Morgan Lewis

REPORT

EMEA PRIVATE EQUITY

A LOOK AHEAD AT 2024

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EMEA PRIVATE EQUITY: A LOOK AHEAD AT 2024

The private equity industry has faced a number of challenges over the last year: we have seen interest rate rises in response to greater inflationary pressure including increasing labor, transport, and energy costs, the unwinding of government support put in place to assist businesses and households in response to the COVID-19 pandemic, and ongoing political and economic upheavals. These events have resulted in a slowing of deal activity as market participants have sought to assess the new environment.

Throughout this period we have also seen new business models and opportunities driven by changes in technology and environmental, social, and governance (ESG) considerations. There remains a continued appetite for investment technology–related businesses, including those facing artificial intelligence developments, infrastructure to support the rollout of new energy delivery, and communications, among others, and we expect these trends to continue into 2024 with a range of potential carveout opportunities arising.

Dealmakers have sought to contend with the differing pricing expectations between buyers and sellers using tools such as vendor financing, earnouts, and deferred consideration. Private credit has offered sources of debt finance where availability from traditional lenders may have been more limited. The consensus is that interest rates may have peaked and price expectations may now have adjusted. While this will be welcome news, interest rates are likely to remain higher than they were during the M&A boom years of 2021 and 2022. We anticipate there will continue to be greater use of equity and other tools to close value gaps. Private equity sellers may also continue to use continuation funds to manage investments where the hold period may be extended.

The public markets continue to be constrained in Europe. Proposals have been put forward in the United Kingdom and Germany to reform capital markets and drive greater activity. Challenging market valuations are also likely to continue to lead to a focus on further private-to-public transactions.

WE ANTICIPATE A SIGNIFICANT INCREASE IN PRIVATE EQUITY DEAL ACTIVITY IN 2024 FOR CONTINENTAL EUROPE AND GERMANY IN PARTICULAR.

Key drivers for the increase include the significant backlog in the deal pipeline for sponsor-driven exits and the continuing strong pressure for financial investors on deploying funds. Intended exit processes in Germany for large cap assets (including Techem (infrastructure), Douglas (retail) and Stada (pharma)) have already been announced or even started. Private equity sellers may also continue to use continuation funds to manage investments where the hold period may be extended.

Pressure on corporates to streamline their businesses in view of mega trends digitization, energy transition, and aging population in Europe remains strong.

Compared to the UK and Europe, private equity investments in China (especially by non-Chinese investors) have been more influenced by geopolitical tensions and China's economic performance than by interest rates. As US private equity players face political uncertainties at home for their China investments, investors from other markets including the Middle East have been moving in, building teams, and gearing up for higher levels of activity.

While the softer valuations can be attractive, these investors appear to be waiting for clearer evidence of resolution of the debt burden, strengthening of consumer confidence, stronger government support, and a general uplift of economic sentiment. Given the political uncertainties, we anticipate that there will continue to be ongoing attempts to regulate aspects of deal activity and ensure appropriate ownership transparency.

In this report, we will explore developments in foreign investment control and proposals to regulate sports investments as well as tax highlights relating to the global minimum tax rate, carried interest, and tax transparency.

FOREIGN INVESTMENT CONTROLS

FOREIGN DIRECT INVESTMENT (FDI) SCREENING IN EUROPE CONTINUES TO BE OF MAJOR IMPORTANCE IN THE TRANSACTIONAL SPACE.

The European Commission recently released its third annual report on FDI screening, which report demonstrates that foreign investments face ever greater scrutiny, with an ever-higher percentage of notified transactions leading to a formal FDI screening procedure. However, there is still a general openness of EU member states to foreign investment. The percentage of transactions that were authorized without conditions increased and the percentage of transactions requiring mitigating measures decreased. The percentage of blocked transactions remained stable at a low level of 1%, and the foreign investment control introduced by the National Security Act in the UK continues to be refined.

It is vital market participants understand that the duration of FDI screening procedures may vary greatly. Timing for the FDI process hence becomes a major element of transaction planning. Additionally, the amount of information to be provided to the competent authorities in cross-border deals is significant. Importantly, there has been only limited scrutiny by the government of passive LP investors in the context of FDI screening procedures so far.

Outbound investment remains on the EU's radar, and the recent publication of the EU framework on outbound investment provides useful insight into the approach we expect the EU to adopt. While not yet implemented, it is significant that the EU outbound investment framework largely tracks the approach taken by the United States.

The framework presents a roadmap to the issues of concern for the EU, the anticipated focus from a technology and process perspective, and the expected timeline for any regulatory implementation. Given the publication, understanding how this framework may impact future investments or investment strategies would be important when assessing the risks associated with outbound transactions.

An important change to the regulatory landscape, including for private equity investors and their portfolio companies, is the introduction of the EU Foreign Subsidies Regulation (FSR).

- Unlike FDI screening, the FSR screening (provided certain thresholds are met) is not aimed at the protection of national interests but rather at the protection of undistorted competition in the internal market.
- The FSR is relevant for private equity investments into European companies, in particular, in case the acquiring party has received funds from a state-backed entity such as a sovereign wealth fund.
- Private equity investors are privileged under (but not fully exempt from) the FSR, as only foreign financial contributions granted to the relevant fund vehicles involved in the deal and their controlled portfolio companies are reportable, but not those granted to any other entity of the same group.
- The review of transactions under the FSR may lead to additional burdensome information collection processes, which should be factored into the deal planning and closing timeline.

China is attempting to simultaneously encourage foreign investments and stimulate capital flow, while still safeguarding security on various fronts. At the same time that it is removing substantially all restrictions on foreign investments in the manufacturing sector, it is expected to shorten the Special Administrative Measures for Foreign Investment Access (i.e., the "Negative List"), exempt smaller acquisitions (threshold still being determined) from merger control filings, and streamline the requirements on transfer of personal data out of China.

SPORTS INVESTING

Private equity investment in sports has risen over the years, attracted in particular by the growth in franchise value, new media tools to exploit that value, and the potential to continue achieving greater operational efficiencies. New revenue growth can also be achieved through, e.g., increased interest in women's participation in sports as has been seen with football and motorsports.

In Europe, sports investment has been dominated by top-level football, which is increasingly institutionalized around private equity and sovereign wealth investments, and media streamers and other technology companies have increasingly looked to acquire screening rights.

Efforts to create a new European Super League and associated media rights have faced considerable political and fan-based pressure as well as resistance from UEFA and FIFA. While the proposals were ultimately shelved, the European Court of Justice recently ruled that UEFA and FIFA rules that require approval of interclub football competitions, such as the Super League, are contrary to EU law on competition.

While there will be further consideration of the issues involved, this has implications for clubs and other sports with similar regimes and we anticipate this will present further avenues for private equity investment. At a political level, there has been increased scrutiny of football ownership and regulation leading to new proposals in the United Kingdom.

OVERALL, WE EXPECT INTEREST FROM FINANCIAL SPONSORS TO DEPLOY CAPITAL IN THE SPORTS INDUSTRY IN EUROPE TO REMAIN STRONG.

The German Soccer League (DFL) recently restarted the process to bring in private equity investment for its media rights business after two previous failed attempts. The DFL envisages to raise up to €1 billion to be used to strengthen the German soccer broadcast product and increase the value of international media rights, building a stronger global audience. The DFL aims to narrow the material gap to the English Premier league, which had generated billions in revenues from its overseas television deals.

The partnership with private equity and stronger commercialization of the broadcasting rights may further spark interest from financial investors in German soccer clubs. However, unlike with other European soccer leagues, investments in German clubs are limited by the so-called 50+1 rule, which effectively prevents financial investors from acquiring a control position in such clubs.

Recently, certain investors took minority positions in German soccer clubs, but the economic drivers for abandoning the 50+1 rule remain powerful. Previous legal pressure on the 50+1 rule from an antitrust perspective was recently mitigated after the German Federal Cartel Office signed off on the rule in view of the commitment offered by the DFL to apply the rule without any exemptions which had been applied in the past.

TAX HIGHLIGHTS

Global Minimum Tax Rate

2024 will see the introduction in the UK, EU, and other jurisdictions of the OECD BEPS "Pillar 2" rules. This represents a fundamental change to the international tax framework intended to tackle base erosion and profit shifting.

THE RULES ARE INTENDED TO ENSURE THAT LARGE MULTINATIONAL GROUPS (I.E., THOSE WITH ANNUAL CONSOLIDATED REVENUE IN EXCESS OF AT LEAST €750 MILLION) WILL PAY AN EFFECTIVE RATE OF TAX OF AT LEAST 15% IN EVERY JURISDICTION IN WHICH THEY OPERATE.

Relevant to investment funds, the rules do contain a concept of "excluded entities," which we expect will apply to many collective investment schemes and certain holding vehicles. Excluded entities are generally not subject to the Pillar 2 rules other than being included when determining whether a group meets the revenue threshold. While this should be of assistance to many funds, it is important that the full impact of Pillar 2 and the availability of any exemptions is considered on a case-specific basis.

Pillar 2 raises a number of issues for private equity investment. While on its face it is only applicable to larger groups, and potentially not directly applicable to investment funds themselves, managers will need to consider the scope of any exemptions and ensure that portfolio investments (which are unlikely to be excluded) are not consolidated through funds so as to remain below the revenue threshold. Pillar 2 also introduces complexity in terms of monitoring and compliance, and if applicable (or potentially applicable in the future based on forecasted growth) will need to be modeled into investment returns.

Carried Interest

There is continuing political interest in the taxation of carried interest in the UK and, with a general election almost certain to take place in 2024, the (current) opposition Labour party has indicated that changes may be coming. The current UK tax treatment of carried interest has developed following the 1987 BCVA and Inland Revenue (as it then was) memorandum of understanding, which outlined general principles for determining how carried interest should be treated for UK tax purposes.

In broad terms, the UK rules now impose a capital gains tax charge (at up to 28%) on "genuine" carried interest which represents capital gain. In recent years the UK has introduced the "disguised investment management fee" and income-based carry rules, imposing an income tax charge (at up to 45%) and national insurance contributions on certain items of fund manager compensation that are not otherwise taxed as employment income.

If there is a change of administration in the UK, it would be pure speculation to comment on how a Labour government would approach carried interest, but it is important that private equity funds keep their executive compensation arrangements under regular review.

The UK approach can be contrasted with that of the Hong Kong government, which is encouraging private equity managers from around the world to set up not only their operations but also the funds themselves in Hong Kong or under Hong Kong law by offering exemptions of carried interest from Hong Kong's profits tax.

Tax Transparency

Continuing the trend toward greater tax cooperation, information sharing, and transparency, EU public country-by-country reporting (CbCR) will commence in 2024. CbCR is already in operation, requiring disclosures to tax authorities, but this new regime will require large groups (those with consolidated revenues in excess of €750 million) with either an EU-based parent or with entities in the EU to publicly disclose information relating to their tax affairs, including turnover, profits, and income taxes paid. As with Pillar 2, the impact of this for many private equity funds will likely depend on whether portfolio entities are consolidated.

Other developments include the EU's proposed "UNSHELL" directive (also referred to as ATAD 3), which, if introduced, will impose minimum substance requirements for certain entities in order to rely on EU directives and tax treaties with EU member states. Originally targeted for commencement on January 1, 2024, the proposal has not yet been approved by EU member states, although it seems likely that the directive will be adopted in some form, which may impact some common private equity holding structures unless minimum substance levels are met or other exemptions are available. While funds themselves are expected to be exempt, the draft proposals do not (as yet) extend that exemption to holding entities.

TAX TRANSPARENCY REQUIREMENTS CONTINUE TO EXPAND, FORMING AN INCREASINGLY IMPORTANT COMPONENT OF ESG FRAMEWORKS.

With greater transparency comes increased compliance risk as tax authorities have more visibility on the tax operations of entities, which may lead to audits and disputes. Transparency also risks negative media coverage, particularly of complex structures that the general public may not fully understand (as demonstrated by some of the media coverage of carried interest arrangements in certain jurisdictions).

UAE Corporate Income Tax

2024 marks the first full year of the new corporate tax regime introduced in the UAE for financial years starting on or after June 1, 2023. The tax rate is 9% (with a higher rate for businesses that fall within Pillar 2), although various exemptions are available.

The tax applies with respect to businesses carried on by companies and certain partnerships and individuals, although businesses carried on in designated free zones, such as the Abu Dhabi Global Market (ADGM) and Dubai International Financial Centre (DIFC), and extractive industries may benefit from exemptions. Investment funds that are not tax transparent but satisfy certain requirements may also benefit from exemptions.

Generally speaking, the tax does not apply to capital gains and dividends. A consequence of the introduction of the tax is an increase in private equity funds being established in the ADGM or DIFC, both of which have partnerships laws that will be very familiar to those in the industry.

The use of ADGM holding companies, particularly for investments in the Gulf Cooperation Council, is becoming increasingly common given the favorable tax regime for holding investments and as there is currently no UAE withholding tax on outgoing dividends or interest.

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