the same period in 2022. There were fewer platform deals in the market, which resulted in heightened competition for those strong assets that did go to market, and the bulk of transactional activity centered around add-on acquisitions.



Global M&A for private equity firms fell 58% in value in the first three quarters of 2023 compared with the same period in 2022.

Value of Global M&A Deals

2020-2023 ($ Trillion)



Source: Dealogic

Depressed valuations in the public markets fueled interest in public-to-private activity and some carve-outs. However, many PE firms turned their attention to strengthening existing portfolio companies and as a result, had less bandwidth for new platform acquisitions.

On the transactional front, the deals that did get done tended to be more bespoke. For example, private equity sponsors looked at growth equity deals to gain a toehold in businesses with a view to building stakes over time.

The sectors that remained busy included energy & infrastructure and health care & life sciences. There was also increased distressed and special situations investing and structured equity transactions. Buyers and sellers struggled to align expectations on valuation and terms, resulting in earn-outs, seller notes, reps and warranties insurance and staple financing used to bridge gaps.

Decreased deal volumes led to a significant reduction in the price of representation and warranties insurance policies, making liability gaps easier to overcome and clean exits more straightforward.

Liquidity Constraints

With financing challenging in the public markets and banks retrenching, it was a good year for private credit providers that were able to increase their share of sponsor lending. In portfolios, liquidity management was a priority; default rates remained low as we saw constructive discussions with lenders that focused on identifying issues early and addressing capital structures as a means to navigate good businesses through a tough period.

As debt finance was harder to come by and fundraising was sluggish for the majority, sponsors increasingly looked to syndicate their equity to get deals done. As such, we saw a busy year for equity syndications involving financial sponsors and sovereign wealth funds, particularly those emanating from the Middle East and benefiting from strengthening commodity prices. GP-led secondary transactions were also a feature as a response to LP liquidity demands in a tough exit climate.

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Enhanced Reporting Requirements

A big theme for 2023 was the intensifying scrutiny of regulatory agencies around the activities of funds, which we explore in further detail throughout this report. The demand for further disclosures and reporting around antitrust approval processes, inward and outbound investment filings and managers' internal operations raised questions around who bears the risk of deal uncertainty as timelines come under pressure. As such, we saw a focus on ticking fees and conversations about reverse termination fees as a means to address lag times.

Public Company and Strategic Opportunities

Of note, 2023 was also characterized by continued weak valuations in public markets in sectors such as software and technology which created opportunities for private equity firms looking to engage in take-private transactions and PIPE deals. In addition, as companies looked for ways to generate cash in a challenging financing environment, carve-outs of non-core assets created opportunities for private equity acquisitions.

Looking Forward

Moving into 2024, pent-up demand, significant dry powder (up from $1.17 trillion in December 2022 to $1.27 trillion as of November 2023, according to Bain & Co.), inflation control and stabilization of interest rates should yield more private equity deal activity and pent-up demand will drive increased deal activity over the course of 2024.

Our view is that the year ahead will feature a continuing focus among investors on take-privates, add-ons, growth equity and the lower middle market, with the hope that traditional leveraged buyout activity will strengthen over the course of the next 12 months.

Sector-wise, the outlook remains bullish for energy transition and infrastructure strategies, while health care & life sciences, technology and aerospace & defense should also continue to see steady activity. Within technology, we continue to see a lot of focus on transformative technology, meaning deals centered on generative artificial intelligence (AI) and payment processing tools will remain a solid feature of the market.

All transactions will be subject to enhanced scrutiny from regulators, as well as from cautious investment committees. Sponsors continue to sit on record volumes of dry powder despite the sluggish fundraising climate, but are nevertheless mindful of the potential for further choppiness ahead. Our expectation is that a renewed focus on deploying capital and securing exits will inevitably result in increased deal activity.

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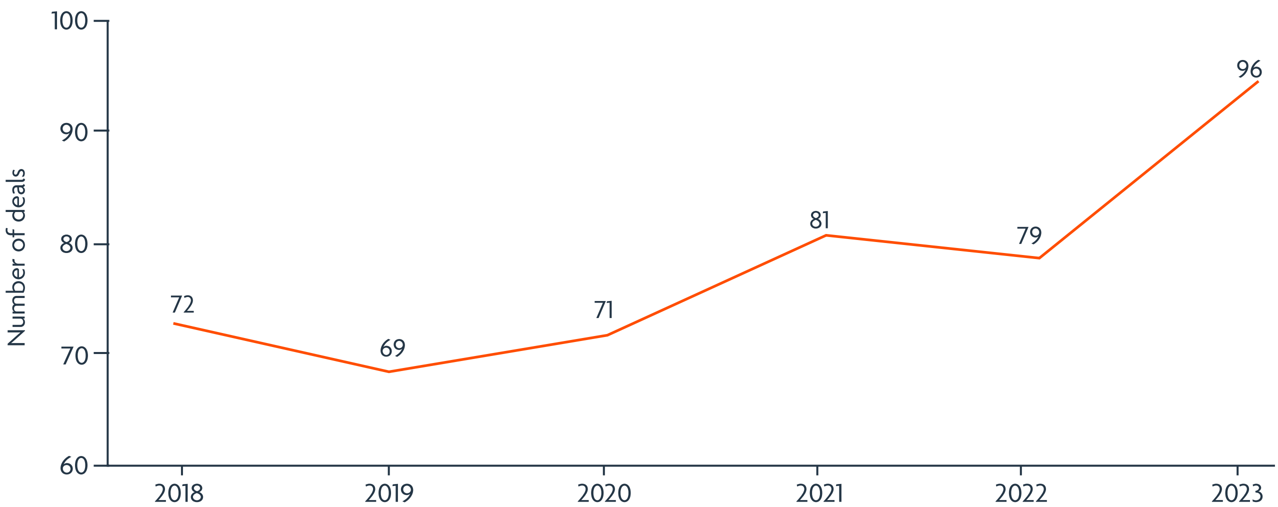
Number of Take-Private Deals Globally

2018-2023



Source: Evercore

Workforce Management

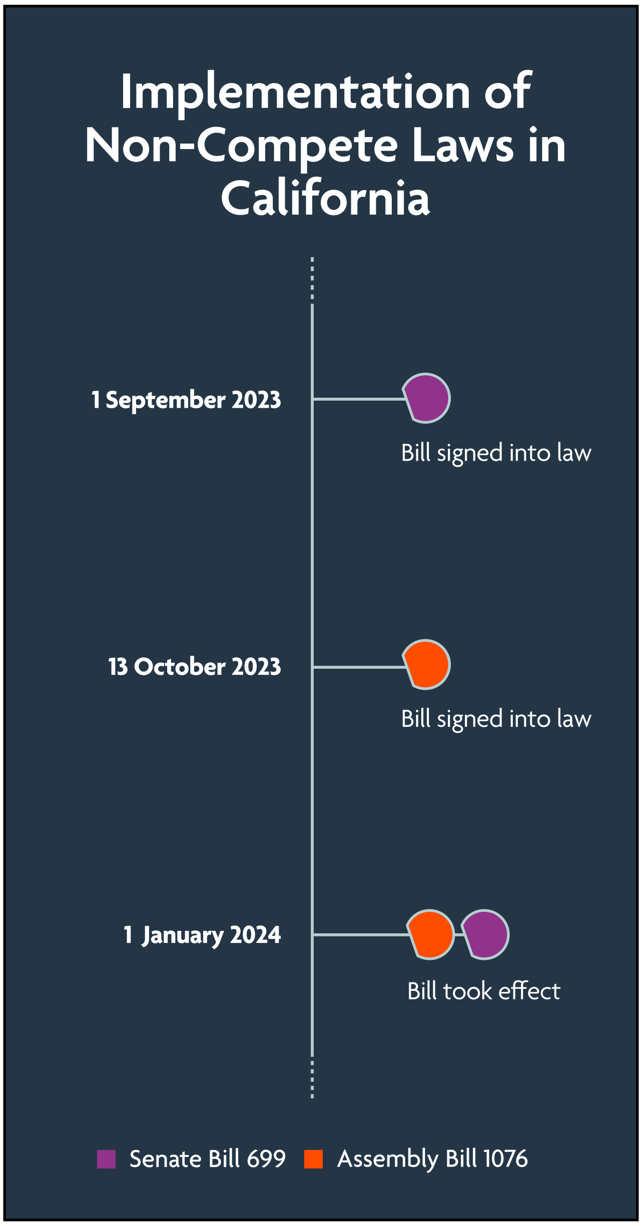
The Non-Compete Landscape

In the past two years, there has been a significant move across the United States to effectively ban the use of non-competes and other restrictive covenants in employment agreements. We have seen this taking place through a combination of statute and court decisions, creating a varied landscape across the country as different states pursue different routes, including outright bans or bans beyond a certain salary threshold.

In California, it has long been difficult to enforce non-compete and certain non-solicit clauses, with the state passing additional laws in 2023 that expand on those restrictions, effective January 1, 2024. The first of two new laws will prohibit employers from enforcing or entering into any contract containing such provisions, regardless of where and when the contract is signed and whether the employee is employed outside of California.
The second law explicitly voids and prohibits the inclusion of non-competes in employment contracts and in the employment context.

While New York Governor Kathy Hochul ultimately vetoed a complete ban on non-competes passed by the New York legislature, it is likely that additional legislative efforts will be made to limit their enforceability in the state with a particular focus on having a salary threshold for those subject to such restrictions.

For private equity, Delaware has always been the favored jurisdiction but recent court decisions have struck down non-competes there too, including in the sale of business and profits interest context. We expect more states to go down the same route, leaving employers to look for more favorable jurisdictional alternatives and to review the enforceability of the language in their agreements.



For private equity, Delaware has always been the favored jurisdiction but recent court decisions have struck down non-competes there too.

Outside of California, non-solicits remain broadly acceptable as long as they are not drafted in such a way as to be considered a non-compete.

At a federal level, the Federal Trade Commission (FTC) has proposed a rule banning non-competes but it is not expected to vote on that until April 2024 and the National Labor Relations Board's general counsel declared that non-competes violate employees' rights under Section 7 of the National Labor Relations Act. It remains unclear whether the FTC has the authority to institute a nationwide ban.

2024

At a federal level, the Federal Trade Commission (FTC) has proposed a rule banning non-competes but it is not expected to vote on that until April 2024.

In the U.K., the government has indicated an intention to restrict non-competes to three months, and has said it will introduce legislation in due course. We see private equity firms have not historically relied on non-competes in employment contracts increasingly looking to include those in the current environment, given that bonuses may be lower and therefore less likely to act as a retention lever. Other European countries, such as the Netherlands, are considering restrictions on non-competes, while many jurisdictions like France and Germany already have restrictive laws in place.

Executive Compensation

With sponsors getting less retention value out of bonuses this year, there was some movement at the start of 2023 to reset executive rewards and re-incentivize management at a number of funds, but that effort has largely slowed down.

Where management equity is underwater, sponsors are looking at ways to keep management aligned.

Where management equity is underwater, sponsors are looking at ways to keep management aligned. In the U.K., managers will have paid for their equity, so creative thinking is required. Often management equity only participates after the sponsor has made a return or IRR hurdle, so that hurdle can be reduced to boost the value of equity.

Recent Cases in Delaware Where Non-Competes Have Been Struck Down

October 2022
Kodiak Buildings Partners LLC vs Adams

January 2023
Ainslie vs Cantor Fitzgerald L.P.

February 2023
HighTower Holding, LLC vs Gibson

March 2023
Intertek testing Systems vs Eastman

November 2023
Sundar Energy LLC vs Jackson, et al,

A second option is to put the management equity higher up, potentially alongside the shareholder debt so that it can make a return regardless of whether the value breaks into the equity. Or sponsors can reduce the interest rate on their debt to minimize the drag on profits. In the U.S., where incentive equity is typically in the form of profits interests (with no up-front payment or tax), it is relatively simple to reset the awards by resetting the threshold or issuing a new series.

> Where management equity is underwater, sponsors are looking at ways to keep management aligned.

Unionization

Another issue capturing employer attention in the U.S. is the increase in union activity taking place in various jurisdictions. While unionization is still a small proportion of the private workforce, sponsors considering acquisitions of targets with unionized workforces will want to pay close attention to the terms of any applicable collective bargaining agreements, including defined benefit pension obligations.

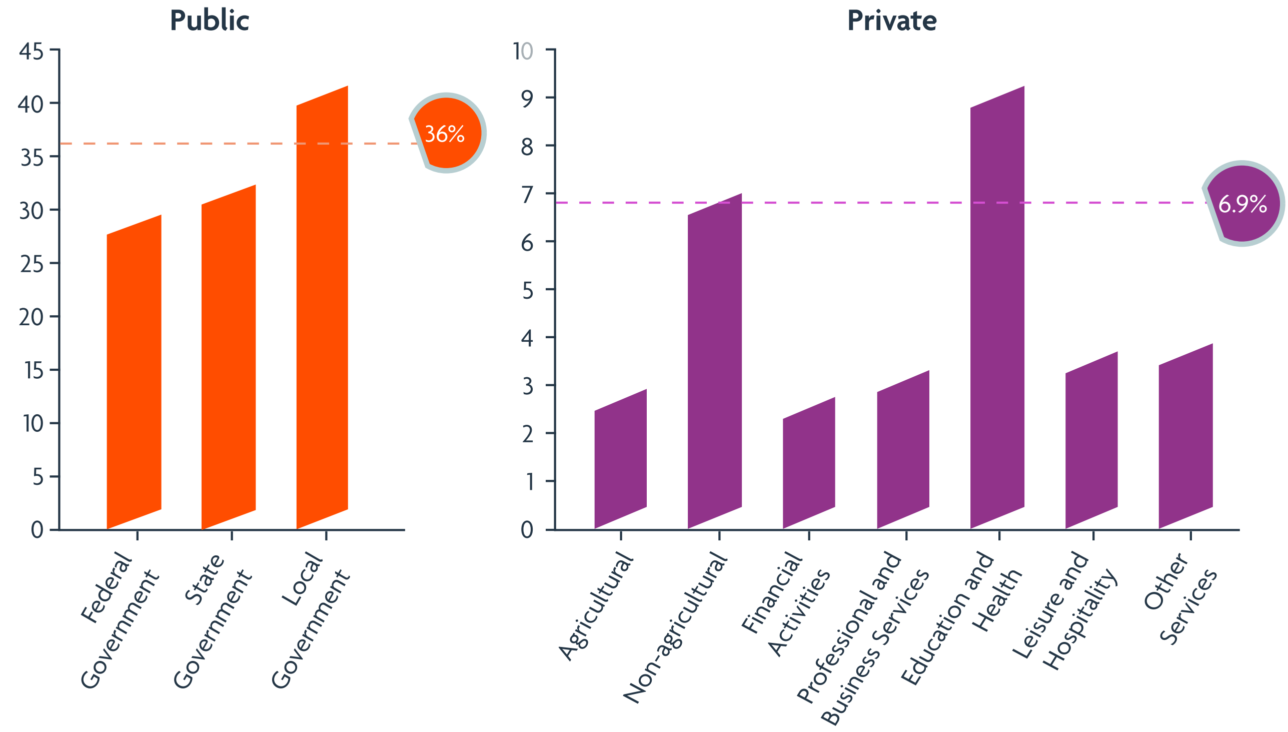
Furthermore, even if the company is not in an industry that is widely unionized, in the current climate the potential for unionization of plants or assets down the line should be given careful consideration.

UK Political Outlook

From a political perspective, the prospect of the election of a Labour government in the U.K. in 2024 could result in moves to tax carried interest as income for private equity professionals. With many deal teams in London staffed primarily by non-U.K. residents, we anticipate a heightened focus on the mobility of the workforce and renewed efforts to incentivize general partners outside of carry.

Workers Represented by Unions in the U.S.

(% of workers)



Source: Bureau of Labor Statistics

Antitrust and Merger Control

Recent actions by antitrust agencies globally deliver on their promises for increased scrutiny of private equity-sponsored transactions and strategies in at least three ways.

Scrutiny of Roll-ups

First, as part of its goal to prevent "stealth roll-ups", the Federal Trade Commission (FTC) challenged a series of acquisitions of localized anesthesiology providers that spanned more than a decade by Welsh, Carson, Anderson & Stowe, a private equity sponsor.

Although we have seen the FTC challenge past acquisitions as violations of the antitrust laws (e.g., FTC v. Meta), the FTC included a novel basis to challenge Welsh Carson's acquisitions. The FTC claimed that certain of its acquisitions in question amounted to an unfair method of competition under its own statute, the FTC Act, which, if sustained in court, would permit the FTC to pursue merger enforcement under a lower burden of proof (for example, the FTC did not define an antitrust market to support its claims).

Subsequently, the agencies finalized Merger Guidelines that include a specific section aimed at these so-called "roll-up" strategies and explain that the agencies will examine a firm's history of acquisitions and its current and future incentives to determine whether the practice is illegal.

> The CMA wants to "make sure the boardrooms are aware of the kind of deals that should or shouldn't be going ahead".

The U.K. Competition and Markets Authority (CMA) has also had private equity on its radar over the past year or so, particularly in relation to the increase in private equity investments in the consumer-facing areas of veterinary services, animal health, dentistry and health care more broadly.

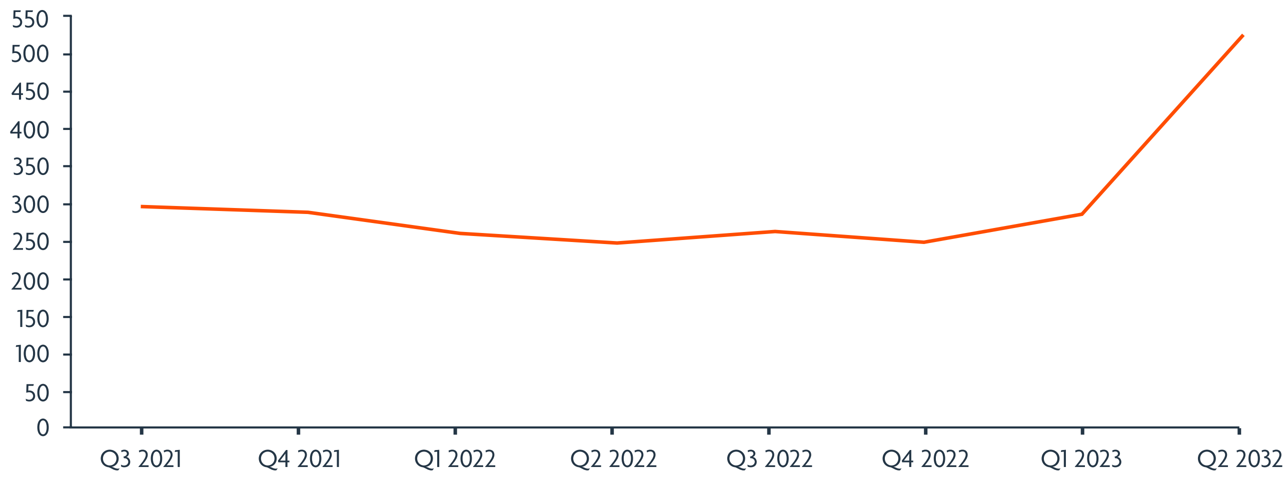
Indeed, last year the CMA CEO noted that that the Mergers Intelligence Unit has "[t]aken quite a conscious strategy" to look out for "roll-up" acquisitions. The CMA wants to "make sure the boardrooms are aware of the kind of deals that should or shouldn't be going ahead" and that it is "sending a clear message this is a sector … going to come in for very close scrutiny".

July 2023
Public consultation process begins

September 2023
FTC sues private equity firm over "roll-ups

December 2023
New FTC Merger Guidelines published

Total Number of Divestures in the U.S.



Source: Mergermarket

Divestiture Buyers

Second, the FTC and the Department of Justice (DOJ) have extended their scrutiny of private equity-backed transactions into private equity's ability to restore competition as divestiture buyers, even going so far as litigating the adequacy of a divestiture that eliminated the horizontal overlap in United/Change because the divestiture buyer was private equity instead of an industry participant. The parties overcame the DOJ challenge, in part, because of strong testimony from the divestiture buyer, but private equity should expect similar skepticism in the future.

Historically, the European Commission (EC) had not allowed the acquirer to include pure private equity or financial sponsor players (i.e., those without existing investments) in an auction process for divestment businesses in complex industrial sectors that require industry-specific expertise (see, for example, Linde/Praxair and Ball/Rexam).

We have seen less resistance to private equity divestiture purchasers in appropriate cases.

More recently, we have seen less resistance to private equity divestiture purchasers in appropriate cases. For example, the EC accepted a consortium of financial investors, including Meridiam, GIP and CDC Group, as divestiture purchasers of assets that allowed Veolia's takeover of Suez to close, with the CMA allowing EQT's Saur to acquire U.K. assets.

Interlocking Directorates

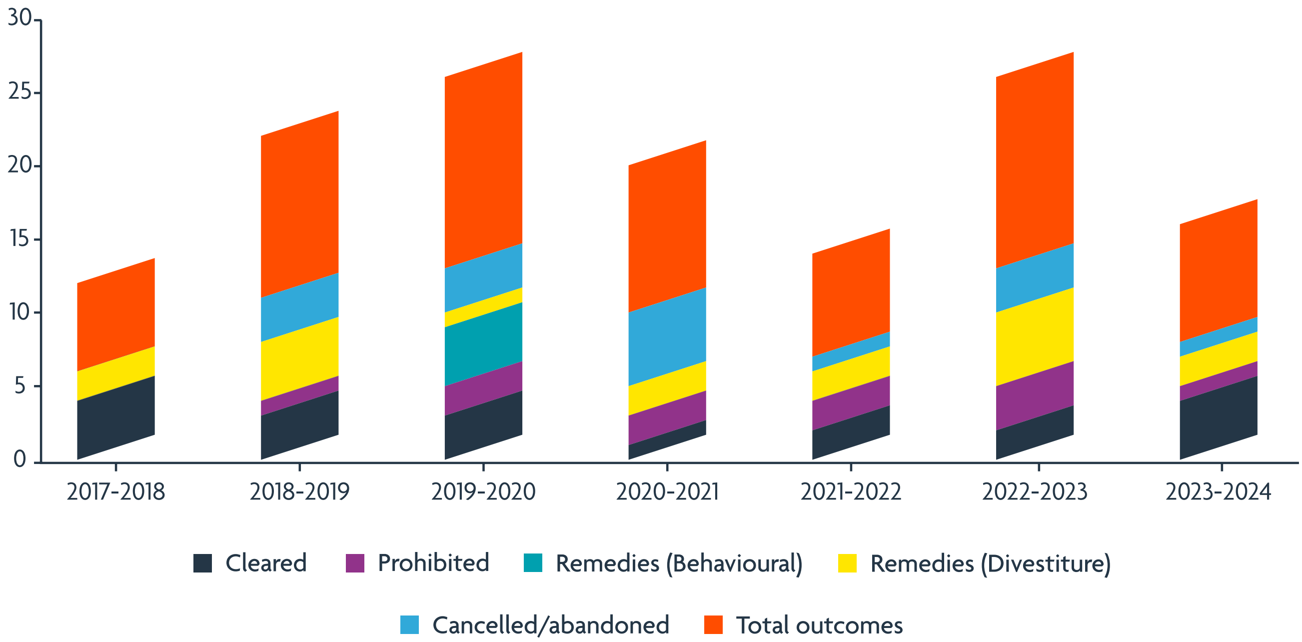
Finally, the agencies' efforts to invigorate enforcement of the antitrust law's prohibition on interlocking directorates have resulted in greater scrutiny of private equity. Specifically, Section 8 of the Clayton Act prohibits any "person" from simultaneously serving as a director or officer of two competing corporations.

The agencies have construed "person" to include entities, not just natural persons, which would mean that an entity that appoints board directors on competing entities would violate the antitrust laws. This interpretation affects private equity firms because they often focus investments within an industry and protect their investments with rights to appoint board members.

In fact, many of the DOJ's actions to enforce Section 8 have required private equity firms to relinquish board representation to cure alleged violations. Even more, the agencies' proposed changes to the HSR form, if implemented as currently drafted, would require all filers to identify officers and directors, including information about other boards on which they serve, which would improve the agencies' ability to detect violations and would likely result in more Section 8 enforcement.

Total CMA Phase 2 Outcomes

2017-2024



Source: CMA

EC and CMA Priorities

In Europe, relatively few private equity acquisitions have gone to an in-depth Phase II EC or CMA review, but as portfolios continue to expand we are seeing more substantive issues arising. Concerns about common ownership, interlocking directorships and information exchange are becoming more acute. This year EC and CMA enforcement priorities will continue to focus on digital markets, including artificial intelligence (AI), energy, as well as health care/life sciences and consumer-facing products/services more broadly.

Investment Regimes

The proliferation of foreign investment laws across Europe—and the EU cooperation mechanism allowing member states and the EC to exchange information on national FDI cases, which spurred call-ins from other member states—was a key area of regulatory friction in many private equity transactions.

Ministries and other FDI authorities were particularly keen to understand the upstream LP make-up, as well as the extent to which sovereign wealth fund co-investors had rights beyond typical minority protections in club deals. That said, private equity acquirers were subject to relatively few vetoes or conditional approvals. Further, the EU's new Foreign Subsidies Regulation, introduced to allow the EC to identify and police any distortive effects of foreign subsidies in European markets, has added an additional layer of screening and potential delays to M&A transactions and necessitated a new layer of information-gathering protocols for private equity firms at both fund and portfolio company levels.

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Overall, the agencies' actions demonstrate that private equity-backed transactions remain on their radar, and private equity firms can expect the agencies to be watching their activities in a wide range of contexts.

Private Funds and Dealmaking

Fundraising's Effect on Dealmaking

Fundraising has been challenging over the past 12 months, primarily driven by the fact that distributions have slowed as a result of the lack of exit opportunities. For institutional investors such as pension funds and endowments, their ability to make new allocations has been hindered as they await distributions, while sovereign wealth funds—particularly those in the Middle East benefiting from rising oil prices—have been increasingly active.

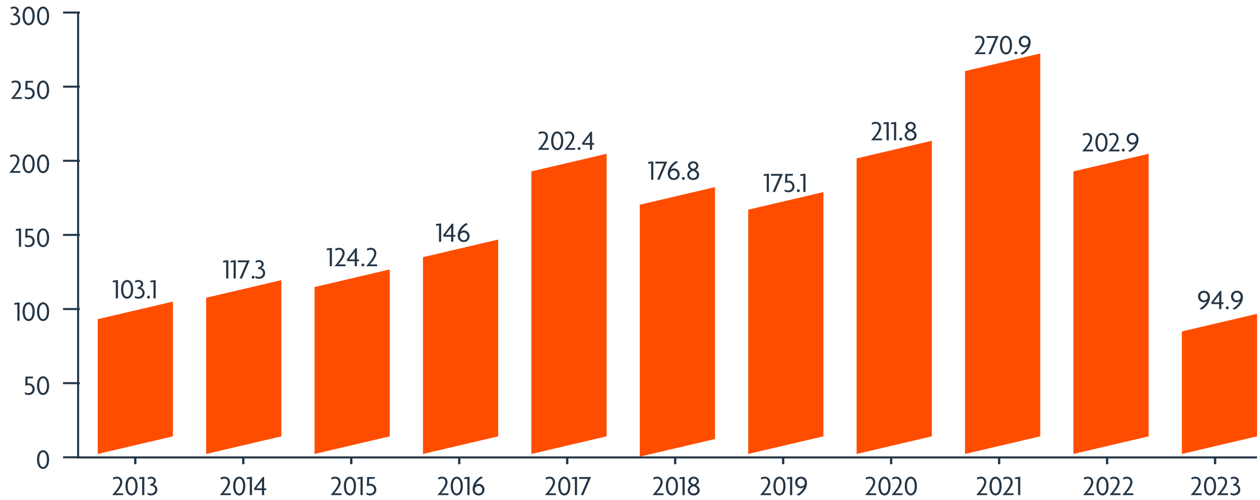
Fundraising has been challenging over the past 12 months, primarily driven by the fact that distributions have slowed as a result of the lack of exit opportunities.

Sponsors are taking various initiatives in a bid to bolster fundraising efforts, with greater use of first closing fee discounts and other incentives and a push to bring in brand-name LPs early to create momentum. Those raising capital are being more judicious in identifying a target fund size and in their approach to making substantive changes from one fund to the next, with those more difficult to justify in this environment.

We are seeing a real push on fundraising in Q1 2024 as sponsors look to tap limited dry powder early in the new year. There remains strong appetite for certain strategies, including private credit, infrastructure and energy transition, and we expect that investors will continue to favor allocating capital to existing relationships over new ones. Family offices and high-net-worth investors represent a growth opportunity for private funds, but come with operational challenges that require significant manager commitment.

Capital Raised by Private Credit Funds Globally

2018-2023 ($ Millions)



Source: Pitchbook

We have seen an enhanced focus on co-investment as a route to supplement primary fundraising. Access to co-investment opportunities is being used as a carrot to encourage LPs to allocate to new funds, while simultaneously allowing managers to write bigger equity checks and overcome shortfalls during the current high interest rate environment.

Managers have also turned to cornerstone investors for capital to warehouse investments. This allows the manager to showcase an attractive pipeline, often in return for favorable co-investment arrangements with the cornerstone investors. In addition, large institutional investors are increasingly interested in acquiring GP stakes in exchange for making anchor commitments to emerging managers and new fund products.

We see no signs of a slowdown in the secondaries market in 2024.

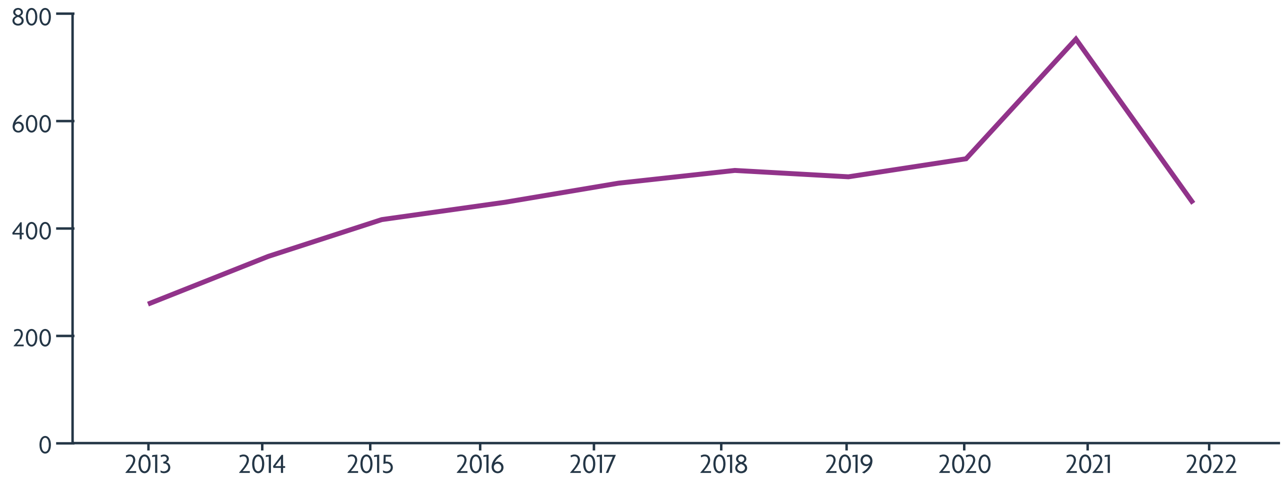
We have also seen a significant increase in the volume of GP-led secondary transactions in recent years, both as a portfolio management tool and a liquidity solution. LP-led secondaries continue to be robust, driven by LPs seeking to generate liquidity or reduce their exposure to certain asset classes or managers. We see no signs of a slowdown in the secondaries market in 2024.

2024

We are seeing a real push on fundraising in Q1 2024 as sponsors look to tap limited dry powder early in the new year.

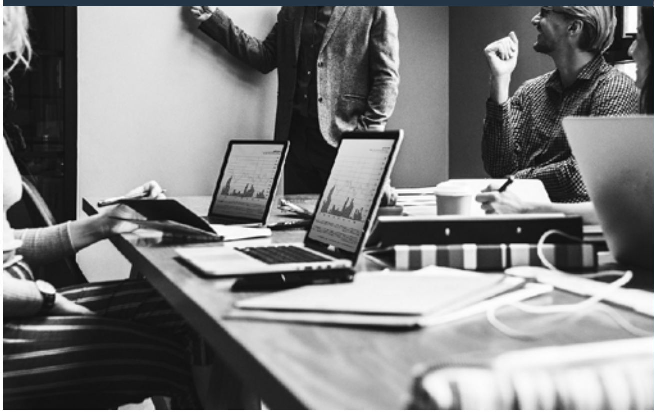
New Funds Started by Emerging Managers

(2013-2022)



Source: Pitchbook (ft. in Fortune)

The rule is applicable in 2025 for existing companies, but immediately effective (on a 90-day lag) for entities created in 2024.



FAR also requires disclosure of value, and prohibits differential disclosures and liquidity at the fund level.

Funds Regulation and M&A

CTA

Under the Corporate Transparency Act (CTA), which became effective on January 1, 2024, all companies (including limited partnerships) formed or registered and doing business in a U.S. state need to disclose (i) all 25% or greater beneficial owners, and (ii) all others with "substantial control" over the entity. There are exemptions for registered investment advisers and for 3(c)(1) and 3(c)(7) funds, but there are no express safe harbors for portfolio companies.

In addition, "upstream" and "downstream" entities in a management company structure, or in a fund structure, will have to be examined to determine if they are subject to their own reporting obligations. The rule is applicable in 2025 for existing companies, but immediately effective (on a 90-day lag) for entities created in 2024.

Private Funds Rule/Private Fund Adviser Rules

Changes to Form PF and the new Private Fund Adviser Rules (PFAR) will require more information from private fund sponsors (and, indirectly, from portfolio companies), including information on valuation determinations, which will be used for mandatory public and regulatory reporting and other purposes. Because there are numerous materiality assumptions to be made under both rules, counsel and other relevant decisionmakers should be consulted.

PFAR also requires disclosure of value, and prohibits differential disclosures and liquidity at the fund level. In addition, PFAR requires audits in all cases, so SPVs and other holding companies that currently use the "surprise examination" option to comply with the Custody Rule will now have to produce a financial statements audit, which may require the participation of portfolio company management.

Changes to 13D and 13F

The Securities and Exchange Commission (SEC) amended or adopted several rules relating to persons investing in securities, which became effective in 2023 or with compliance dates in 2024.

Most significantly, the SEC adopted amendments to Regulation 13D-G under the Securities Exchange Act of 1934 to accelerate (i) Schedule 13D filings to five business days following an acquisition resulting in beneficial ownership of more than 5% of an equity security and amendments within two business days following a material change starting on February 5, 2024, (ii) the initial filing deadline for initial Schedule 13Gs to 45 days following quarter-end (instead of year-end) or within five business days, depending on the type of filer, starting with the quarter ending September 30, 2024 and (iii) amendments to update Schedule 13Gs within 45 days of the end of a quarter in which there is a material change (instead of the end of the year in which there is any change) starting with the quarter ending September 30, 2024, with even faster filings if the beneficial owner acquires more than 10% or subsequently acquires or disposes of 5%.

In addition, the SEC clarified its treatment of groups to continue the requirement for "concerted action" between beneficial owners to form a group and declined to extend beneficial ownership to include certain cash-settled instruments for activist investors.

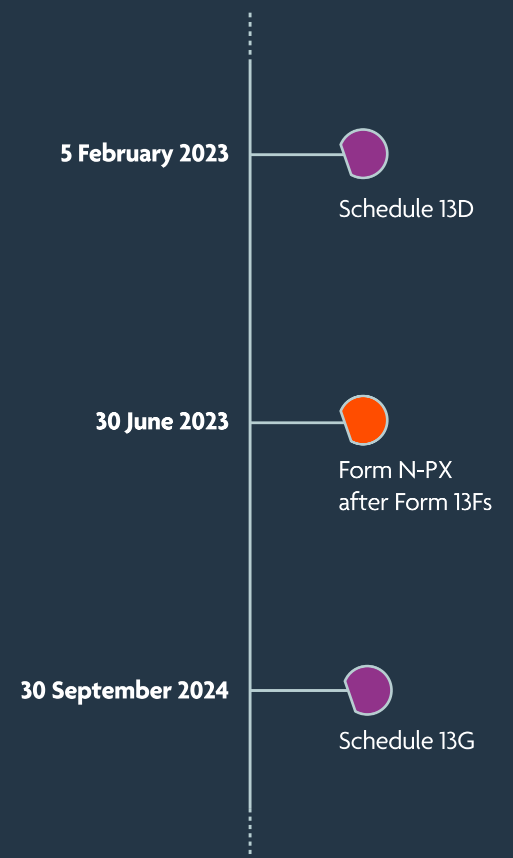
The SEC also increased its enforcement with respect to reporting of ownership—bringing charges resulting in civil monetary penalties against (i) six officers, directors and large shareholders of public companies for failing to timely report information about their holdings and transactions in company stock, and (ii) five publicly traded companies for "contributing" to their Section 16 insiders' disclosure violations.

The SEC brought enforcement actions relating to a nonprofit that filed Form 13Fs through shell companies to obscure and misstate its control over the portfolio and against an investment adviser that failed to file Form 13Fs for several years.

Further, the SEC adopted two other significant new forms for persons trading securities. Rule 14Ad-1 and Form N-PX, which will require institutional investment managers who file Form 13F with the SEC and exercise voting power over securities to file a Form N-PX for all securities for which it voted relating to a "say-on-pay," "say-on-golden-parachute," or "say-on-frequency" vote for issuers with a Section 12 registered class through June 30 of that year, not later than August 31 of the year, starting with the voting year ending June 30, 2024.

Finally, the SEC adopted Form SHO, which will, starting with the month ending January 31, 2024, require an institutional investment manager with a gross short position in excess of the applicable threshold to file a Form SHO within 14 days of the end of the month reporting the gross short position in the reportable security on the last settlement day and the changes in gross short position on each settlement day of the month.

Effective Start Dates for New SEC Compliance Rules



Inbound & Outbound Investment Regulatory Risks: CFIUS & FDI

The U.S. government has been increasing its scrutiny of inbound foreign investment for national security risks and concurrently is establishing a new program that would prohibit certain outbound investments. Both developments directly affect private equity funds. In contrast, the EU's regulatory response is nascent, with concrete proposals not expected before fall 2025.

> The Committee on Foreign Investment in the United States (CFIUS) continues to be aggressive in taking action to address identified national security risk.

Foreign Investment into the United States

The Committee on Foreign Investment in the United States (CFIUS) continues to be aggressive, maintaining a high volume of reviews and more frequently taking action to address identified national security risk. In particular, the following developments affect funds:

- **Foreign Limited Partners.**
  CFIUS is closely examining the rights of foreign limited partners to determine if CFIUS has a basis for asserting jurisdiction and to determine if these rights could cause national security risks.

- **Third-party Ties.**
  CFIUS also has been increasingly scrutinizing "third-party ties" to countries of concern—that is, commercial or investment ties that investors from lowrisk countries have with countries such as China.

- **Mitigation.**
  CFIUS has been increasingly requiring mitigation conditions to clear transactions, including to address risk associated with third-party ties.

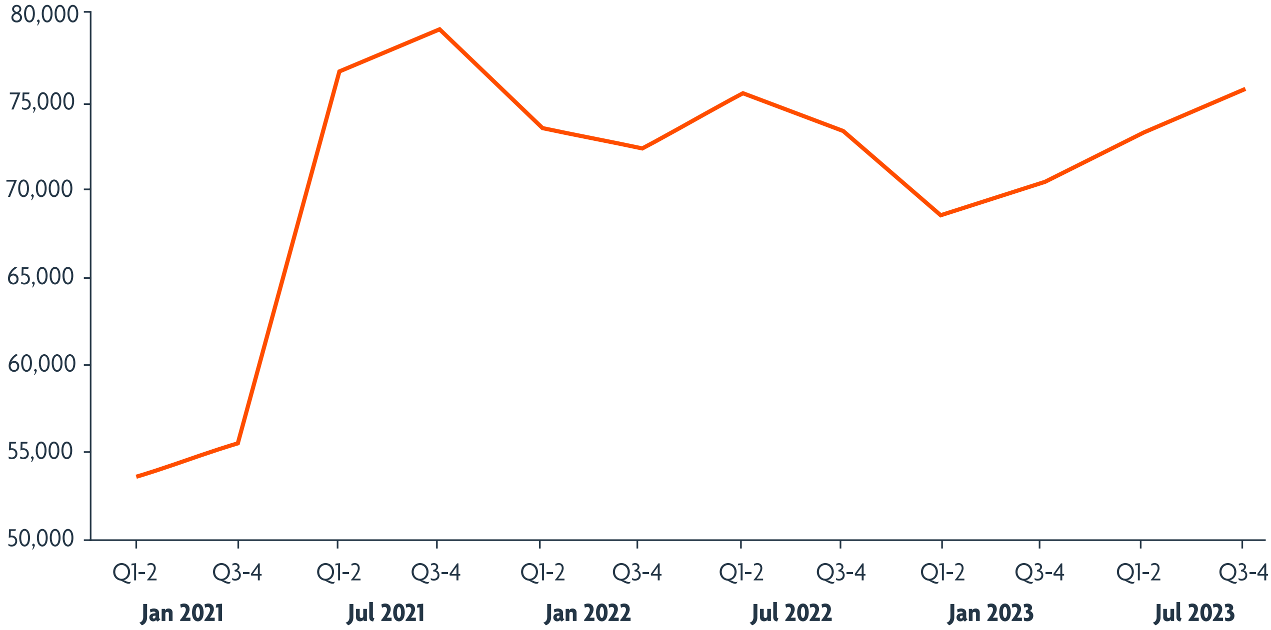
- **Enforcement.**
  CFIUS has made enforcement a top priority, including calling in transactions that parties have not voluntarily filed with CFIUS and becoming stricter with respect to mandatory filings.

- **Mandatory Filings.**
  Where filing 30 days in advance is mandatory, CFIUS has taken the position in its guidance that it no longer allows "springing rights." That is, parties cannot satisfy the mandatory filing requirement by closing a funding round and holding rights that trigger CFIUS jurisdiction (such as board membership or observer rights) until CFIUS clearance is obtained post-funding. Rather, parties must wait until the 30-day post-filing period has lapsed before funding such transactions.

- **Areas of Focus.**
  Technology and personal data continue to be particular focus areas. Even acquisitions of sensitive technology that is not state of the art could be considered a national security structures and third-party relationships, and factor CFIUS review into their timeline. risk if it would allow a country of concern to close a technological gap.

Foreign Direct Investment Inflows to the U.S.

2021-2023 ($ Million)



Source: US Bureau of Economic Analysis on TradingEconomics

In light of these developments, private equity funds must increasingly conduct diligence on the business activities of U.S. targets, consider their own ownership structures and third-party relationships, and factor CFIUS review into their timeline.

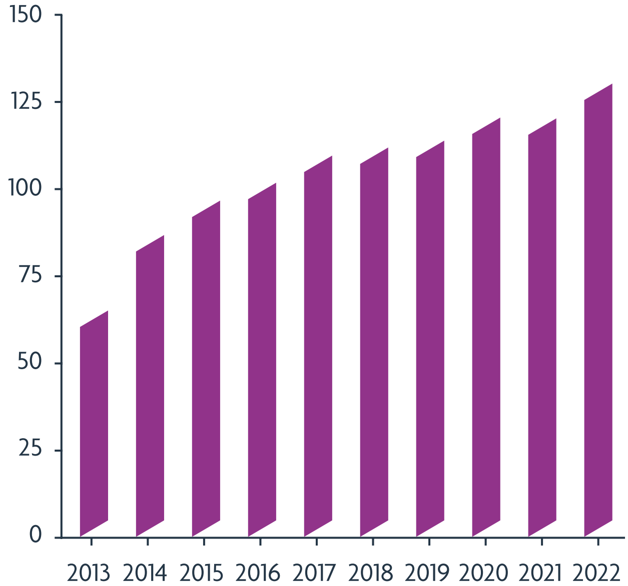
U.S. Investment into Chinese Companies

On August 9, 2023, President Biden issued a long-awaited Executive Order on outbound investment to China (including Hong Kong and Macau) that will prohibit or require notification of certain investments by U.S. persons into certain Chinese or Chinese-affiliated entities, namely those that develop or produce semiconductors, quantum computers or certain artificial intelligence (AI) applications.

The Executive Order is being implemented through a new rulemaking process, and the U.S. Department of the Treasury issued an Advanced Notice of Proposed Rulemaking for public comment, laying out proposed parameters for the new program. Private equity firms are squarely in the crosshairs.

U.S. Foreign Direct Investment in China

2013-2022 ($ Billion)



Source: Statista

Key Takeaways

- General Partners. Treasury has stated an intention to cover funds with U.S. general partners regardless of the country of formation. These funds will need to undertake additional due diligence and ensure compliance with both prohibitions and notification requirements. Non-U.S. managers may not be directly targeted by these rules, but ties to U.S. persons (e.g., investors or employees) could impose compliance obligations.

- Limited Partners. Treasury has proposed an exception for some but not all indirect investments by U.S. limited partners. Where a limited partner invests over a certain monetary or percentage threshold or has assets under management over a certain threshold (in each case, still to be determined), these indirect investments may be covered under the new program even if passive. Therefore, non-U.S. funds will need to take measures to ensure compliance for their U.S. limited partners.

- Knowingly Directing. If U.S. persons sit on the management committees or boards of foreign funds or entities, they would need to recuse themselves from certain investment decisions.

Outside of the U.S., we are seeing some other governments consider the necessity of rules on investment in China and elsewhere.

We expect draft regulations to be published in the first part of 2024 with a final opportunity for public comment. Final rules will likely become effective in the second half of 2024.

Congress also continues to debate restrictions and notification requirements relating to outbound investment to China and other countries of concern. Some of these proposals would cover more types of passive investment than Treasury's proposed approach and could potentially have a more significant effect on funds.

Outside of the U.S., we are seeing some other governments consider the necessity of rules on investment in China and elsewhere. The British government has been conducting a study to analyze the need for new measures to regulate outbound investment, particularly in relation to China following President Biden's Executive Order.
More recently, the European Commission (EC) published its White Paper on Outbound Investments. That said, rather than provide details of a concrete proposal—as had been originally anticipated when the Commission published its European Economic Strategy in June 2023. The White Paper instead proposes further steps for gathering information before any more concrete proposals are made.

While the EC already restricts the export of dual-use technologies and provides a legislative framework for Member States to screen inbound investments, there is currently no monitoring of outbound investment flow. In its White Paper, the Commission emphasises the complex and sensitive nature of the field of outbound investments, and the tentative steps it must take to ensure that the EU's response is proportionate and targeted.

Despite having already gathered information from Member States, and the EC Expert Group on Outbound Investment having met thrice last year, more reliable data is needed. Over the next couple of years the Commission has committed to running a public consultation on the proposed monitoring and review of existing outbound investments, and expects to issue a Recommendation to Member States this summer.

After another year of monitoring and reviewing risk assessments, the Commission's assessment of the need for policy responses and possible proposals are currently expected to be announced in fall 2025.

Debt Finance

Throughout 2023, we have continued to see activity in the debt finance markets, but the higher cost of capital, ongoing geopolitical uncertainties and mismatch in buyer/seller pricing expectations meant that deals have been getting done with less leverage. The syndicated lending market remained challenged through 2023 and therefore, private capital providers played a more significant role in lending activity.

The secular trend underpinning the proliferation of direct lenders in the market shows no signs of abating and those lenders have gained further market share in recent years. Certainty and speed of execution alongside the ability of direct lenders to provide long-term, flexible and supportive capital to sponsors, even in a distressed environment, continue to appeal to private equity borrowers.

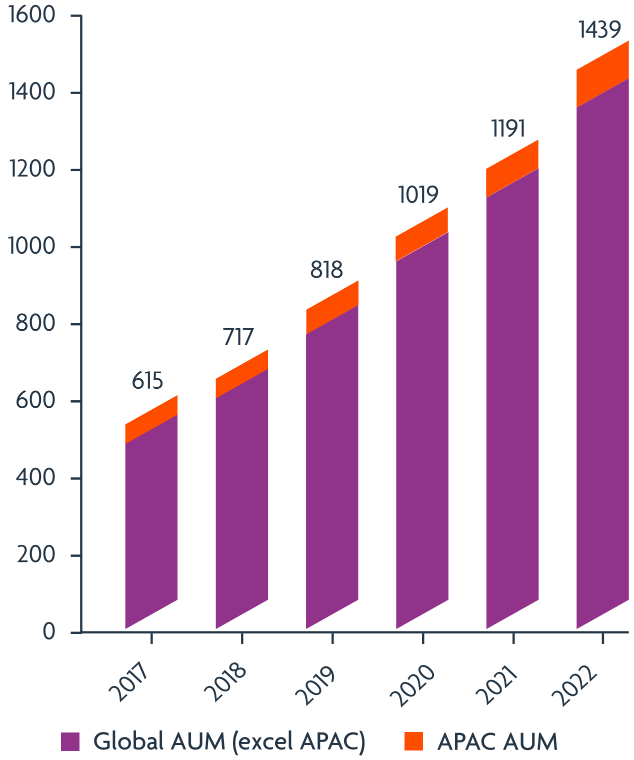
> The secular trend underpinning the proliferation of direct lenders in the market shows no signs of abating and those lenders have gained further market share in recent years.

In a higher rate environment, the pricing delta between private capital and syndicated lenders has also narrowed, such that even when M&A markets recover, we expect to see little that will displace private credit funds as a reasonable alternative to traditional banks.
The looming threat of more regulation of direct lenders, as well as conflicts issues between sponsors and private capital providers, could dampen growth but for the immediate future, private credit looks to remain a solid option for borrowers.

> For the immediate future, private credit looks to remain a solid option for borrowers.

Growth of Private Credit AUM Globally

2017-2022 ($ Billions)



Source: Preqin Pro.

There has been an increase in the number of distressed borrowers in some industries as parts of the economy continue to experience difficulties. We are seeing an increase in workout activity as lenders agree to bespoke structuring solutions to address covenant and other potential defaults. In both the U.S. and Europe, default rates have crept up but still remain at relatively low levels. Private credit providers have, for the most part, been constructive and solutions oriented.

The need to overcome a bid/ask spread on transactions is driving the use of more creative structuring in financing packages, with greater adoption of preferred equity, contingent payments, seller notes and earn-outs as part of capital structures.

The 2023 market was characterized by more follow-on acquisitions by existing portfolio companies than platform deals and a significant volume of refinancings via amend-and-extend transactions, covenant resets and workouts.

With interest rates high and funds themselves struggling to access liquidity, there is more appetite to use fund financing solutions to support portfolios. Subscription credit lines have proved harder to access following the challenges in the U.S. regional banking market at the start of 2023, which impacted many traditional subscription facility lenders.

With interest rates high and funds themselves struggling to access liquidity, there is more appetite to use fund financing solutions to support portfolios.

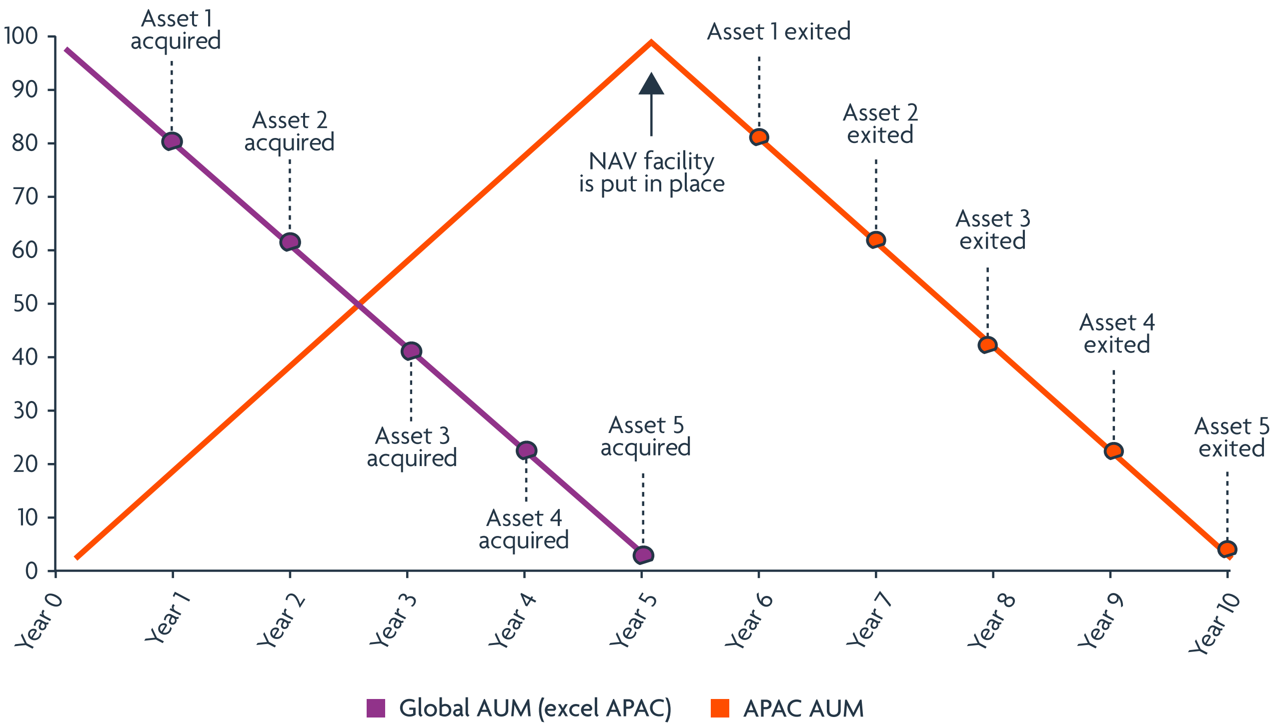
Issuers with B-Credit Ratings or Lower by Sector in 2023

- Software - **75**
- Health Care Providers & Service - **34**
- Chemicals - **18**
- Diversified Telecommunication Services - **17**
- Machinery - **16**
- Health Care Equipment & Supplies - **15**
- Hotels, Restaurants & Leisure - **14**
- Media - **14**
- IT Services - **13**
- Food Products - **9**

Source: Pitchbook and S&P Global Ratings Credit Research & Insights

Number of Take-Private Deals Globally

2018-2023 ($ Millions)



Source: Preqin Pro.

For later stage funds, NAV credit facilities that allow funds to borrow against the value of their underlying portfolios are becoming more common. Such tools offer only a small boost of liquidity in most cases, because loan-to-value ratios are typically well below 40%, but they can give sponsors much-needed additional flexibility and a bridge to extend the timeline to exit in anticipation of improved valuations.

Fund finance is another part of the market coming in for additional regulatory scrutiny, with enhanced reporting rules from the Securities and Exchange Commission (SEC) now requiring managers to state performance with and without the impact of fund-level subscription facilities.

Moving into 2024, we see more focus among lenders generally on avoiding losses, meaning they are reducing hold sizes, entering into more club arrangements on large deals and employing tougher due diligence at deal inception. They are willing to sacrifice incremental gains in terms of sponsor relationships or market share in order to preserve capital, particularly given the ever-present threat of a looming maturity wall.

Despite headwinds, we expect that liquidity will be available as the LBO markets recover through the coming year. Until then, we expect the continuation of creative deal structuring and more risk averse approaches from credit funds as their strength in the market keeps growing.

Health Care & Life Sciences

Despite strong private equity interest in drug and device targets, policy changes in the healthcare industry have made the M&A market tricky to navigate. Healthcare has been one of the most active policy focus areas in 2023 and this ongoing policy activity has the potential to impact private equity investors in the industry.

Chief amongst them, the Inflation Reduction Act (IRA), enacted in August 2022, is fundamentally reshaping the landscape for investment in healthcare and life science businesses in the United States, introducing a wide range of new incentives and disincentives and – for the first time – the federal government setting drug prices through the unprecedented Medicare Drug Price Negotiation Program, in addition to new Medicare Part B and Part D inflation rebates, and Part D benefit redesign.

The Inflation Reduction Act (IRA), enacted in August 2022, is fundamentally reshaping the landscape for investment in health care & life science businesses.

Inflation Reduction Act Implementation

Over the past 12 months, the US Centers for Medicare & Medicaid Services (CMS) has moved forward with implementing various price-setting provisions of the IRA and this remains an actively evolving landscape.

10 Drugs Selected for the First Cycle of Medicare Drug Price Negotiations

Drug Name	Most Commonly Treated Condition	Year of First FDA Approval
Eliquis	Blood clots	2012
Jardiance	Diabetes and heart failure	2014
xXarelto	Blood clots and coronary or peripheral artery disease	2011
Januvia	Diabetes	2006
Farxiga	Diabetes, heart failure and chronic kidney disease	2014
Entresto	Heart failure	2015
Enbrel	Rheumatoid arthritis, psoriasis, and psoriatic arthiritis	1998
Imbruvica	Blood cancers	2013
Stelara	Psoriasis, Crohn's disease, ulcerative colitis and psoriatic arthritis	2009
NovoLog/Fiasp	Diabetes	2000

Source: ASPE analysis of Drugs@FDA

The commercial viability of commercial and pre-commercial pharmaceutical products therefore continues to be in a state of flux with continued uncertainty a big issue for those investing in developing and launching new medicines for patients.

CMS published multiple sub-regulatory guidance documents in 2023 as they implement the IRA statute in relation to drug pricing, giving some preliminary insight into how the agency intends to apply IRA's price setting and drug rebate reforms.

August marked a particularly noteworthy IRA inflection point, with CMS unveiling the first 10 drugs that will be subject to the new Medicare Drug Price Negotiation program. Under this program, CMS designates certain high-spend, single-source drugs covered by Medicare for negotiating a "maximum fair price" with drug manufacturers. There have so far been at least 10 lawsuits launched, challenging the legality and constitutionality of the IRA in different courts across various states and adding further uncertainty around the reforms.

Adding to uncertainty around healthcare and life sciences investment, Congress and regulatory agencies continue to look at additional drug pricing reforms. For example, Congress is continuing to scrutinize the high list prices of certain drugs and the Biden administration has made lowering drug prices an administration-wide priority.

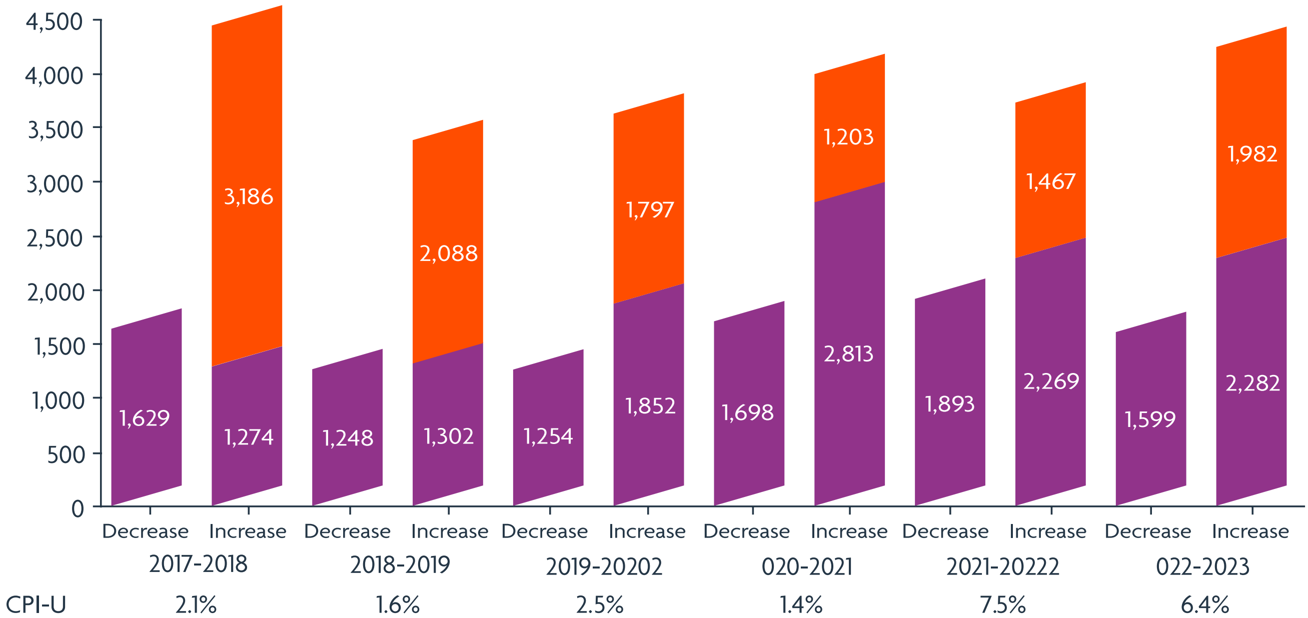
There have so far been at least 10 lawsuits launched, challenging the legality and constitutionality of the IRA in different courts.

Separately, the IRA and CMS's implementing memoranda also have flagged federal government funding of research and development as a factor to be assessed in setting prices of drugs that qualify for inclusion in Medicare'price-setting program.

In addition, out of a concern for anti-competitive behavior that could inflate drug prices in the marketplace, the Federal Trade Commission (FTC) issued a policy statement threatening legal action against drug manufacturers who delay generic competition through the improper listing of patents with FDA's "Orange Book" which protects drug products from generic challenge.

Number of Drug Price Changes in the U.S.

2017-2022 ($ Billions)



Above inflation At or below inflation

Source: Preqin Pro.

Uptick in scrutiny of PE in healthcare

In addition to the wide-ranging impact of the IRA, we have seen Congress generally taking a closer look at business practices in the healthcare sector and considering reforms to address increasing consolidation and its impact on patient access and affordability.

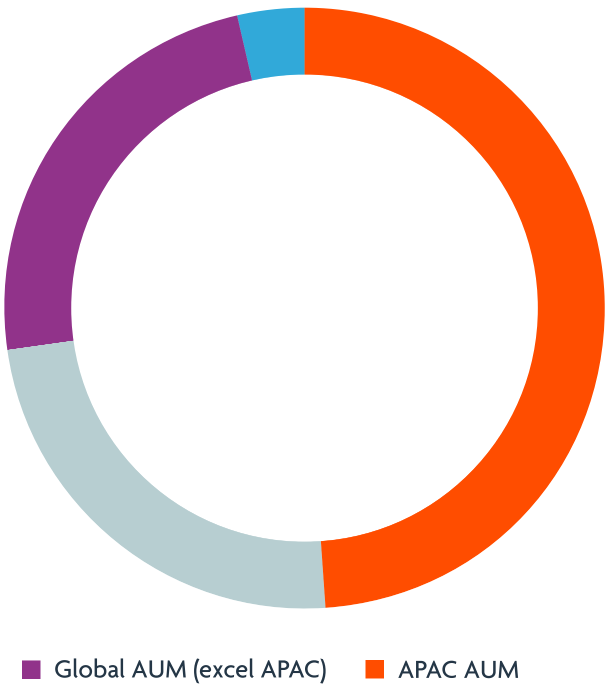
The 118th Congress' work on health care policy has included hearings and consideration of proposals related to imposing new disclosure requirements on healthcare entities owned by private equity and creating new non-compliance penalties.

While proposed private equity transparency provisions were not ultimately included in the latest related legislation to pass the House of Representatives, we can expect continued bipartisan focus on private equity ownership in the healthcare industry.

The concerns around consolidation and vertical integration across healthcare have also led to an unprecedented focus on the business practices of pharmacy benefit managers (PBMs).

Share of Buyout Deal Value Globally 2023E

($ Millions)



Source: Preqin Pro.

As part of the Senate's focus on drug pricing, it had PBMs testify at a hearing focused on the vertical integration of PBMs with insurers, pharmacy chains and others, as well as the flow of rebate dollars from PBMs to the insurers that are their customers. The bicameral, bipartisan interest in PBM reforms continues to grow and could result in further reforms to an already fast-changing drug pricing landscape.

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In short, the ongoing Congressional interest in healthcare and life sciences remains highly dynamic, in relation to ownership, consolidation, and competition, as well as around the implementation of IRA price controls.

Right now, all of the cases challenging the IRA's drug price setting provisions include constitutional challenges that could result in the law being stricken in its entirety. If the law is upheld (even in part), we can expect a second wave of litigation under the Administrative Procedures Act to challenge CMS' implementation of IRA, further adding to the foreseeable uncertainty in this space.

On a parallel track, the Biden Administration has also taken on the issue of ownership in the provider sector, announcing in December a number of initiatives to look into consolidation, a decline in independent physician practices, and the potential for private equity investment to result in "aggressive profiteering...lead[ing] to higher patient costs and lower quality care."

As a result, a number of initiatives are being undertaken including a cross-government inquiry into private equity investment in the sector including the DOJ, FTC and HHS; initiatives to focus on potential antitrust violations and anticompetitive effects of transactions in the sector, and requiring greater transparency of ownership of provider entities including hospital systems.

The current level of uncertainty and change in this space inevitably creates opportunities for smart investors, with the potential for new winners and losers. Those that stay close to the pace of regulatory change will be better positioned to navigate these complex and evolving considerations in 2024 and beyond.

Energy Transition

The energy transition posts a tremendous opportunity for private equity investors. The scale of the investment requirement makes private capital a "must have" and a broad spectrum of energy transition opportunities, particularly in "hard to abate" solutions, where direct electrification does not provide an efficient solution, offer a risk and return profile well suited to private equity fund expectations with significant value enhancement and upside potential.

Energy transition investments do, however, present novel or enhanced risks that will need to be well understood and carefully managed to ensure that they facilitate and do not hamper successful return generation and a timely exit.

These include uncertainty over the transition's trajectory and timescales; exposure to first-of-a-kind technology risks; merchant feedstock and offtake volume; price and revenue risks; reliance on and access to key natural resources; stranded asset risks; heavy dependance on government policy, financial or regulatory support creating potentially material political, regulatory and change in law risks; greenwashing and reputational risks; and specific ABC and modern slavery risks.

With such a wide spectrum of investment opportunities available, fund managers will need a clear vision of how the global energy mix is changing and where they can best add value, manage and mitigate key risks and find synergies to build strong growth.

An "In Demand" Asset Class

A recent report from McKinsey & Company estimated that the transformation of the global economy from fossil fuels to clean energy will require about $9.2 trillion of annual investment in physical assets through 2050, which is a $3.5 trillion yearly increase on current investing.

With governments limited in their capacity to step up and completely embrace the risk necessary to advance some of the emerging technologies and markets necessary to advance the energy transition, these potential investments present a huge opportunity for private equity and other private capital.

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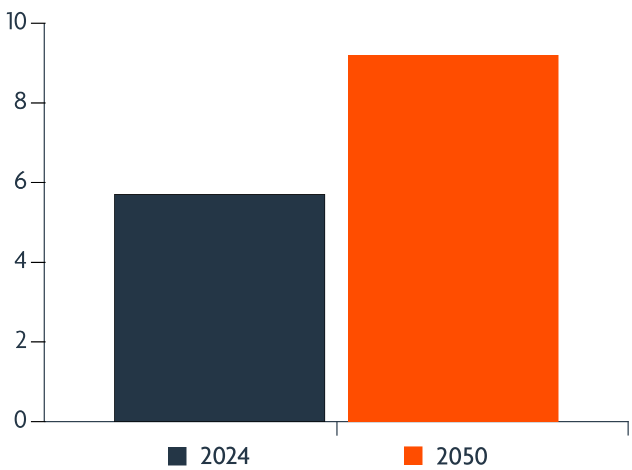
A key trend in private equity fundraising in recent years has been the development of energy transition focused funds specifically targeting investments in energy transition solutions across the energy, infrastructure, natural resources and transport sectors, with recent, successful examples, including familiar names like BlackRock, KKR, TPG and Brookfield Asset Management, all highlighting the scale of LP appetite to investment capital and seek returns in the sector.

Annual Investment Required in the Energy Transition

($ Millions)



Climate Tech Investment as a Percentage of Venture Capital and Private Equity Investment

2013-2023

Source: Pitchbook, PwC analysis

While this period of higher interest rates has resulted in an overall slowdown in transactional activity by private equity as the market seeks to readjust pricing expectations, we are seeing no let-up in appetite for good energy transition assets with the potential for solid rates of return and growth. This is coinciding with growing demand from investors for investment in energy transition assets that deliver on both environmental, social & governance (ESG) principles and fund financial return expectations.

Incentivizing Energy Transition Investment Through Government Support Mechanisms

In an ever increasing number of jurisdictions (including the U.S., U.K. and the European Union (EU)), governments and regulators continue to introduce and expand clean energy strategies and support private investment into energy transition assets, creating tangible investment opportunities out of projects and businesses that were previously considered commercially unviable, without significant government intervention and providing opportunities for developers to scale and optimize new technologies to de-risk future deployment and drive assets along the cost reduction curve.

Just as more mature clean energy markets like wind, solar, energy storage and battery manufacturing once needed significant policy and financial assistance to advance and now are thriving, the goal of these strategies is to catalyze in private investment to facilitate emerging energy transition technologies to eventually get to a similar place in the market—commercial viability without any or significant government intervention. It is this period of uncertainty in which private equity can play a pivotal role in bringing these emerging technology solutions to market.

In the U.S., the Inflation Reduction Act (IRA) introduced a wave of incentives evidencing a clear enhancement of government support for energy transition investments, including in emerging areas like carbon capture and green hydrogen.

With the IRA setting out a framework for a huge amount of tax incentives yet to be fully developed, albeit, with IRA guidance either opaque or not yet understood, there is significant policy development still to come to crystalize the IRA incentives that were intended to jump start the energy transition in the U.S. This creates opportunity and risk for investors.

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The U.K. and the EU are also developing and delivering their own clean energy strategies, having led the way in government support to date, including via the EU's new Green Deal Industrial Plan.

In the U.K. and the EU, policy is generally targeted at early-stage investment support and then at insulating developers from offtake price and price volatility risk (and sometimes also offtake volume or feedstock price risks) using, for example, contract-for-difference mechanisms or regulated asset-based models, rather than the tax credit model currently favored by the U.S., to bring energy transition investment to market. Nonetheless, the goal remains the same—to support deployment and crowd in private capital—and the opportunity abounds for private equity.

At the heart of the initial deployment of capital to support the energy transition sits a core assumption that government support will continue to incentivize the flow of capital into the asset class. This can, in turn, lead to political, regulatory and change in law risk across jurisdictions and some forum shopping to obtain (and combine) the most generous government support regimes taking into account the specific risk profile for the relevant technology in the applicable region.

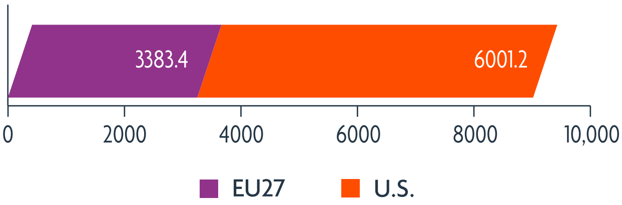
The U.S. is currently leading the way in the generosity of the government intervention, but continues to play catch up with Europe on overall aggregate investments in transition to date. For now, we also see investors trying to combine various programs to maximize the potential return on investment and hedging bets on cross-jurisdictional synergies in advancing the technologies, for example, manufacturing clean hydrogen in Canada and then exporting it into the EU, taking advantage of subsidies at both ends, or using green hydrogen in the U.S. to generate green ammonia for export to the EU.

Projects with higher perceived risk/reward profiles and newer innovations in areas like green hydrogen, ammonia and carbon capture and storage are increasingly attractive to private equity investors; provided that, as mentioned above, government support mechanisms are in place to de-risk and/or create financial incentives to undertake such projects and other key risks can be well understood and carefully managed.

In addition, we are seeing a growing interest from private equity in potential abatement or sequestration technologies in hard-to-abate sectors such as aviation, maritime and heavy industry, where emissions are either prohibitively costly or very difficult to affordably reduce with currently available abatement technologies (such as electrification supported by an increasingly green electricity grid).

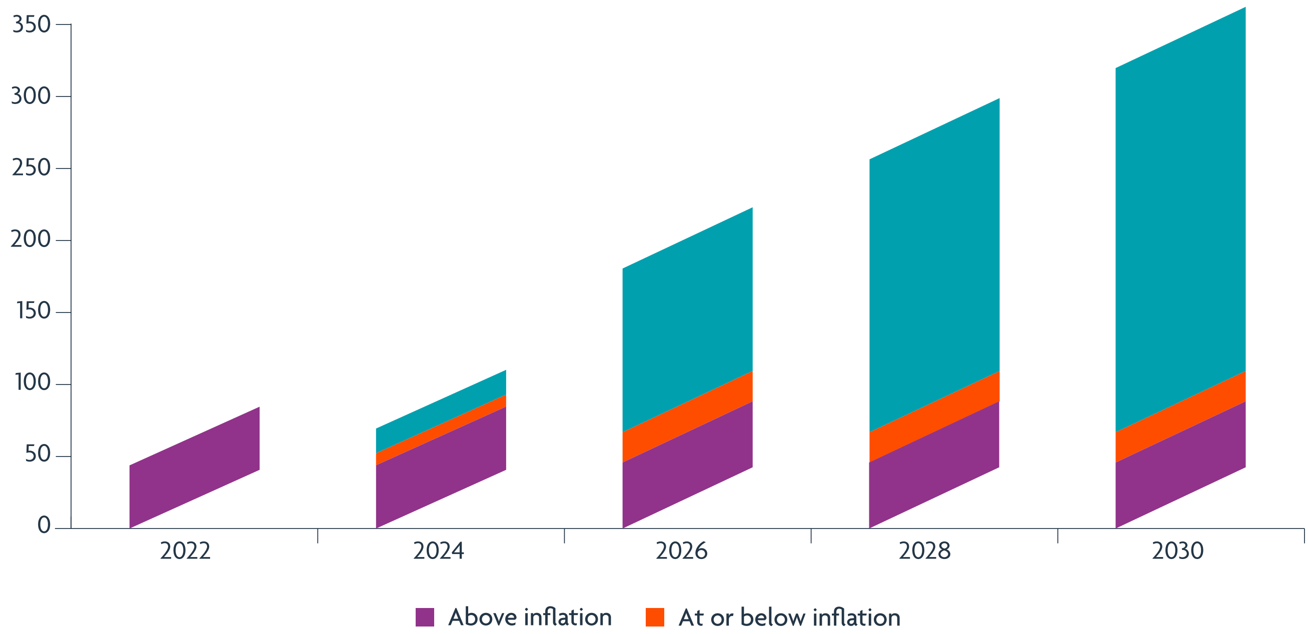
Greenhouse Gas Emissions of the U.S. and EU27

(MTCO2e per year, 2023)



Planned and Opertional Carbon Capture Capacity in Mt Manually

(MT CO2 per year, 2022-2030)



Source: Preqin Pro.

Transactional Considerations for Private Equity

While government support is critical to enhancing the commercial viability of the relevant technology or project, understanding the spectrum of novel or enhanced energy transition specific risks associated with the relevant investment (including e.g., technology risk, policy and regulatory risks (including change of law), merchant feedstock and offtake volume, price and revenue risks, greenwashing and reputational risks; and ABC and modern slavery risks) is key in a transactional context.

This is ultimately a focus for investment due diligence where a tailored and targeted approach may be needed. As an initial step, investors should understand the underlying regulatory frameworks and determine what risks government support is seeking to eliminate or minimize and how and when that support will be provided versus what risks will remain with the project.

Typically, we see asset delivery risk (intensified by supply chain uncertainties) and technology risks remaining with the target—in particular, in the U.K. and European models. Offtake and pricing support only come into play once the asset is operational.

On recent deals, we have seen investors focusing more intensely on the extent to which revenues are enhanced or guaranteed by government support.

On recent deals, we have seen investors focusing more intensely on the extent to which revenues are enhanced or guaranteed by government support, how much is contracted to stabilize counterparties and how to value energy or commodity price risk and merchant volume and revenue risks (if this is not mitigated through a government-backed instrument, for example, a contract for difference).

Although private equity players are no strangers to investing in energy & infrastructure assets, investment in emerging clean energy technologies does often necessitate a shift in the traditional method of private equity investing looking at longer hold periods to realize value and different investment structures to mitigate risk (e.g., risk sharing through joint venture structures or deferring investment tranches to certain milestones).

The "exit" can also be more complicated. Risk allocation and the traditional "clean break" approach can be tested where decommissioning and environmental liabilities may be prevalent (with insurance unlikely to cover these risks) and the sector also tends to result in greater regulatory scrutiny (and regulatory change), typically engaging foreign direct investment regimes and often involving consents from specific energy related regulatory authorities, which can drive extended timelines for deal-making and reduce the pool of potential suitable buyers.

Taking a step back, we also see a critical role for private equity in instigating a transition story for traditional fossil fuel assets through investing in and implementing new technologies. Examples include evaluating existing enhanced oil recovery assets for permanent sequestration, installing on-site renewable power or using existing rights of way for the development of carbon pipelines to sequestration sites.

Private equity is well placed to capitalize on these types of investments, adding value through responsible ownership during their hold period and entering a subsequent sales process with a more valuable asset with access to a greater pool of buyers.

Looking Forward

COP28, the UN's Climate Change Conference, closed in December 2023 with an agreement that targets reduce dependence on fossil fuels (but without an explicit commitment to phase out fossil fuels), laying the groundwork for deep emission cuts and scaled-up financing for energy transition.

Still, political support for green investment looks set to remain the subject of fierce debate in general elections across the globe with elections due to be held in 50 countries affecting more than two billion voters in 2024 (including, notably, the U.S., the EU and most likely, the U.K.) with policy seeking to support economic growth via reliable and cost-effective power generation while simultaneously advancing the general goals of the energy transition—increased efficiency and decarbonization.

Ever mindful of the need for government support, we see private equity continuing to allocate more capital to funding the energy transition and expect 2024 to be a busy year for deals as elements of the IRA (such as green energy tax credit transferability), the EU's Green Deal Industrial Plan and competing government support around the globe start to make an impact.

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