PRIVATE MARKETS UPDATE

2023

McDermott
Will & Emery

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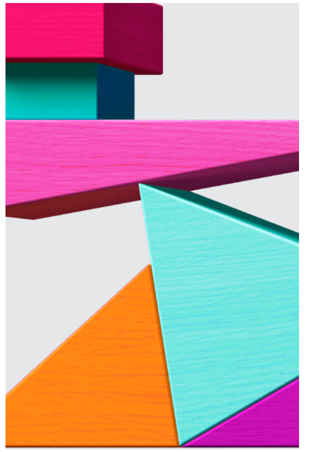

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MARKET ANALYSIS

Welcome to the inaugural Private Markets Update from McDermott Will & Emery's multidisciplinary team. This Report highlights developments in the European private markets, covering the issues that matter to investors in alternative assets. Touching on themes as diverse as predictions for fintech, transatlantic restructuring trends and aligning price expectations in the German Mittelstand, we review what we learned from markets shifts in 2022 and share predictions for 2023 and beyond.

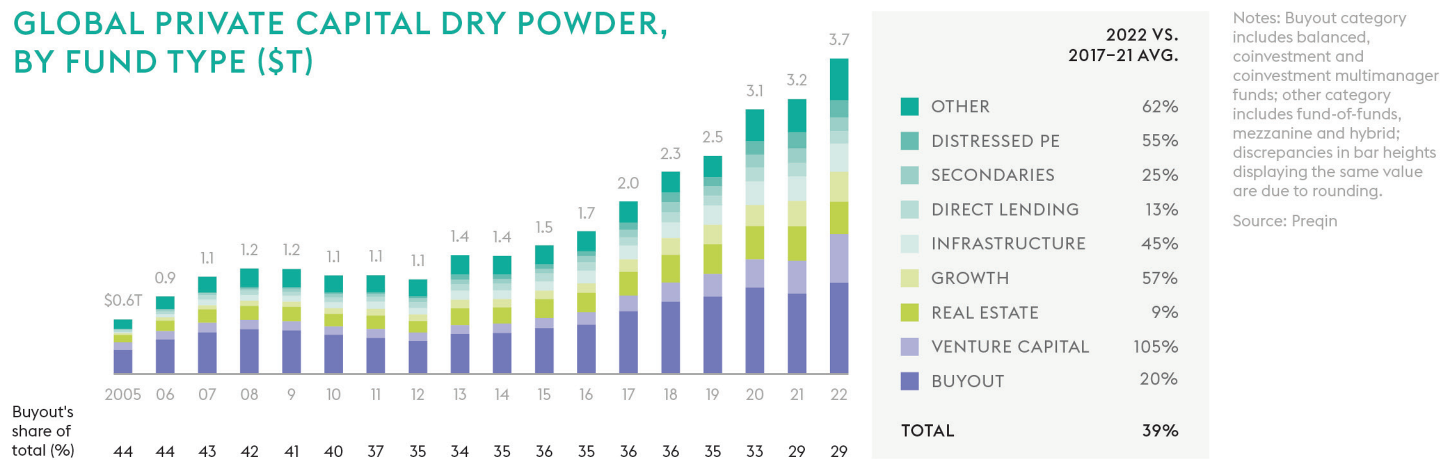
To kick off, we crunched the numbers to bring you the "10 Trends To Track." This is our pick of last year's themes that tell the story of where the market is today and where it might be going. As the private markets prove more adaptable, confident and robust than their publicly traded contemporaries, we believe the following trends will tell the story of the year ahead, and these data points should be high on the agenda of all market participants.

TREND 1: PRIVATE EQUITY HAS MORE CONFIDENCE THAN STRATEGICS

As uncertainty compounded by record inflation, rising interest rates, geopolitical unrest and banking volatility rocks the M&A markets, it is private equity buyers that stand ready to kickstart the recovery in dealflow later this year. With assets in their portfolios ripe for sale and dry powder on their books that needs deployment, we can expect private markets to fuel an uptick in transaction volumes that will likely start to take shape after the summer.

At the start of 2023, private capital held more than $3.7 trillion in dry powder globally, setting a record for the previous 12 months with buyout funds taking the lion's share, according to Bain & Company.

GLOBAL PRIVATE CAPITAL DRY POWDER, BY FUND TYPE ($T)

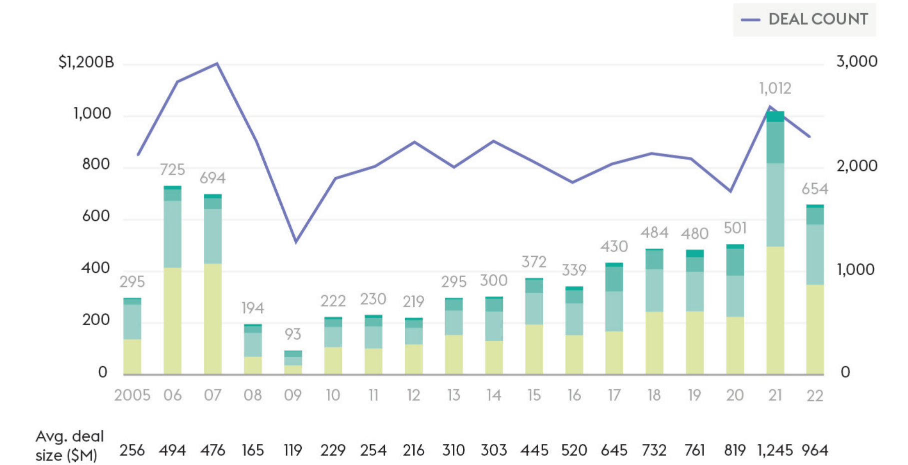


TREND 2: EUROPE AND THE US WILL DOMINATE GLOBAL DEAL ACTIVITY

In uncertain times and facing a challenging macro and geopolitical climate, now is not the time for investors to take risks on newer and emerging markets. Private capital is likely to revert to more conservative strategies in the years ahead, fuelling predictions that it will continue to be the US and Europe that will dominate deal activity and where private funds will put most capital to work.

In 2022, global buyout deal value dropped by more than a third as banks backed away from large transactions, but the drop-off was less significant in Europe and North America than it was elsewhere.

GLOBAL BUYOUT DEAL VALUE, BY REGION



CHANGE IN DEAL VALUE	2022 VS. 2021	2022 VS. 2017–21 AVG.
REST OF WORLD	-72%	-47%
ASIA-PACIFIC	-59%	-33%
EUROPE	-28%	22%
NORTH AMERICA	-30%	27%
TOTAL	-35%	12%

Notes: Excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location; average deal size calculated using deals with disclosed value only.

Sources: Dealogic; Bain analysis

TREND 3: HEALTHCARE, TECH, INFRA AND ENERGY TRANSITION ARE THE SECTORS TO WATCH

In recent years, private markets investors have shown increasing favour towards resilient industry sectors better placed to ride the economic headwinds that we are now enduring. Healthcare, business services and software deals have increasingly dominated both private equity and private debt investing since the outbreak of COVID in 2020, and as we move into 2023 we see infra and energy transition similarly grabbing a growing share of private capital.

Data from PitchBook shows the capital invested in B2B, energy, healthcare and information technology combined jumped to $847 billion in 2022, up 12% on 2019.

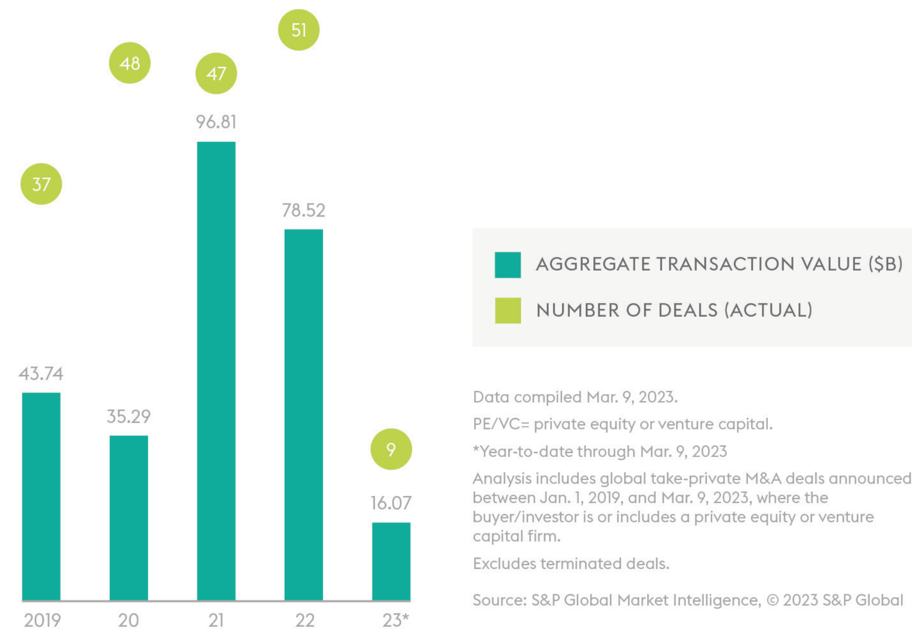
Primary Industry Sector	(B2B)			ENERGY			HEALTHCARE			INFORMATION TECHNOLOGY			ALL		
Year	Company Count	Deal Count	Capital Invested	Company Count	Deal Count	Capital Invested	Company Count	Deal Count	Capital Invested	Company Count	Deal Count	Capital Invested	Company Count	Deal Count	Capital Invested
2023	3	3	-	106	106	28,857.56	309	309	44,085.99	778	778	28,462.88	1,196	1,196	101,406.43
2022	12	12	37.12	666	667	244,474.28	2,066	2,070	230,861.42	4,560	4,563	371,157.01	7,304	7,312	846,529.83
2021	11	11	2,896.08	750	752	134,823.55	2,593	2,598	305,028.71	5,491	5,496	418,176.04	8,845	8,857	860,924.38
2020	5	5	2,005.73	544	547	65,410.01	1,901	1,903	288,918.57	3,706	3,707	234,306.82	6,156	6,162	590,641.13
2019	21	21	83.15	611	612	189,735.23	1,783	1,785	275,437.55	3,576	3,578	294,146.94	5,991	5,996	759,402.87
2018	11	11	8,403.64	700	701	217,966.74	1,998	2,004	271,928.90	3,706	3,709	277,757.04	6,415	6,425	776,056.32
All	63	63	13,425.72	3,319	3,385	881,267.37	10,508	10,669	1,416,261.14	21,534	21,831	1,624,006.73	35,424	35,948	3,934,960.96

TREND 4: PUBLIC-TO-PRIVATES AND CARVE-OUTS GATHER MOMENTUM

As public market valuations take a hit and large strategics grappling with squeezed margins seek to streamline their businesses, opportunities abound for private markets to capitalise on both take-privates and carve-out deals. With private equity's deep pockets and private credit's ability to deliver flexible finance, we expect these two deal types to feature heavily in the M&A rebound when it comes.

Data from S&P Global shows take-privates typically account for about 20% of private equity deal value globally, but that doubled to about 40% in 2022 and accounted for about 70% of private equity's deal value in the first three months of 2023.

GLOBAL TAKE-PRIVATE DEALS WITH PE/VC INVOLVEMENT 2019-2023

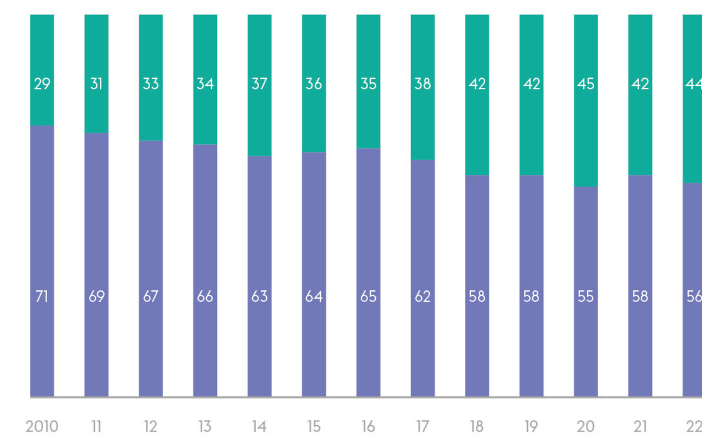


Data compiled Mar. 9, 2023.
PE/VC= private equity or venture capital.
*Year-to-date through Mar. 9, 2023
Analysis includes global take-private M&A deals announced between Jan. 1, 2019, and Mar. 9, 2023, where the buyer/investor is or includes a private equity or venture capital firm.
Excludes terminated deals.
Source: S&P Global Market Intelligence, © 2023 S&P Global

TREND 5: BOLT-ONS WILL KEEP SPONSORS AND LENDERS BUSY

Add-on deals have consistently grown in popularity among private equity firms over the past decade, increasing from 49% of total buyout deal count in 2009 to 72% of all buyouts globally in 2022. In a challenging M&A market, when exits are harder to execute, industry roll-ups and bolt-on deals represent value creation strategies that can capitalise on cost-orientated synergies and accelerate expansion into new markets. Add-on transactions also keep PE deals busy and continue to deliver fee income for private credit providers at a time when platform acquisitions are fewer in number.

PE BUYOUT DEAL VOLUME, %



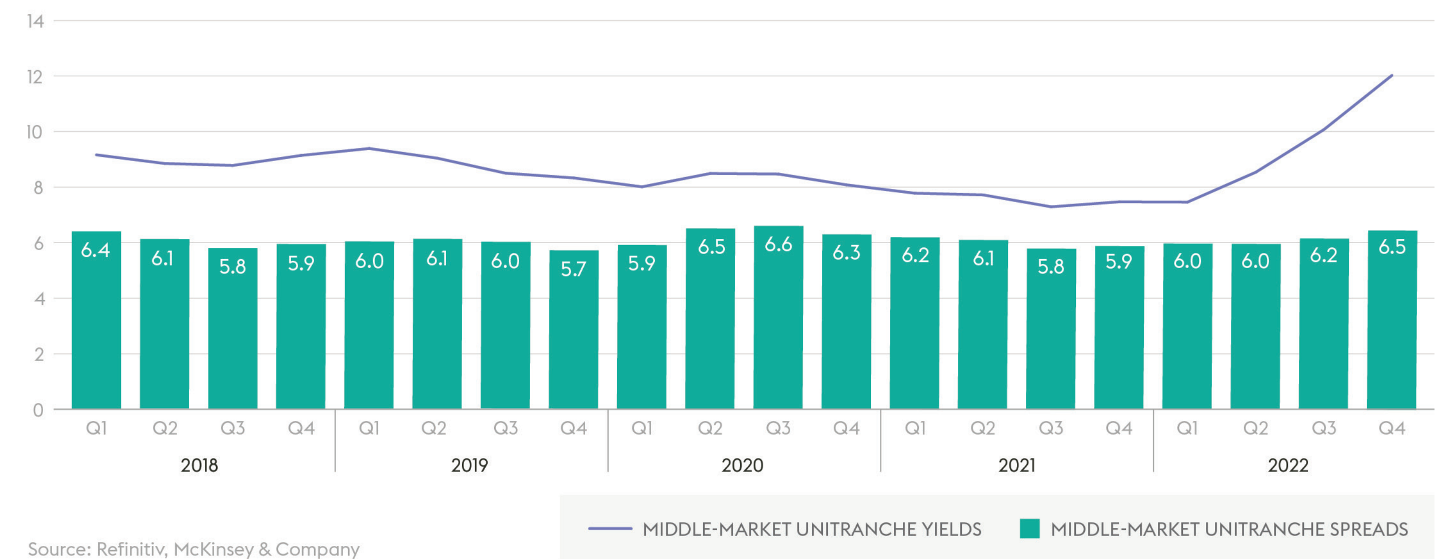
NON-PLATFORM DEALS, % OF DEAL COUNT

Source: PitchBook, McKinsey & Company

TREND 6: DIRECT LENDERS WILL BENEFIT FROM THE ECONOMIC HEADWINDS

With most direct loans pegged to floating-rate pricing, coupon payments are increasing as interest rates rise and direct lenders are simultaneously benefitting from widening spreads driving up the expected yields on new loan issuance. With leverage levels coming down, equity cushions strengthening, documentation getting more lender-friendly and distress in the liquid credit markets allowing for market share gains in Europe especially, private credit funds are set to do well. That perhaps explains why private debt fundraising hit an all-time high of $224 billion in 2022.

SPONSORED MIDDLE-MARKET UNITRANCHE SPREADS AND YIELDS, %

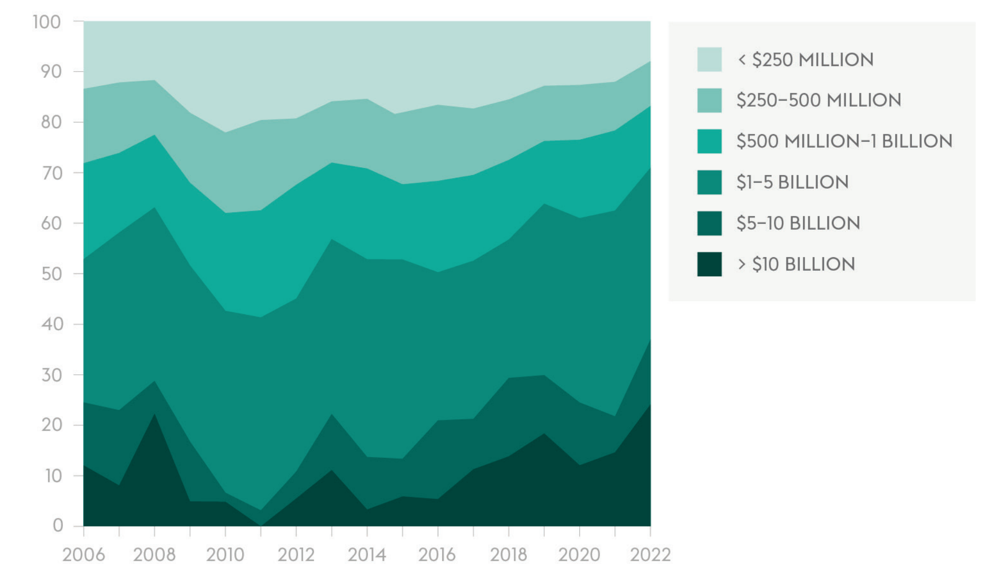


Source: Refinitiv, McKinsey & Company

TREND 7: INVESTORS WILL GRAVITATE TO ESTABLISHED LARGE FUNDS

Fundraising was more challenging for private funds in 2022 than it has been for a long time, dropping 11% globally across private markets, according to McKinsey & Company. But in turbulent times, nervous LPs continued to channel allocations towards bigger players with established track records: funds greater than $5 billion raised a record $445 billion last year, 51% up on 2022, while funds smaller than $1 billion raised just $349 billion, down 31%. In PE, the largest 25 managers raised 42% of the global total, the highest annual share since 2013.

GLOBAL PRIVATE MARKETS FUNDRAISING BY FUND SIZE AND CLOSE YEAR,[1] % OF TOTAL IN-YEAR FUNDRAISING AMOUNT

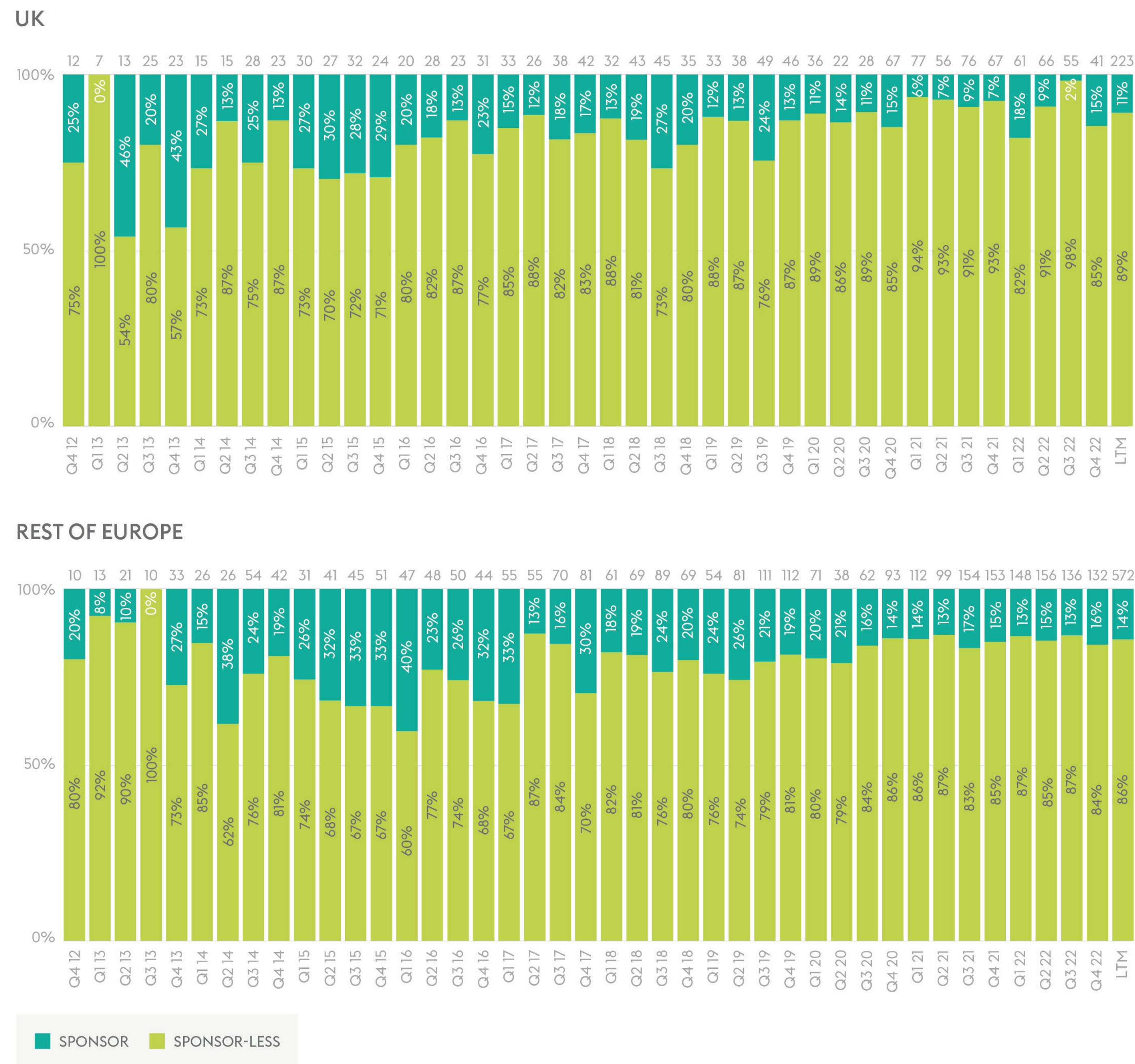


[1] Secondaries and funds of funds are excluded to avoid double counting of capital fundraised.
Source: Preqin, McKinsey & Company

TREND 8: PRIVATE CREDIT WILL BE ON THE LOOKOUT FOR SPONSORLESS DEALS

Sponsor-backed M&A continues to comprise the backbone of European private debt deals, accounting for 85% of transactions in the UK in Q4 2022 and 84% in the rest of Europe, according to Deloitte data. But bilateral sponsorless deals that involve corporate borrowers interacting directly with direct lenders outside of a buyout scenario are increasingly seen as both more lucrative and more interesting for debt funds, many of whom are strengthening on-the-ground sourcing capabilities across Europe to tap into non-sponsored opportunities.

SPONSOR BACKED VERSUS PRIVATE DEALS AS % OF TOTAL DEALS PER QUARTER



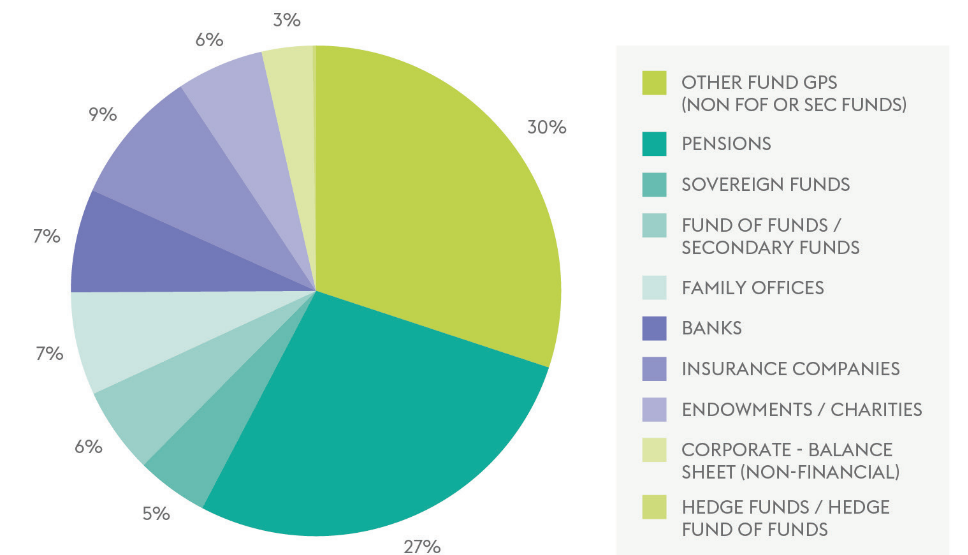
Source: Deloitte Analysis

TREND 9: THE SECONDARIES MARKETS WILL THRIVE...

With challenging public markets and sedentary M&A activity, private equity firms struggling to sell portfolio companies and facing longer hold periods have turned to the secondaries market in increasing numbers in recent years. With GP-led secondaries and continuation funds offering LPs much-needed liquidity, GPs accounted for 30% of secondary market sellers in 2022, according to a Setter Capital survey.

More than a third of participants in that survey felt meaningfully more GPs coordinated tender offers or attempted to liquidate or restructure older funds in 2022 compared to 2021, and 42% felt a materially higher number of GPs sought staples last year than they did in the year before.

TYPES OF SELLERS IN FY 2022



Direct investing GPs (*i.e.*, not fund of funds or secondary funds) and pensions were the most active sellers in FY 2022, making up 30.1% and 7.6% of the FY 2022 volume, respectively. Most buyers expect pensions to be the biggest sellers in FY 2023 (43.4% of total transaction volume).

Source: Setter Capital

TREND 10: ...PARTICULARLY FOR PRIVATE DEBT

PRIVATE CREDIT SECONDARY DEAL ACTIVITY

Source: Coller Capital, PitchBook

While the secondaries market overall saw volumes fall in 2022 in the face of broader macro uncertainties, credit secondaries enjoyed another record year. According to secondaries firm Coller Capital, the trade in secondhand stakes in private debt funds hit $17 billion in 2022, more than 30 times the total in 2012. At the current rate, the value of secondary deals could hit $50 billion by 2026, the firm predicts.

Volatility in the past few years has driven heightened demand for liquidity on the part of both GPs and LPs, leading credit secondaries to balloon as both an investment strategy and a tool for delivering liquidity solutions. The denominator effect that left some LPs overweight on private assets simply because of falling valuations in the public markets has further fuelled activity in a market predicted to keep growing at pace in the coming years.

OUTLOOK FOR M&A AND PRIVATE EQUITY IN 2023

Tom Whelan and Garrett Hayes

KEY TAKEAWAYS

- So far, as expected, it has been a tricky start to the year, with busier M&A markets anticipated in the second half of 2023
- Dealmakers are more bullish on the mid-market than on large-cap deals
- Until forced sellers engage, the mismatch in pricing expectations will prevent deals
- European activity may take longer to recover than the US and Asia
- Private equity buyers are more confident than strategics, with sizeable dry powder
- Dealmakers will get creative to unlock transactions and mitigate risks
- Deals will take longer and sellers will take a less aggressive approach to auctions
- We will see more public-to-privates and GP-led deals

A recent MergerMarket survey of deal-doing executives globally found that more than three-fifths of respondents expect overall levels of M&A activity to increase in 2023, rising to four-fifths in respect of mid-market transactions (deals up to US$2 billion).

This optimism is welcome as we move into 2023, but is clearly not a consensus view, as other surveys and commentators expect 2023 to continue to present a difficult deal environment. Our expectation is that global macroeconomic and geopolitical conditions – including the ongoing war in Ukraine, supply chain issues arising out of ongoing COVID issues in China and higher interest rates in the main western economies – will continue to dampen M&A activity in the first half of 2023 but the second half of the year is likely to be significantly busier.

Our experience in the second half of 2022 was that a material mismatch in pricing expectations had arisen between sellers and buyers. Whilst all of the macroeconomic and geopolitical conditions referred to above are a factor in this, the principal cause is the significantly higher borrowing costs resulting from the multiple increases in base rates during 2022. Those have resulted in private equity buyers almost universally reducing the prices they are willing to pay while sellers are still hoping for the valuations seen at the height of the market.

This mismatch has led to a number of transactions going on hold while sellers decide whether or not to transact at the lower level of purchase price currently on offer. Until sufficient “forced” sellers are willing to transact at a lower multiple, due to financial difficulties, the sale of non-core assets or the end of a fund life, for example, then non-forced sellers may prefer to defer sales believing that multiples will return.

Any optimism for 2023 M&A activity also needs to be understood in the context of a decrease in deal activity from 2021 into 2022, with deals down approximately 10% in number and more than 30% in value between 2021 and 2022, and every sector and deal size showing a decline in the second half of 2022 versus the second half of 2021. In addition, the outlook in Asia and the US appears to be more robust than the more challenging European outlook. Given the ongoing market challenges, including the lower global growth forecasts from the IMF of 2.7% in 2023, down from 3.2% in 2022, it is unlikely that deal activity will return to 2021 levels before 2024 and perhaps even later in Europe.

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Private equity investors have almost double the levels of confidence regarding levels of M&A activity compared to corporates. This is interesting given the issues with availability of debt funding on acceptable terms, which is a critical component of most PE deals, and given the inherent advantage that committed corporate credit facilities and cash on balance sheet offers to corporate bidders. However, such optimism is most likely due to the significant amounts of dry powder still available to private equity funds (estimated to remain in excess of US$3 trillion). With the drop in deal activity during 2022, the time available to deploy this dry powder will have shortened, increasing pressure on PE investors.

Financial investors are approaching the market with caution and a lot of private equity investors sat out the last quarter of 2022, with reports of a 66% drop in private equity activity by value. However, historic

performance figures show that funds invested into difficult markets often out-perform funds invested during more positive market conditions and we expect financial investors to identify and pursue attractive opportunities during 2023, increasing their activity levels in the second half of the year particularly.

A more difficult deal environment often leads to more creativity, as bidders seek ways to mitigate associated risks. During 2023, we expect to see an increase in vendor loan notes to help bridge the funding gap caused by the availability and cost of third party financing; an increase in earnouts, which have historically been a useful tool to reduce the risk of overpaying for a target; and an increase in deals where private equity seeks to acquire two or more relatively undervalued businesses from multiple sellers at the same time, merging them to create a more valuable business of scale. Private equity investors are increasingly willing to take significant minority stakes in businesses, enabling selling shareholders to realise part of their stake at what they perceive to be a low valuation whilst retaining a controlling stake that will benefit from future growth, and we also see private equity investors pursuing joint ventures with strategics, enabling the deployment of capital into projects alongside corporate partners.

Difficult market conditions have historically seen private equity investors pursue more bolt-on acquisitions as they look to optimise their supply chain, to accelerate market penetration and to realise synergies of scale, and we expect this to be a feature of 2023.

Transactions will take longer to execute, thanks to a greater focus on due diligence and more difficulty in arranging financing. Except perhaps for the most attractive assets, the sell side will need to take a less aggressive approach to auctions, and we expect to see fewer auctions requiring high multiples, accelerated timelines, offering limited due diligence opportunities, zero recourse terms and setting an expectation that bidders will assume financing risk. These became the norm during the market peak but are, for now at least, a thing of the past.

We anticipate an increase in public-to-private transactions due to lower public market valuations, while the relative strength of the dollar versus the euro and sterling will mean dollar-denominated funds finding UK and European markets good value. As ever, the takeover rules in some European markets present challenges around acquiring control and delivering a return to private ownership compared to the UK takeover rules, which may concern some funds.

The market in secondary transactions should continue to grow, particularly in tougher markets where investors are seeking liquidity. We think that GP-led secondaries will dominate, particularly where fund managers want to hold onto assets near the end of a fund's life and see the appeal of a continuation fund because public markets cannot deliver expected returns.

Fundraising will continue to be tougher, even though funds raised and invested during a downturn tend to perform well. Still, many asset managers are overweight in private equity thanks to the recent sharp falls in the capital markets, so some fund managers will opt to hold onto assets longer and extend the life of existing funds until better fundraising times return.

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CROSS-BORDER TRENDS IN FINANCING PE TRANSACTIONS

Aymen Mahmoud, Samantha R. Koplik and Jun Won Kim

KEY TAKEAWAYS

- A key cause of recent inactivity is the bid-ask misalignment
- The buy-side and sell-side will quickly converge thanks to the availability of dry powder
- Transactions are being structured with more back-ended economics
- 'Most favoured nation' clauses will be in focus
- Buy-and-builds and take-privates will feature heavily in M&A activity
- Smaller private credit funds will look to pick up market share
- Amend and extends and operational hedging are moving up the agenda
- Jumbo deals will require clubs of lenders
- Instances of stress and distress will create opportunity

Looking back on 2022 shows the delayed impacts of COVID did not singularly drive inflation rises. Interest rates, raw material costs arising out of conflict in Ukraine and broader geopolitical instability were meaningful contributors, as was the flux in UK politics and fiscal policy. Alongside these was the impact of a fatigued M&A market, where 2021 was so remarkable as to have, perhaps, overworked the M&A engine, with some refinements and repairs required.

Together, these markers brought the economic indicators that signal stress and distress, making special situations prevalent and causing even performing credits to demand greater stress-testing among cautious participants. Higher interest rates, greater consequential inflation, high raw material and energy prices and public market and FX volatility all suggest a directional shift away from a prolonged period of cheap and abundant liquidity.

> 2021 was so remarkable as to have, perhaps, overworked the M&A engine, with some refinements and repairs required.

A key cause of recent inactivity is the bid-ask misalignment of expected valuation multiples. As 2008 taught us, the relative absence of credit creates a more challenging private equity environment, but causes lenders (and therefore borrowers) to closely examine the asset class valuation multiples. That private market response is exacerbated by the impact in the equity markets, with widespread downward revaluation seen across numerous sectors in H2 2022. The sheer availability of dry powder within both equity and debt markets, alongside deployment incentives and a search for yield, created a thriving sell-side. This, and the growth of competitive buyout markets, drove valuation multiples upwards, with buyers relying on exit valuations to create value as M&A volume reached all-time highs in the 18 months following COVID.

The withdrawal of the credit markets and refocus on valuations will have multiple impacts, ranging from NAV-based fund financings to new opportunities for this and other secondary type transactions to maximise value and returns. But the delay between buy-side and sell-side expectations converging should be short; with the huge amounts of committed, sophisticated and private capital available in the markets, which money managers are paid to deploy, we can expect the realisation period to be shorter in this part of the cycle than in previous years.

Within buyout documentation, transactions may be structured using increasingly back-ended economics, such as earn-outs to better align value with performance, or seller financing in the form of seller promissory notes. On the financing side, however, the key focus has been, and will continue to be, economics. There will be a keen focus on 'most favoured nation' clauses in financing documents and in particular on the ability to subvert those provisions. Whilst European financings have always been more susceptible to workarounds for the most favoured nations compared to US markets, participants have typically respected the spirit. We may see more clubs of lenders and new lenders entering capital structures where an incumbent lender is more reluctant to deploy increased risk participation on a single credit; incumbents will be focused on any passive ability to reprice their facilities.

> On the financing side, the key focus has been, and will continue to be, economics.

This overall theme of bolstering economics helps lenders to adjust risk-pricing in a trickier environment and mitigate the impact of any blips in portfolios. For private credit, this continues to make the product offering attractive to investors who can already benefit from an inflation-adjusted asset class at a time when value may be harder to obtain. All-in yield will generally continue to remain higher than at more active periods, whether through fees, margin, call protection or some combination thereof.

There are various other M&A themes that we can expect to punctuate market behaviours in 2023. One, which will ultimately represent a continuation of the last few years, is buy-and-build. It has long been understood that adding appropriate synergistic businesses, either vertically or horizontally, tends to be more conservatively priced prior to acquisition than following integration into an existing business. Whilst this applies to the larger business transformative acquisitions that provide significant growth, a smaller add-on can yield a very significant return in relative terms and, if done systematically, in overall value. This investment thesis will likely be further supported through the ability of larger capital structures or more patient investor types being able to better withstand periods of economic stress than, for example, individual business owners or traditional banks, leading to an attractive arbitrage opportunity.

Challenges in equity markets also create arbitrage opportunities for PE funds with available dry powder. As macroeconomic factors continue to put downward pressure on public markets, sometimes affecting public companies irrespective of their underlying value, funds may face increased opportunities to acquire public targets at a discount. Accordingly, we would expect the take-private market to remain globally relevant in 2023. Additional arbitrage opportunities may be available for US dollar investors, even though sterling rates have bounced back. It was less than 10 years ago that £1 would cost you $1.65, so the relative pricing opportunity for US investors into European structures is still strong, even with sterling priced around $1.20.

One interesting development that may continue to feature in 2023 is that of smaller private credit funds looking to help with buy-and-build capital structures by providing liquidity at a lower pricing threshold than some of their more established competitors, in order to pick up market share. Effectively deploying funds during a period of reduced activity may well propel future fundraising rounds and stimulate LP interest, boosting those smaller funds in the same way as it did for today's larger credit funds in previous periods of capital market inactivity.

To combat certain market risks, we have seen more amend and extends and the return to focus of hedging exposures. The latter touches on operational hedging, but more so relates to indebtedness, on both a floating-rate interest basis and a volatility of FX basis. Whilst not universally required by lenders mandatorily just yet, hedging remains a key focus area, including for borrowers as they look to ensure that they are properly defending their capital investments within an expensive market for derivative products.

On amend and extends, there have been a large number of borrowers opting to try to extend their maturities for 12 or 18 months in the belief that a

more accessible lending market will be available in that period, versus seeking refinancing in the current environment. In a market where private credit has such a heavy participation, the benefits of patient and less aggressively regulated capital can be seen. Direct lenders don't need to move precipitously during a period of underperformance in the same way that a more traditional lending bank would. They can instead work with companies to provide time and flexibility at an appropriate risk-adjusted cost where all stakeholders can benefit.

That risk-adjusted economics here are a double-edged sword. For some credits, particularly those with publicly traded debt, there may be an arbitrage opportunity even for borrowers. Being able to buy par debt back at a 20% or 30% discount could represent a sound economic investment in the secondary markets. We have seen this tactic deployed in the past, particularly in high-yield capital structures and, although the window for secondary trades in the aftermath of COVID was short, the current economic landscape may make these trades more interesting.

> **Periods of stress or distress also create significant opportunity.**

We anticipate the jumbo deal being risk-on for a single credit institution will be an unlikely feature of the near-term markets. Recent jumbo transactions have needed a number of lenders to underwrite the credit, meaning there are a greater number of 'take-and-hold' participants, particularly in the private credit space. That also makes it potentially more difficult to obtain an amend and extend on an existing credit, or a covenant reset, meaning a hold-out lender becomes more meaningful in such situations.

For 2023, we think transactions will be slower, outside of trade buyer acquisitions. The increased focus on diligence to ensure all eventualities have been carefully considered will show LPs the vigilance of their asset managers. This helps ensure a transactor does not feel that they have been first to act for fear of being shown-up by other market participants and is supported by the fact that lenders (particularly in the US) are once more focused on base rates, even though initial indications are that we should not expect low interest rate floors in the near or even medium-term. That said, a few deals opening up the markets and setting new standards will likely pave the way for a glut of transactions and activity across the private equity and financing gamut.

We certainly expect more special situations financings in the next 12 months: those businesses that can be supported by patient capital will be, at an appropriate price. For businesses where things have simply gone too far or where there is an unseen factor that precipitates a speedy decline, debtors can look to more modernised restructuring regimes across Europe, bringing them closer to the US systems to protect going concern viability. We expect this to align well with public policy across Europe and the US, where governments will be keen to avoid increased rates of unemployment, particularly in the mid-market.

It will be interesting to see what route is adopted by start-up or scale-up businesses, which have been unable to weather more difficult conditions owing to their size. Of course, there is the opportunistic M&A route where a larger buyout house can these pick up relatively cheaply, but we may see more creativity around these businesses merging with other business lines to consolidate and defend a strong underlying asset that faces only temporary difficulties. The scale-up and start-up communities are known both for their creativity and their willingness to help one another.

History has shown on many occasions that periods of stress or distress also create significant opportunity and the most creative actors are often the best rewarded.

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MARKETING PRIVATE FUNDS INTO THE US: EU AND UK MANAGERS

David N. Solander, Todd A. Solomon, Brittany T. Esser and Steven Haywood

KEY TAKEAWAYS

- EU and UK managers often want to diversify their investor base into the US
- US-based clients of global asset managers also like to access European fund strategies
- Non-US managers targeting US investors are subject to numerous federal securities laws
- EU and UK managers often rely on the private placement exemption in the Securities Act
- Non-US funds generally have two routes to exemption from the Investment Company Act
- When using a third party for US investor solicitation, ensure they are an SEC-registered broker-dealer
- Sponsors with no place of business in the US may be able to avoid Advisers Act registration
- A careful analysis is required for non-US sponsors with a US place of business
- The new SEC marketing rule changes how offering documents should be drafted
- EU and UK managers may also wish to avail themselves of certain exemptions under ERISA if they can

EU and UK managers often wish to market their funds to US investors, seeing the US market as an attractive place to raise capital and a means of diversifying their investor bases by opening up relationships with different limited partners. Where the EU or UK manager is part of a global asset management group that can be particularly the case: EU and UK-based teams may wish to take advantage of the reach of their organisations into the US as an additional source of capital and the US-based clients of those global asset managers may want to access European fund strategies as a way of diversifying their own portfolios and opening up new relationships.

Here, we focus on some of the issues that EU and UK managers should keep in mind when targeting US investors from a US regulatory perspective. Any non-US sponsor marketing a private fund domiciled outside the United States to US investors will be subject to certain federal securities laws, including the Securities Act of 1933, the Investment Company Act of 1940, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. However, in nearly all cases, non-US sponsors of private equity funds will seek exemption from most, if not all, of these laws.

THE SECURITIES ACT

Under the Securities Act, offers and sales of securities to US persons must either be registered with the US Securities and Exchange Commission or exempt from registration. Non-US private funds marketing interests to US persons must generally rely on the private placement exemption contained in Section 4(a)(2) of the Securities Act and, in particular, the safe harbour provisions provided by Regulation D of that section.

Generally, most private funds offering to US persons limit the offering to purchasers who are 'accredited investors' pursuant to Rule 506(b), which requires that the offering not use general solicitation or advertisements in the United States. Rule 506(c), however, is becoming increasingly popular as it permits issuers to use general solicitation or general advertising provided they take reasonable steps to verify that purchasers of such securities are accredited. Still, uptake of this safe harbour has been gradual.

THE INVESTMENT COMPANY ACT

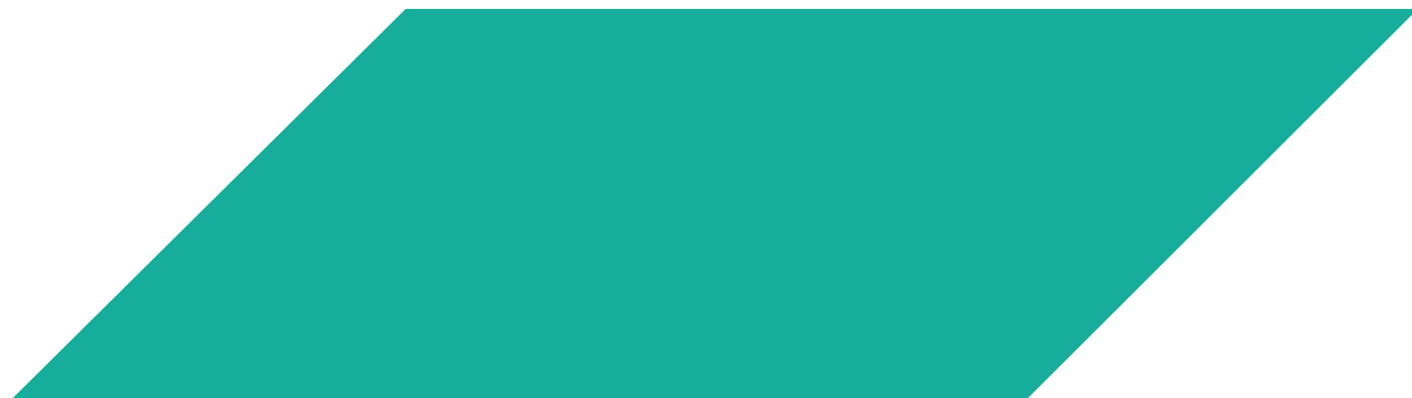
The Investment Company Act requires registration of any issuer of securities that meets its definition of an 'investment company', which is generally the case for all private funds. Registration as an investment company under the Investment Company Act imposes substantive limitations and restrictions, independent governance and ongoing reporting requirements on registrants, which are generally incompatible with the operations of a private fund. A non-US private fund is also not generally permitted to register with the SEC as a matter of law.

Therefore, non-US private funds must generally seek an exemption from registration under the Investment Company Act through reliance upon Section 3(c)(7) or Section 3(c)(1) of the Investment Company Act and SEC staff interpretations of those sections. A non-US private fund relying on Section 3(c)(7) would be required to limit its US person investors to solely 'qualified purchasers', while one relying on Section 3(c)(1) would be required to limit the number of US person investors to 100 or fewer. Other exclusions or exceptions may also be available depending on a private fund's specific investment programme, and there may be exceptions to these generalities where non-US public offerings are involved.

THE EXCHANGE ACT

Under Section 15 of the Exchange Act, any person who uses US interstate commerce to engage in the business of acting as a broker or dealer is required to register with the SEC as a broker-dealer, or as an associated person of a broker-dealer, unless an exemption from such registration is available. The term broker is defined in the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others." A dealer is defined in as a "person engaged in the business of buying and selling securities for such person's own account," except for "a person that buys or sells . . . but not as part of a regular business."

When using a third party for solicitation of US investors, a non-US fund should be careful to ensure that the party is registered with the SEC as a broker-dealer if



necessary. Rule 3a4-1 under the Exchange Act provides a non-exclusive safe harbour by which persons associated with an issuer of securities may avoid the need to register with the SEC as a broker-dealer (or for individuals to be licensed as associated persons of a broker-dealer) in connection with offering and selling shares of a non-US fund in the United States. When relying on this safe harbour, directors of a fund, or directors or employees of the fund's investment manager, should not receive commissions on the interests that they sell, nor should they otherwise be compensated in a manner that reflects the success of their selling efforts. Such sales-based compensation would give rise to broker-dealer registration issues under the Exchange Act.

> **Non-US private funds must generally seek an exemption from registration.**

THE ADVISERS ACT

The Advisers Act generally regulates 'investment advisers' based in the United States, who advise clients in the United States, or who manage funds with US person investors. Under the Advisers Act, private managers and sponsors generally meet the definition of investment adviser and are potentially subject to regulation under the Advisers Act.

Private fund sponsors with no place of business in the United States can typically avoid most substantive regulations under the Advisers Act so long as they limit the number of US person investors across all sponsored funds to less than 15 and advise less than $25 million in assets from US persons. If sponsors exceed those limits, they can avail themselves of exemptions from registration under the Advisers Act but will still be required to make annual reporting to the SEC, submit to SEC jurisdiction and be subject to certain anti-fraud provisions. So long as they only advise US persons as investors in private funds, advisers without a place of business in the United States can generally avoid registration with the SEC no matter how large their US investor base.

Non-US sponsors who have a place of business in the United States could be subject to full registration with the SEC as investment advisers. A careful analysis must be undertaken in these cases, including whether the place of business is a 'principal' place of business and whether assets are managed from there. Investment advisers registered under the Advisers Act are subject to substantive regulation but non-US sponsors may be able to avoid that with respect to the portions of their business with no US connection.

RECENT MARKET UPDATES

Recently, the SEC released a new marketing rule under the Advisers Act that applies to registered investment advisers (RIAs). The new marketing rule has resulted in changes to the way offering documents are drafted and marketed for private funds sponsored by RIAs. At a high level the new marketing rule now includes:

- Requirements for testimonials and endorsements to investors in funds
- Principles-based general prohibitions that apply to most offering materials
- Requirements relating to third-party ratings
- Requirements for presenting performance
- Substantiation of all factual statements

Under the new rule, an RIA must meet certain requirements to display gross performance, related performance, extracted performance, hypothetical performance and predecessor performance data in advertisements. This directly affects the way fund sponsors must disclose and present performance metrics in their private placement memorandums and offering materials, particularly when offering to US investors.

The rule requires any advertisement that presents gross performance to also present net performance with at least equal prominence, calculated over the same time period and using the same type of return and methodology. As a general note, any RIAs should always present fund-level gross and net returns with equal prominence.

Under the rule, if the performance of one investment or a group of investments is disclosed it is considered to be an extracted performance and, accordingly, an adviser may not show gross performance of one investment or a group of investments without also showing the net performance of that single investment or group of investments with equal prominence. In order to calculate such metrics, the sponsor would likely need to make estimates and assumptions to calculate the net IRR (or other metrics) for these investments, so it is important that the sponsor include sufficient disclosures in the offering materials regarding the estimates and assumptions used when calculating the net IRR.

Non-US sponsors who are not RIAs should consider these new rules when marketing in the United States as guidelines even if not applicable, because the SEC may still use the general principles in any claims of fraud in marketing activities directed at US persons.

ERISA

Typically, EU and UK managers targeting US investors will seek to avail themselves of either the significant participation exemption (also known as the less than 25% rule) or the Venture Capital Operating Company (VCOC) exemption under ERISA.

The VCOC route is usually only available if the fund is a private fund investing in private equity, as the nature of VCOC means that management control rights must be obtained and the first investment that the fund makes must qualify as a VCOC investment. The significant participation exemption is usually desirable for EU and UK managers seeking to raise capital in the US alongside their capital raise in Europe, as typically less than 25% of fund commitments in any case will be sourced from the US, whether those investors constitute ERISA investors or not.

As such, the significant participation exemption is useful for managers who are raising private funds like credit funds or direct lending funds, where management control rights are not usually available in a way that would assist with achieving the VCOC exemption. A similar exemption to VCOC also exists for funds investing in and developing or managing real estate.

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TRANSATLANTIC RESTRUCTURING: WHAT TO EXPECT IN 2023

Aymen Mahmoud, Mark Fennessy, Felicia Gerber Perlman and Jonathan Levine

KEY TAKEAWAYS

- The roots of the current slowdown were obvious during the pandemic
- Geopolitics compounded issues, creating markets where special situations are prevalent
- Liquidity is harder to access and more expensive
- But economic indicators of stress or distress do not automatically lead to restructurings
- A lack of maintenance financial covenants removes early warning signs for lenders
- But non-bank lenders favour covenant resets, waivers and amend and extends
- Some companies will fail – many will come through if given time and space
- We expect consolidation, distressed M&A and recapitalisations by supportive lenders

Much of what we saw in 2022 was arguably predictable based on prior markers: the roots for the economic slowdown in the second half can be seen clearly as we look back to the pandemic, though they clearly needed some help.

COVID led to stimulus and other palliative measures that were predicted to drive inflation and increased taxes that might negatively impact the economy. At the same time, the world cruised through an extended period of easing across various economies. Whilst those features alone did not pull us into a recession, they exacerbated the global economic impact of the war in Ukraine that in turn impacted raw material and energy costs, leading to increased inflationary pressure.

Geopolitical instability was arguably a stronger contributor to the slowdown, as was the continuing change to UK politics and fiscal policy. What then was the role of the M&A markets? Had the splintering pace of activity in 2021 taken its toll on the market?

These ingredients are part of the usual recipe for stress and distress and permeate the kinds of financial markets where 'special situations' are prevalent. In such markets, even performing credits are stress-tested by increased costs of materials, labour and energy, facing greater difficulty in tapping markets for liquidity and, ultimately, having to seek more expensive debt.

Add to that some volatility in FX markets on one side of the Atlantic, and the directional shift is worsened. We have moved quickly from a long period of very cheap liquidity to a period where access to liquidity is more limited, and where any available liquidity is more expensive.

What the last five years have shown is that traditional economic theory may not present in actuality and, when it does, may do so in short bursts with a quick rebound to the status quo.

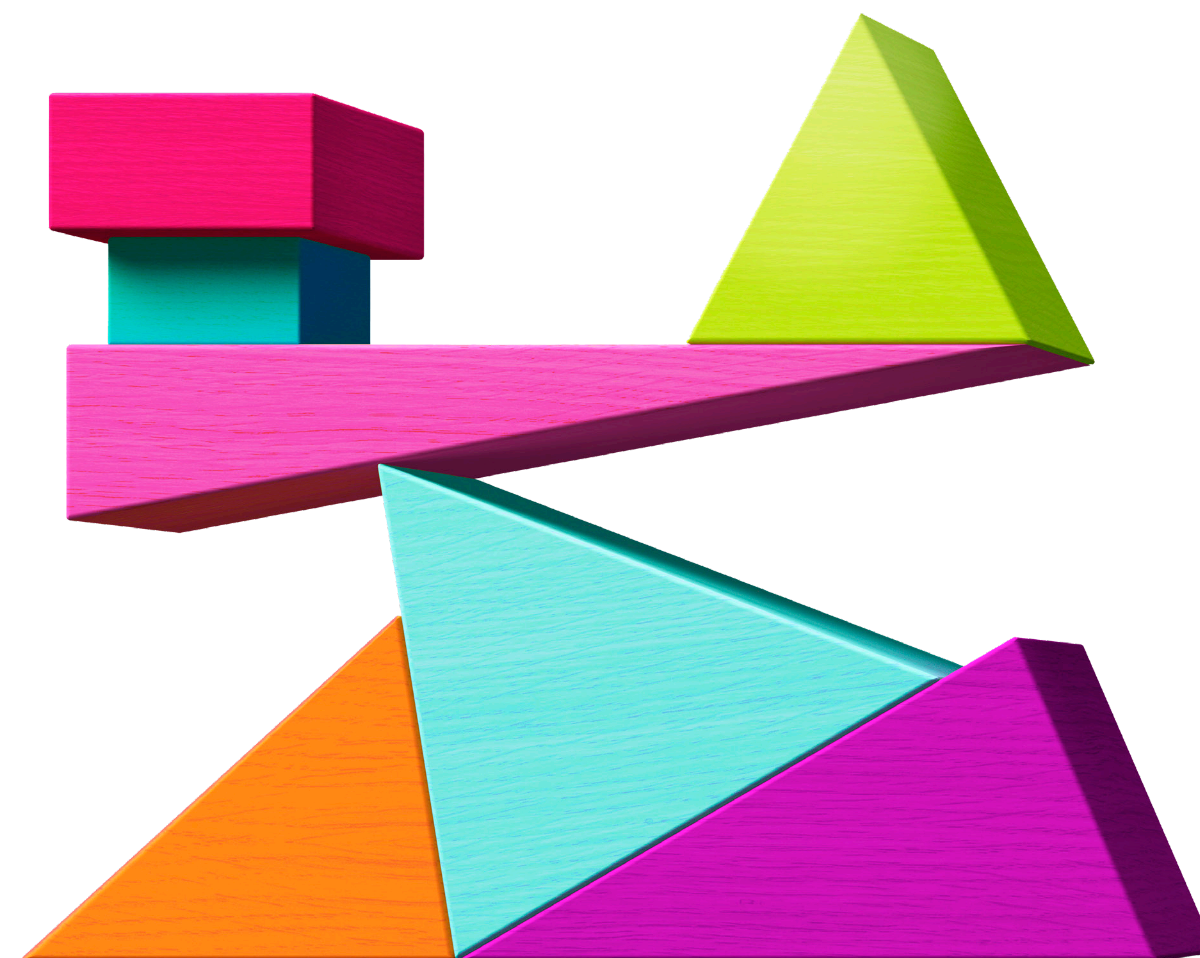
Looking forward, more orthodox economic views might suggest that consumer discretionary spending will be hard-hit, leading to reduced activity and more stress in less defensive industries. But that prediction does not yet appear to have taken hold – for example, technology and SaaS businesses continue to drive market activity. Exits and recapitalisations predictably slow while market participants try to understand where pricing should be and reduce risk, but this may represent more of a transactional reluctance than a deeply illiquid market. After all, liquidity is still here, it is just not being deployed quite as freely as it once was.

For the most part, economic indicators that lead to stress or distress do not always drive restructuring activity. For that to happen, a business itself needs to be in a position of stress or distress and a trigger is needed to drive forward some type of process. That trigger either comes from the company side, when needing to take an action or respond to a need for accountability by reference to directors' duties, or from the equity holders ultimately directing the company.

Alternatively, that impetus comes from a different stakeholder with some power to act or compel, typically a creditor. For companies that have benefitted from widely permissive debt documentation, for example, the financial covenant that was typically seen as the 'canary in the coalmine', letting creditors know when things are bad, may not always be of particular use.

> What the last five years have shown is that traditional economic theory may not present in actuality.

Over the last few years, an increased number of transactions have been underwritten without a maintenance financial covenant, as is often seen in the capital markets. Even those with proper maintenance financial covenants may have been crafted with very wide headroom and allow for EBITDA adjustments that mean that a covenant breach is extremely hard to



occasion. In those more extreme circumstances, when the covenant is breached, the early warning sign is of little use and the company is in very real distress, leaving a lender very little room for manoeuvre.

Combining the covenant impact described above with what is, in all practical terms, a less liquid market for companies to borrow can easily give rise to a more formal process. However, we are commonly seeing more temporary measures, such as covenant resets, waivers, forbearances or amend and extends (A&Es). The terms of these A&Es vary considerably but in the most typical examples, a 12-18 month extension to maturity is sought in exchange for an economic uptick of around 100 basis points.

> Without the liquidity to extend the timeline, businesses may become fodder for those with access to capital.

Many capital structures are financed by direct lending or other non-bank sophisticated capital, which is able to apply greater levels of flexibility to stressed situations, whether in covenant reset or maturity extension terms or even documentary flexibility. This aligns with the oft-cited ‘patient capital’ approach from direct lenders and assumes a performance normalisation in the medium term. Typically, borrowers (and often their lenders) believe that the period of stress or distress is short, and that rather than entering into a more formal, convoluted or expensive process, the going concern value of the business is better maintained outside of the process. This is in line with what was seen during the global financial crisis – many businesses were fundamentally good businesses that would come through if given the time and space to do so.

It is the natural order for some types of companies to fail, whether in the consumer discretionary sector where spend has reduced or among early-stage companies that have borrowed aggressively to drive growth and now stutter owing to the economic climate. Those businesses most commonly impacted by inflation, such as manufacturing or accommodation, fall into this category. For early-stage businesses reduced liquidity may be particularly impactful – to the extent a business considered that it would later have easy access to the debt markets to take it through the next stage of its development, the absence of liquidity and the concomitant difficulty of accessing the equity markets may meaningfully stunt the type of growth required to achieve performance metrics, and in a pre-EBITDA business that quickly leads to distress.

Might this lead to 2023 peppered with the type of consolidation in which smaller or less-developed businesses are subsumed by larger businesses, or even turn to merger-like structures to ensure their going concern veracity? Following the theme of difficulties in the equity markets, we can expect to see a continuation of failed SPACs, as well as defunct asset managers. We have already seen examples of asset managers having multiple portfolio issues, often rendering their continued management of those assets unsustainable. Much like the merger or acquisition dynamic that might apply to early-stage companies, these failed SPAC and asset manager failures may spark a significant amount of M&A, particularly add-ons where opportunistic investors try to buy cheap.

As we move into 2023, the impact of economic slowdown and the actions taken to stave off the resulting distress will yield opportunities for some and concern for others. As many market participants still have significant liquidity, there is likely to be an increase in distressed M&A. Those with capital, or access to capital, will be able to take advantage of situations in which companies took temporary measures – betting incorrectly that the period of distress or stress would be shorter than it was – and now find themselves unable to access the capital markets or sustain the leverage offered by those markets.

Some of these businesses continue to be impacted by the increase in costs of goods and labour. Other businesses were over-levered as a result of incurring additional debt to try to get past the market challenges of the last several years or by excessively seeking to maximise returns through high, non-amortising leverage. These businesses are now unable to service their debt, hit by an increased cost of capital due to the uptick in interest rates. Many are good businesses but need a longer runway than available to return to financial health. Many start-ups will be challenged by access to capital as their timelines to profitability are reduced.

Without the liquidity to extend the timeline, businesses may become fodder for those with access to capital. This will likely result in market consolidation in newer markets as investors either pick the strongest to sustain, roll up several market entrants or utilise their own strengths to put their smaller competitors out of business. The market instability will provide companies with liquidity and the ability to benefit from market misperceptions that result in their debt trading below par. Companies can take advantage of wrongly depressed debt prices to buy back their own debt, often at substantial discount.

In the year ahead, it may become more common for companies with liquidity issues to utilise, with the support of all or a subset of their lenders, out of court solutions such as up-tier or drop-down transactions. Although both such transactions have been challenged in the courts in recent years, companies continue to access capital through them, especially in light of the flexible financing agreements out there. For those capital structures that go beyond those buy-backs, up-tier exchanges or consensual processes, there is likely to be a continued increase in the number of cross-border transactions looking to use a larger variety of regimes than in previous years.

In the past, most cross-border restructurings took place through a US chapter 11 proceeding with foreign recognition proceedings elsewhere. The UK and many European jurisdictions have now enacted modernised restructuring regimes more similar to US chapter 11 and allow cross-border restructurings to proceed with more certainty and impact. In addition, while the US still has the benefit of a clear history and process for these transactions, with the enactment of new restructuring regimes, parties may look to take advantage of non-US jurisdictions going forward.

Even the most astute students of economics would have struggled to identify the magnitude of factors now affecting global economies, so predictions must be made cautiously. Investors, and therefore markets, will continue to move carefully. A strong feature of private capital is that sophisticated investors do not want to have to go back to their investors to explain mishaps. Equally, private capital is only economically efficient if it is deployed; sophisticated investors do not like to go back to investors to say they have done nothing at all.

With the difficulties that CLOs have in reinvesting repaid capital, private credit looks to be the key source of debt financing in the medium term. Therefore, we can expect a number of priming instruments to be made up of private debt at a high economic threshold, much as was the case following the global financial crisis. Sales processes will likely be less competitive for a period, while corporate carve-outs are expected to form a more significant proportion of M&A transactions in 2023. Hung bridge facilities will likely continue to exist and be syndicated to private capital at deep discounts. And, of course, those businesses for which things have gone too far will have no option but to consider a formal process to restructure.

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ALIGNING PRICE EXPECTATIONS IN THE GERMAN MITTELSTAND

Dr. Michael Cziesla

KEY TAKEAWAYS

- Small and mid-sized German companies represent attractive PE targets
- Many sellers are seeking external capital but cannot get comfortable with pricing
- Some are postponing bringing companies to market, but that comes with risks
- Earn-outs and vendor notes can help bridge the gap
- Reinvestments into the buyer structure often provide a win-win

Small and mid-sized German companies, known collectively as the Mittelstand, constitute the backbone of the German economy. Many are family businesses with a long history and have their origins in rural areas, while collectively, according to the Federation of German Industries, they generate more than one-third of national revenues and employ nearly 60% of all workers.

For private equity, the German Mittelstand has been a playing field of promising targets for decades. Investors from all over the world value the deal opportunities on offer and yet, outside of a few hot sectors, there is a mismatch in pricing expectations between seller founders or family owners and potential PE buyers.

Certainly, there is growing pressure on mid-sized companies. Increasingly facing succession issues, they are also exposed to growing competition from companies in countries with far lower wages and taxes and sometimes struggle with the digital transformation putting their existing business models at risk. In order to keep pace with a changing economy many companies in the Mittelstand need massive investment, and thus seek external capital.

> Small and mid-sized companies constitute the backbone of the German economy.

Whilst private equity funds tend to judge their targets from a purely economic view, owners in the Mittelstand have a company's history and values in mind, feel much more responsible for their employees, and seek to sell the business fully or in parts for a reasonable price that reflects their lifetime achievement. In a global economy shattered by various crises. a significant number of companies have been put under heightened pressure. On the one hand, they need to secure fresh money that in many cases can no longer be expected from a bank, while on the other, they cannot afford to let go of their lifetime achievement for a bargain.

One solution could be to postpone the transaction until markets have cleared up, but this provides various downside risks for sellers and buyers, plus a potential loss of upside. First, it is hard to tell when and how markets will return to normal, with better prospects for sellers. Second, buyers with the need to spend their funding may well move on to other targets that – if direct competitors – will profit from fresh cash and improve their standing in the respective market segment. Finally, especially in a succession situation, the only alternative to buyout may be closing the business down.

We see various structures being employed to bridge this gap. One option is to agree on a purchase price with earn-out elements. The clear benefit for a purchaser is that earn-outs minimise the risk of overpaying, but they also allow the seller to benefit from future developments if things develop as planned. Whilst some critics argue an earn-out is lost money for the seller, in our experience earn-outs can provide a fair compromise if structured properly and including standard protections for the seller.

Another alternative to bridge the gap can be vendor notes, namely long-term loans granted by the seller to the buyer in order to minimise the immediate cash need upon completion. A portion of the purchase is simply converted to a loan note that will in most cases be repayable in the event of a general refinancing or exit. Depending on specific terms, vendor notes can be very favourable for sellers.

Finally, reinvesting into the buyer structure can provide interesting structuring alternatives for a buyer and seller seeking to overcome a misalignment, while helping with the succession of a family business. The rollover of shares or a reinvestment of proceeds will enable the seller to stay connected to the company, its employees and customers. Reinvestments often require more explanation and a fair approach to minority protections of the seller in the shareholder agreement. But this extra effort often pays off as reinvestments can really provide a win-win scenario for both parties.

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A YEAR IN, THE UK'S NATIONAL SECURITY LAWS FAIL TO HINDER SPONSORS

Tom Whelan

KEY TAKEAWAYS

- It was feared the UK's NSIA would put sponsors off bidding for UK assets
- The UK government has so far acted judiciously and proportionately
- Fewer than 10 percent of transactions notified have been called in
- For investors from allied countries, some mitigation has been needed where concerns arose
- Some deals involving China-backed buyers have been blocked or divestment required
- Deals involving Russian buyers will also receive more scrutiny
- The rules apply to both foreign and UK buyers if the target is in the UK
- Deals will take longer and there will be additional focus on LPs and governance rights
- For most PE buyers, the regime is similar to other foreign investment rules elsewhere

When the UK's National Security and Investment Act came into force in January 2022, many feared sponsors might be put off bidding for UK assets and deals would start being blocked for political reasons rather than on genuine national security grounds.

Over a year in, this fear has proved ill-founded and the new laws have thrown up few real surprises, with the UK government apparently acting judiciously and proportionately to protect national security. Investors coming from so-called allied countries have so far found government measures limited to mitigation where concerns arose, and where non-allied countries are involved there have been very few blocking or divestment orders.

> This fear has proved ill-founded and the new laws have thrown up few real surprises.

Generally, it will be a source of reassurance to private equity firms looking at UK assets that the government has called in fewer than 10 percent of all the transactions notified since the start of last year. From data published by the Department for Business, Energy and Industry Strategy (BEIS) in June 2022, we can see it called in 17 trigger events for a full national security assessment in the first three months of the legislation, with 14 being mandatory notifications and three voluntary.

Out of the 16 final orders issued to date, only five have blocked trigger events from completing or a stake being divested, and in every case bar one Chinese-backed buyers were involved. The proposed acquisition of vision-sensing IP technology from the University of Manchester by Beijing Infinite Vision Technology was blocked, as was Super Orange HK's acquisition of Pulsic, and the acquisition of HiLight Research Ltd by SiLight (Shanghai) Semiconductors Ltd. Another Chinese-backed company, Nexperia, was required to divest its 86 percent stake in the UK's only semiconductor chipmaker Newport Wafer Fab, leaving it with no more than a 14 percent share. The final order was the required divestment by apparently Russian backed L1TFM Holdings UK Ltd of Upp Corporation Ltd.

Given the current perceived national security threat from China and Russia, these are not unexpected outcomes. In the case of China at least they do not mean that investments made by China-backed buyers are no longer possible, even in the 17 sensitive sectors outlined in the Act. Sichuan Development's acquisition of Ligeance was permitted to proceed subject to mitigating measures, which included the removal of Sichuan directors from the board of Ligeance and restrictions on asset transfers and information sharing. Likewise, China Power's proposed acquisition of 90 percent of XRE Alpha has been permitted subject to mitigation around electricity offtake and information sharing. It is not clear at this stage if other Russian-backed investments will be allowed to proceed if mitigating measures are put in place.

Perhaps the biggest surprise according to recent press reports is that the UK government recently waived through the takeover of tech company Aveva by France's Schneider without mitigation, despite the fact that Schneider apparently has a Chinese joint venture partner within its structure. That deal aside, Chinese and Russian backers are clearly in the spotlight, even if the transaction were sanctions compliant where Russian investors are involved.

For the vast majority of private equity buyers considering UK deals, the new regime looks substantively similar to other foreign investment regimes around the world, with the biggest challenge being the additional time and cost requirements associated with assessing whether or not a mandatory filing is required or a voluntary filing is advisable. Many PE firms are choosing to informally brief the BEIS to better understand their risk of post-acquisition call-in.

There are some nuances that PE firms need to remember. First, the rules do not differentiate between overseas and domestic investors, so a UK private equity fund can be subject to a mandatory notification obligation just like an overseas acquirer. In addition, the only UK nexus required is that the target is active in the UK or provides goods or services to the UK, and internal reorganisations can also be in scope. If a sponsor restructures a portfolio company within the scope of the mandatory regime, this can require a notification even without a change of ownership.

Furthermore, while the focus may be on China and Russia-based investors, there is still some uncertainty as to how the rules will be applied to fund structures, so sponsors with Chinese and/or Russian LPs will need to give careful consideration to structuring and LP governance rights, and of course sanctions (where applicable). Likewise, where an acquisition is being made by a consortium, careful diligence of co-investors will be necessary to assess exposures to the new regime.

Still, so far at least, if you are an investor from the US, UK, EU or other allied countries, your transaction seems less likely to be blocked and more likely to result in mitigation measures if it is felt to pose a national security threat. For China- and Russia-based investors, the Act may have a more chilling effect based on recent outcomes, but each investment will turn on its own facts, and for now UK assets remain as attractive as ever to most investors.

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FIVE PREDICTIONS FOR FINTECH IN 2023

Arvin Abraham

KEY TAKEAWAYS

- Fundraising is going to be difficult
- There is more downward pressure to come in crypto
- More bankruptcies and consolidation are likely
- Governments will up their efforts on digital currencies
- FinTech regulation is going to be in the spotlight

FinTech in 2022 was buffeted by a cyclical sectoral downturn combined with a souring macro-economic environment. In part, the sector was a victim of its own success. After flying high as one of the most heavily invested-in sectors for the past several years, it was only natural that values would come back down to reality and align with historical norms.

High valuations and market euphoria also come with opportunities for bad actors to con even sophisticated investors, or for companies with no real business to get funded. In 2022, we saw numerous examples of bad actors being exposed and businesses going bust, leading to value destruction and economic pain for investors. Given the high profile of recent bankruptcies and frauds, particularly in the crypto space, there is an ever-growing push for regulation.

But there is little room for gloom. FinTech is still in its adolescence and opportunities for growth and value creation are huge. There are incredible innovations on the horizon and the future is positive long term, though this year may prove rocky in areas.

1 IT'S GOING TO BE A WHOLE LOT HARDER TO FUNDRAISE

Obtaining funding in a souring market is challenging and made more so for FinTech businesses that last raised in 2021 at the height of the market. Valuations for well-known public FinTechs are down significantly, while in the private markets the market dislocation is hidden until a company needs to get new funding. Only then does the reality of valuation compression come to light. Whereas it may have been possible a year ago to raise at a valuation multiple of 20-100× revenues, this has been compressed significantly to multiples on average of 10 or less.

Down or flat funding rounds will become more prevalent for privately held companies, with some putting off seeking funding for as long as possible to avoid seeing a realised valuation hit and others pursuing non-equity options like venture loans.

The funding that is given will also be on stricter terms. We can expect to see investors seeking more governance rights, limiting founders' operational flexibility and seeking tighter cost controls. Management teams used to running their companies as they pleased will have to adjust to this new reality if they are to secure funding this year.

2 WE HAVEN'T SEEN A BOTTOM YET FOR CRYPTO

Blockchain technology is here to stay and is being increasingly employed in computing protocols to create long term efficiencies. But when it comes to crypto assets, things are more nuanced. Focusing on exchange tokens like Bitcoin, Ether and others, there are real use cases but they have also been a popular asset for speculation, leading to huge booms and busts. With the retracement in values across the market, this asset class has taken a pummelling and, while values have stabilised recently, there is more downward pressure to come.

If the general market continues to decline, expect Bitcoin and Ether to fall in value by another 30-50% from their current levels, before they start to rebound in late 2023 or 2024. This will be exacerbated if there are more large-scale frauds or bankruptcies, which will lead to panic selling and create a negative feedback loop for valuations.

3 A SPIKE IN BANKRUPTCIES AND ACQUISITIONS

In a reflection of the old adage, whatever goes up must come down. With a market hangover after a raging bull market, the crash back down to earth will be particularly painful.

We are now at a market inflection point where easy money has stopped. Investors are still seeking returns but are getting a lot more sceptical about where

they put their money and at what price. Marginal companies that were able to raise funding during the bull market may find themselves forced to file for bankruptcy, including many in the FinTech sector, both big and small.

In addition, FinTech includes many actors whose entire business models have revolved around riding a bull market and relying on increasing asset prices and low interest rates. The clearest examples of this are in the crypto space but it is also the case in areas like buy-now-pay-later, where many business models relied on historically low interest rates.

An alternative to bankruptcy is a sale, and we can expect more consolidation in the FinTech sector in 2023 as stronger players acquire rivals. Companies that secured sufficient funds at the market peak to weather the coming storm are in a great place to make opportunistic acquisitions of embattled rivals.

4 CBDC PROJECTS WILL ACCELERATE

Governments across the world are locked in a race of regulatory and technological competition to co-opt cryptoassets for their national currencies. China has already launched its digital yuan. The EU, US and many others have announced studies on the feasibility of digital versions of their own currencies. Central Bank Digital Currencies (CBDCs) allow for a variety of efficiencies versus traditional cash, speeding up settlement and ensuring traceability on a blockchain. For more authoritarian states, they also offer the prospect of additional state control and monitoring over citizens spending habits.

There are clear competitive drivers for nations to develop CBDCs, which keep national currencies relevant versus cryptoassets that are gradually becoming more mainstream and stablecoin projects that aim to be alternative forms of money. CBDCs can also be used as leverage in economic competition between countries, particularly for a state like China that would like its currency to supplant the US as the world's reserve currency.

Expect projects in this area to accelerate in 2023. Even if major Western countries do nit yet implement their own CBDCs, we will see more countries actively working to develop them.

5 MORE REGULATION OF FINTECH, PARTICULARLY CRYPTO

More regulation, like death and taxes, is inevitable but with all the chaos happening in the FinTech sector and economy at large, governments will be more focused than ever on consumer protection and ensuring fair and effective regulation in this space. We have already seen the passage of the Markets in Cryptoassets Regulation (MiCA) in the EU last year and the proposed Responsible Financial Innovation Act (RFIA) in the US is up next.

Expect a renewed push to enact RFIA in the US and analogues to it, alongside MiCA in other countries across the globe. Also expect a broader push to mainstream regulation on areas of FinTech that have the same functions and risks as traditional finance but are not regulated the same way or where retail consumers are heavily exposed and have been shown to face detriments. The crypto space will be a prime target, along with other areas such as digital brokerages or buy-now-pay-later.

It takes time to pass new regulation and for landmark cases or enforcement decisions to be complete. But there have been many regulatory initiatives, cases and decisions percolating in FinTech for years. If 2023 proves tricky, we can expect an acceleration in those efforts and actions to be taken more quickly than might otherwise have been the case.

GET IN TOUCH

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UK IMPLEMENTATION OF THE OECD'S PILLAR 2 RULES

Sarah Gabbai and Francisco Alvarez

KEY TAKEAWAYS

- The UK is on a fast track to implement the OECD's Pillar 2 GloBE rules
- Changes should increase corporate tax revenues significantly
- For multinationals, the compliance workload will increase and tax savings from low-tax structures will decline
- The goal is to ensure entities pay a minimum level of tax everywhere they operate
- The rules apply a system of top-up taxes to bring taxes paid up in low-tax jurisdictions
- They also propose a minimum level of withholding tax on certain payments
- The UK is leading the way with draft legislation to implement the new rules
- Changes set to take effect for accounting periods starting on or after 31 December 2023

The UK remains on a fast track to implement the Pillar 2 Global Anti-Base Erosion (GloBE) rules, developed by the Organisation for Economic Co-operation and Development (OECD), into domestic law. The impact of the GloBE rules is significant. The International Monetary Fund estimates that Pillar 2 will raise global corporate tax revenues by 5.7%, while the UK government estimates that Pillar 2 could raise £2.2 billion a year by 2027-28.

Tax savings from low-tax business structures are expected to decline if and when the 15% minimum tax rate is introduced, and the compliance workload of in-scope multinational enterprises is expected to increase as a result of new tax filing obligations underpinned by additional collation and data analysis requirements.

> The UK government estimates that Pillar 2 could raise £2.2 billion a year by 2027-28.

This note provides an overview of the underlying international framework and discusses the UK's progress towards implementing the GloBE rules to date, as well as the road ahead.

THE INTERNATIONAL FRAMEWORK

Addressing the tax challenges raised by digitalisation has been a priority of the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) since the publication of the report on Addressing the Tax Challenges of the Digital Economy in October 2015. Inclusive Framework members agreed to examine proposals in the two pillars forming the basis for a long-term solution to these tax challenges. In mid-2019, a programme of work to be conducted on Pillars 1 and 2 was adopted, being finally endorsed by the G20 finance ministers in July 2021.

As of 16 December 2022, 138 out of the 142 members of the OECD/G20 Inclusive Framework on BEPS agreed to join the official statement of the Two-Pillar Solution. Pillar 1 envisages reallocating international taxing rights to consumer jurisdictions, while the goal of Pillar 2 is to identify low-taxed entities within large multinational enterprises and ensure they pay a minimum level of tax (set at 15%) on income arising in each jurisdiction where they operate, thereby limiting BEPS and tax competition.

EU countries will be required to implement a version of Pillar 2 under an EU Directive (Council Directive (EU) 2022/2523 of 14 December 2022) as a minimum standard. However, the scope will also include large-scale EU domestic-only groups and will allow Member States to opt for a domestic minimum tax.

PILLAR 2 AT A GLANCE

The key aspects of Pillar 2 were published by the OECD in a blueprint in October 2020. The Model Rules published in December 2021 added significant detail but offered limited indication as to how the rules might operate in practice. The original version of the commentaries to the GloBE rules was published in March 2022 and is expected to be replaced by a revised version later this year. Importantly, the revised version of the commentaries will include the Administrative Guidance released by the OECD in February 2023, which includes the treatment of the US Global Intangible Low-Taxed Income (GILTI) tax as a 'blended' CFC regime (but not as qualifying income inclusion rule (IIR)); a temporary simplified allocation mechanism under the GloBE Rules for GILTI taxes and other blended CFC regimes; and a chapter on the design of Qualified Domestic Minimum Top-up Taxes (QDMTT) – a top-up tax calculated in a similar manner to the IIR that is collected by the jurisdiction of the low-taxed entity rather than that of the multinational's parent.

Pillar 2 includes two proposals that operate almost independently of each other. First are the GloBE rules, which apply a system of 'top-up' taxes: namely, the IIR, which operates like a CFC rule; and the undertaxed profits rule (UTPR); which is meant to serve as a backstop to the IIR where an IIR is unavailable, in order to achieve a tax liability equal to the top-up tax. The IIR and the UTPR bring the total amount of taxes

paid by multinationals in low-tax jurisdictions up to the agreed 15% minimum rate. The IIR will be supported (as required) by a switchover rule to allow parents of tax-exempt permanent establishments to switch over to a credit mechanism to allow the IIR to include the permanent establishment's profits.

The second of the Pillar 2's proposals is a 9% minimum level of withholding tax on certain payments between connected parties that are deemed as having a heightened base eroding potential (subject to tax rule). For a detailed explanation of the GloBE rules and of how these two proposals interact with each other please see our previous article here.

THE UK'S ADOPTION OF PILLAR 2

In January 2022, the UK government launched a consultation seeking views on how the Pillar 2 rules should be implemented into UK law. At the time, the UK was the only country in the world committed to issuing draft legislation with a view to implementing the rules from early 2023. The consultation ran until April 2022 and the responses received echoed the widely-held concern that the UK's pace was too fast for its own good. Other countries had pushed back their implementation timetable to at least the end of 2023 and significant amounts of work remained at OECD level in respect of the rules, which meant that the UK had detached itself from the pack and was working from a new and complex set of international rules that were still in draft form.

In July 2022, the UK government published draft legislation setting out the provisions required for the adoption of the IIR rule for accounting periods beginning on or after 31 December 2023. The draft legislation consists of 116 pages of text accompanied by 239 pages of explanatory notes. The new tax is termed the 'multinational top-up tax' and, like its OECD counterpart, is designed to apply to multinational enterprises that operate in at least two jurisdictions, with revenues in excess of €750m in at least two of the previous four accounting periods. UK multinationals that file CbCR reports will therefore likely be in scope.

Despite differences in terminology, the draft legislation reaffirmed the UK government's desire to track the approach agreed at OECD level – with clause 106 of the rules giving power to the Treasury to amend the provisions of the law to the extent necessary to achieve consistency with the OECD rules, their commentaries or any additional guidance. The July 2022 draft legislation remains a work in progress, with numerous placeholders on a variety of issues, including which countries have acceptable GAAP (clause 90), how the rules are to be applied to multi-parented groups (clause 73), and multiple defined terms.

> The IIR and the UTPR bring the total amount of taxes paid by multinationals in low-tax jurisdictions up to the agreed 15% minimum rate

NEXT STEPS

In November 2022 the UK government doubled down on its commitment to implement the Pillar 2 rules by re-affirming its intention to introduce the IIR and announcing the introduction of a supplementary QDMTT, which will require large groups, including those operating exclusively in the UK, to pay a top-up tax where their UK operations have an effective tax rate of less than 15%. The government also announced a backstop UTPR.

The IIR and the QDMTT will be legislated for in the Spring Finance Bill 2023 and are expected to take effect from accounting periods beginning on or after 31 December 2023. The UTPR will have effect no earlier than accounting periods beginning on or after 31 December 2024. The Spring Finance Bill is expected to be introduced shortly after the Spring Budget, scheduled to take place on Wednesday 15 March 2023.

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