MACFARLANES

# Private Capital Review 2024

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## Introduction

This is the third annual review of our private capital practice, bringing together updates on notable developments across both the legal services and the risk management and ESG aspects of our tailored private capital solutions offering. In this year's review, we discuss developments across a broad spectrum of the private capital industry, touching on many different areas of house advisory work, fund raising, fund and portfolio advice, deployment strategies and ESG matters.

We will be exploring some of these topics in greater detail over the next 12 months via PCS webinars, events and publications.

Unifying broad themes are perhaps harder to identify this year than last, set against the backdrop of a generally challenging fundraising environment and market activity levels that continue to be stubbornly subdued for the most part, however we can glean that:

- the regulatory landscape for the private capital industry continues to evolve regularly and rapidly, with the new Government's policies and legislative agenda adding further impetus in this area;
- the rise of disputes and contentious situations we started to see last year has continued as anticipated over the last 12 months; and
- whilst deployment activity has still not generally bounced back in the way market participants had expected this year, there has nonetheless been strong transaction activity levels in other sponsor-related areas, most notably GP stake sales, which have exploded in volume over the last 12 months.

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## Explore our articles

# House advisory

## Structure, governance, reward and founder arrangements

## Internal and external investigations

## Investment manager M&A and stake sales

# Exit disputes

**The departure of senior management can be a precarious time for a business, particularly against a backdrop of discontent, or where there is a threat of movement to a key competitor. Firms have traditionally addressed these risks through a mixture of post-termination restrictions (non-competes, non-solicits, etc.), intellectual property ownership agreements and confidentiality agreements. Those are typically a feature both of senior management service agreements and their separate remuneration documentation, whether through carried interest vehicles or long-term incentive arrangements.**

We have seen a marked uptick in competitive movement in recent months, both in private equity and other categories of asset management. That may partly be explained by a perceived discontentment with the level of remuneration driven by wider economic concerns. Where multiple members of management move at the same time (a so-called "team move"), the threat to the firm they are leaving is evidently enhanced.

We flagged in last year's review the moves on both sides of the Atlantic against the use of non-competes. The present position is that the US hard ban, which was due to come into force in September 2024, has been blocked by the courts for the time being. Appeals, potentially all the way to the US Supreme Court, remain on the cards. In the UK, the new Labour Government did not include reform in this area in its announced wide-ranging programme, so the proposals appear to have been dropped, at least for now.

A reinstatement of the US hard ban would likely have repercussions for firms whether or not they have US operations or interests. To buttress firms' protective arrangements, in a future in which non-competes are challenging or impossible to enforce, many US and UK clients are looking at their onboarding and offboarding arrangements in more detail, ensuring that all departing employees have, for instance, their IT analysed to check whether any confidential information has been disclosed outside the firm and give formal confirmations as to their good behaviour on exit. This greater focus on preventing confidential information loss in turn requires a careful analysis of what kinds of information are genuinely protectable.

Other protective mechanisms, such as the introduction of longer notice periods, or using malus and clawback structures in remuneration arrangements, are also under increasing review by firms. Harmonising those arrangements across a multinational workforce can be especially problematic, but firms should be alive to the possibility of, and perhaps the need for, creative thinking when it comes to protecting their key business assets.

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# Moving the dial

## Labour's new employment framework

Reform of the UK employment regime was one of the central pillars of Labour's election manifesto, and the King's Speech saw the announcement of a new Employment Rights Bill, to be published as a priority in the first hundred days of the new Government. The Bill is set to contain significant reforms to zero-hours contracts, statutory sick pay and the trade union landscape, but two of the most eye-catching elements are:

### Removing the service requirement for unfair dismissal protection

The current position is that employees need a minimum of two years' service in order to qualify for ordinary unfair dismissal protection. The qualifying period has fluctuated over time, but the new Bill proposes to remove that requirement altogether. The implications for employers of all sizes are material:

- All employees would be able to litigate their terminations from day one. A defence would require both a fair reason and a fair process. The fair reasons are set out in the legislation (conduct, capability, illegality, redundancy or some other substantial reason warranting dismissal). The process is driven by the reason, so a redundancy process will look different from a misconduct dismissal.
- For relatively new employees, the reason is likely to be poor performance – effectively, capability. Fair dismissals for performance typically require performance management processes with the setting of reasonable improvement targets over a reasonable time frame. That is likely to be unattractive in the early months of a role.
- The Bill notes that employers will be permitted to use probationary periods to assess new joiners and deal with underperformance. That is welcome, but neither the Bill nor Labour's pre-election documents confirms how long probationary periods can be, or what process is required to dismiss where a new employee does not pass probation.
- Probationary periods are extremely unusual for senior management. There is likely to be some resistance from this cohort to the introduction of probation in their service agreements.

### Introducing a new right to switch off

Labour's pre-election materials also committed the new Government to introduce a new right to switch off. This is likely to be done through a new Code of Practice rather than legislation, apparently following the models of Ireland and Belgium. Those jurisdictions, however, have very different schemes in place:

- The Belgian model requires all employers with 20 or more employees to implement a right to disconnect, typically through a collective bargaining agreement negotiated with trade unions at industry or sector level. The right is enshrined in legislation, but there is no material sanction for a failure to have the required policies in place – although a failure might well also be a breach of wider health and safety obligations.
- Ireland has had a code of practice since 2021, under which employers are required to monitor working hours, encourage the taking of breaks, and have a policy emphasising the need for a clear line between working and non-working time.
- The UK labour model is much closer to Ireland than to Belgium, and it seems likely any new code will be more aligned with the Irish model. Employee groups and trade unions will hope the new code has teeth, so that individuals or regulators can take enforcement action. Even where no sanctions are available, firms will need to make sure their switch off policies are well thought through and have senior management buy-in, as this is increasingly likely to be a key point for recruitment and retention as new generations enter the world of work.


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# Reform of the UK non-domiciled tax regime

## For many years, the UK has provided for a special tax regime for individuals who are UK resident but non-UK domiciled.

The Labour Government has committed to abolish this tax regime, and to replace it with a new residence-based regime from 6 April 2025.

At the Budget on 30 October 2024, the Government set out the detail of these proposals.

In outline, the key aspects of the new regime are as follows:

### New four-year exemption

- Currently, non-UK domiciled individuals can claim the so-called "remittance basis" for up to 15 years of residence in the UK. Broadly, under the existing remittance basis regime, non-UK income and gains are not subject to UK tax provided they are not brought into the UK.
- From 6 April 2025, the remittance basis regime will be withdrawn and replaced with a new four-year regime. Individuals qualifying for the new regime will not be taxed on most types of non-UK income and gains for their first four tax years of UK residence. Individuals will be eligible for the new four-year regime if they have been non-UK tax resident for at least 10 consecutive years, regardless of their domicile status.
- Although it applies for a shorter period than the existing remittance basis, the new four-year regime in some ways represents a simplification of the current system. It appears that much of the complexity of the remittance basis will be avoided, as non-UK income and gains which are relieved from tax under the four-year regime can be brought to the UK without incurring a tax charge (although these will need to be quantified and the new relief claimed in a tax return). By determining eligibility for the new regime under a residence-based test, rather than the more subjective concept of domicile, it also should be more straightforward for taxpayers to establish whether they will qualify for the new regime.
- For individuals working in the private capital industry who may be eligible for the new four-year regime in the future, the interaction of the exemption described above with the UK's tax regime for carried interest will of course be an important point. The Government is consulting on a wider package of changes to the taxation of carried interest from 6 April 2026.

### Inheritance tax

- From 6 April 2025, inheritance tax will also be moving from a domicile-based system to a residence-based system.
- Under the new rules, an individual's worldwide assets will fall within the scope of inheritance tax once they have been UK resident for ten of the prior 20 tax years, irrespective of their domicile position. If an individual leaves the UK after meeting this 10/20 year test, their worldwide estate will remain within the scope of inheritance tax for a period of time after leaving. The duration of this inheritance tax "tail" will vary from three to 10 years, depending on how long they have been resident in the UK.
- Currently, non-UK assets held in trusts established by individuals who were not UK domiciled (or deemed domiciled) are outside the scope of UK inheritance tax indefinitely. From 6 April 2025, this will no longer be the case. Instead, the inheritance tax treatment of the trust assets will generally depend on the UK residence status of the individual who created and funded the trust, with this being tested at the time of the relevant inheritance tax event. This change will apply to existing trusts as well as new trusts, so many trusts created by non-domiciled individuals will be brought within the scope of inheritance tax in some form from 6 April 2025.
- However, there are some (limited) transitional provisions to mitigate the impact of these changes on non-UK domiciled individuals who established trust structures before 30 October 2024. Where the transitional rules apply, trust assets will not be subject to inheritance tax on the death of the individual who created the trust (though inheritance tax charges may still apply in other circumstances).

### Protected settlements

- Since 2017, non-UK trusts established by individuals who were non-domiciled (and not deemed domiciled) have benefitted from "protected settlement status". This means that the individual who created the trust is not automatically taxed on non-UK income and gains arising within the trust structure, even after they become deemed domiciled.
- From 6 April 2025, protected settlement status is to be removed from all trust structures, including those already in existence. This means that, as a starting point, UK resident individuals who are outside the new four-year regime and who have created trust structures may be subject to UK tax on all income and gains arising within those structures from 6 April 2025. The tax rules applicable to trusts are complex, and individuals' liability to tax will depend on the circumstances in each case.

## Transitional arrangements

- There will be transitional arrangements to mitigate the impact of these changes on current and former non-domiciled individuals.
- These include the so-called "Temporary Repatriation Facility". This is an opportunity for individuals who have previously claimed the remittance basis to remit foreign income and gains that arose before 6 April 2025 to the UK at a reduced tax rate for a limited period (i.e. 12% in the tax years 2025/26 and 2026/27, rising to 15% in 2027/28, after which the arrangement is no longer available). Significantly, these special tax rates can also apply to benefits received from foreign structures received from 6 April 2025 to 5 April 2028 in certain circumstances.
- There will also be an elective rebasing of non-UK assets held by certain non-UK domiciled individuals for capital gains tax purposes to the relevant asset's value as at 5 April 2017. This rebasing opportunity is however subject to several conditions, which is likely to limit its use in practice.

## Further developments

- Finally, as trailed in the Government's July policy paper, it is proceeding with a reform of the UK tax anti-avoidance rules aimed at non-UK structures (including non-UK trust and corporate structures affected by the wider changes discussed above). At the October 2024 Budget, the Government published a call for evidence on how the rules could be reformed. These changes may well prove to be significant for taxpayers who have created, or benefit from, international structures; albeit any changes will not apply before 6 April 2026.

The October 2024 Budget has provided long-awaited clarity as to how the new rules replacing the existing domiciled-based tax regime will work. These changes will have a significant impact on individuals who are non-domiciled, deemed domiciled, or who have benefitted from the tax regime for non-domiciled individuals in the past. Affected individuals should take advice on the consequences of these rules for them and their structures, and determine whether any steps should be taken prior to 6 April 2025.

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# Employee ownership for private equity

We have seen moves towards greater levels of employee ownership at the portfolio company level beyond the typical sweet equity ownership model over the last 12 to 18 months. One US private equity house in particular has become relatively well known for its employee ownership initiatives, including in partnering with charity Ownership Works (which aims to assist companies and investors to transition towards greater levels of employee ownership), and recently Blackstone publicly announced the launch of a new programme of employee ownership at its portfolio company, Copeland, illustrating this growing trend.

There are well-established benefits in offering employee share ownership (see below) and the main catalyst for the recent uptake within private equity is an economy with higher interest rates and less available cash. Employee share ownership schemes have long shown to be useful in keeping running costs low by swapping a portion of any upfront salary and/or bonus for long-term share scheme award at minimal upfront cost to the company (instead relying on future growth), thereby freeing up cash for other useful purposes such as servicing external debt.

The alignment of interest between employees and shareholders generally enables greater levels of employee engagement and can be particularly valuable in driving performance. There is strong evidence to suggest a correlation between high levels of employee ownership and increased productivity and rates of growth – achieving a dual purpose of rewarding employees fairly while helping the private equity house to achieve a favourable exit.

As an added benefit, share incentive schemes are often structured to include multi-year vesting periods and leaver provisions that reduce or remove the benefit entirely if an employee leaves the company prior to an exit. Such provisions can be an effective tool to improve retention and to reduce the costs associated with a higher staff turnover.

Finally, increased employee ownership is also likely to resonate well with ESG principles. Employee ownership schemes are an effective way to promote social equality and more attractive remuneration packages for a wider employee base. In doing so, private equity houses may be more able to attract investors to whom ESG principles are a factor in their decision making.

The most commonly used employee share ownership schemes include non-tax qualified options, growth shares and phantom share schemes, but other more bespoke and business-tailored or hybrid schemes are also increasingly being designed.

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# ESG performance-linked pay in private equity

**Whereas the linking of executive remuneration to ESG objectives is now commonplace for many listed companies (and increasingly fuelled by active institutional investors and proxy agencies), the concept is taking longer to get a firm hold within the private capital sector.**

This is partly due to increased complexities particular to private equity and differences in reward structures at different levels. For example, should private equity firms introduce ESG-linked pay for managers at house, fund or portfolio level, or at all three? The structures of some forms of private equity incentives (e.g. traditional carried interest or sweet equity arrangements) do not easily lend themselves to the inclusion of non-financial performance measures. In addition, there may be many diverging ESG objectives within a fund or investment portfolio which makes it particularly difficult to design a simple set of ESG objectives that can drive performance effectively across the board.

Another important aspect is the relevant time horizon. Whereas a FTSE CEO would typically expect to be in place for 5-10 years, the asset holding periods for private equity investors is normally much shorter (4-5 years), and so there may not be sufficient time to achieve the necessary ESG objectives over the relevant holding period.

Despite these additional complexities, we are seeing an increasing number of private equity firms embarking on ESG-linked incentives and reward in order to focus attention on the achievement of the relevant objectives.

## How to do it

There are numerous ways in which a firm could build ESG into its reward framework – some of the high-level themes to consider when doing so are summarised below.

Whilst there are various mechanisms available for the inclusion of ESG metrics in performance-based incentive plans, to date, where firms have adopted ESG-linked pay arrangements, they have typically done so mainly in their short-term/cash bonus incentive plans (although there are certainly examples in the market of ESG-linked long-term and equity incentives within private equity).

There are three main ways in which to incorporate an ESG performance metric:

- **Targets** – the ESG metric is included as a specific performance target which, if not achieved, results in the lapse of a proportion of the award or award potential. For listed companies, this is currently the most popular method of integrating ESG into pay.
- **Discretion** – ESG performance is included as a standalone independent factor in the discretion of the board or remuneration committee as to the quantum of entitlement to an overall award, or portion of an award.
- **Overlay/underpin** – where a financial target is met, the board/remuneration committee is given discretion to adjust that award up or down based on performance in relation to separately measured ESG metrics. Although similar to discretion, this method in essence adds an additional performance factor which may increase or reduce the outcome determined by reference to a financial performance metric.

Although the above are the most commonly used ways in which to build in ESG metrics, there are other ways in which firms can introduce some element of ESG link into pay or incentives, for example by:

- including ESG performance into the determination of whether someone is a good or bad leaver;
- adding a malus or clawback trigger specifically linked to the failure of an ESG objective or ESG management; and/or
- expanding ESG metrics to broader based all-employee plans.

## Selecting appropriate metrics

One of the most important aspects of linking ESG factors to pay is choosing which metrics to use. There is particular focus on how you can measure and quantify success against ostensibly qualitative measures like diversity and inclusion, environmental impact or customer satisfaction.

There are an increasing number of frameworks available which set out recommended ESG indicators and metrics. There are no "right" metrics to use however; the metrics which are most appropriate to include are those which make sense for the relevant firm or business, taking into account the context in which it operates and the ESG appetite.

Selection requires the key ESG targets and ambitions for the relevant firm or business as well as the environment in which it operates to be identified. ESG should be closely linked to the overall mission and culture and so once those have been articulated, ESG performance objectives start to become clearer. As a rule of thumb, incentives should ideally be linked to a single ESG objective, rather than a basket of objectives where good performance on one can off-set bad performance on another.

Finally, firms should consider the prominence and weight that should be given to the relevant metrics. While it is rare to see entire equity or bonus incentives tied solely to ESG performance, ascribing a 10% to 20% weight to ESG metrics is not uncommon.

## Concluding thoughts

There is no question that ESG-linked pay is finally taking hold in the private capital sector as investors and stakeholders demand more accountability and transparency from private equity firms and their portfolio companies. However, designing and implementing ESG-linked incentives should be handled with thought and care so as to ensure they are robust and effective. Challenges that soft targets are hard to set, but easy to meet can only be credibly addressed by firms and companies that set stretching ESG objectives which are fully in line with the overall mission and culture.

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# Non-financial misconduct

Non-financial misconduct (NFM) is a highly topical area of increasing regulatory scrutiny, where the line between workplace conduct and private life is becoming increasingly blurred. Firms are faced with the difficult challenge of balancing stringent regulatory expectations against the risk of employment law claims from NFM suspects.

## Non-financial misconduct – what does it mean?

Many of the challenges in navigating non-financial misconduct arise from the fact that its definition is not clear-cut.

The FCA refers to NFM as behaviour including bullying, sexual harassment and discrimination, whether inside or outside of the workplace. It includes conduct that does not directly relate to the financial aspects of a firm's business but may nonetheless have a significant impact on its culture, integrity and reputation.

The relevant threshold for the purposes of the regulatory framework (see further below) is "serious misconduct", but there is currently no definition or guidance as to what serious misconduct entails.

## Regulatory landscape

The FCA has made clear that it views NFM as misconduct falling within its regulatory jurisdiction and that the existing regulatory framework (including the FCA Principles for Business, staff and director fitness and propriety assessments for the Senior Manager and Certification Regime (SMCR), the Conduct Rules, the regulatory reference regime and the Threshold Conditions which set out the criteria for firms to maintain their licence to operate in the UK financial sector) applies to NFM.

However, NFM is not specifically referenced in these rules and no clear guidance or examples are included to guide firms on how to deal with NFM incidents. The FCA therefore proposes to amend its rules to integrate NFM into the regulatory framework better.

The proposals are contained in the FCA's September 2023 consultation paper "Diversity and inclusion in the financial sector – working together to drive change" and include: (i) rules which will apply to all FCA authorised firms; and (ii) additional requirements for "large" firms with more than 250 employees.

The proposed base level requirements which will apply to all FCA authorised firms include:

- amendments to the Conduct Rules to include "serious instances of bullying, harassment and similar behaviour towards fellow employees and employees of group companies and contractors" (i.e. NFM within the workplace);
- new guidance to explain that bullying and similar misconduct, whether within or outside the workplace, is relevant to the assessment of whether an individual performing (or seeking to perform) a senior management or certification function is "fit and proper" to carry out their role; and
- new guidance on the suitability threshold condition for firms to operate in the financial sector, which will include offences such as sexual or racially motivated offences and relevant court findings.

While the new rules will not come into force until 12 months after the FCA's policy statement has been published (expected later this year), firms are already required under the existing regulatory framework to:

- report breaches of the Conduct Rules (including those that arise from NFM incidents) to the FCA;
- notify the FCA of anything relating to the firm of which the FCA would reasonably expect notice, pursuant to Principle 11 of the FCA's Principles for Businesses;
- have regard to NFM incidents in the course of conducting "fit and proper" assessments for the purpose of certification of employees under the SMCR and appropriately disclose relevant matters in regulatory returns, including Form C (Notice of ceasing to perform controlled functions); and
- disclose NFM incidents as appropriate in regulatory references.

In addition, from October 2024, employers will be subject to a new legal duty to take reasonable steps to prevent sexual harassment in the workplace, including from third parties.

## Challenges faced by firms

The lack of guidance as to factors which the FCA would regard as indicating serious misconduct makes it difficult for firms to assess whether an individual NFM incident is sufficiently serious to amount to a breach of a Conduct Rule and/or to impact an individual's fitness and propriety to perform their regulated role.

While there will be certain instances where misconduct clearly meets the seriousness threshold (for example, a criminal conviction or obvious abusive conduct towards colleagues), the majority of cases are likely to be less clear cut, often involving one person's word against another and a lack of tangible evidence. The assessments to be conducted by firms in such cases will necessarily be subjective and fact-specific and will require difficult judgement calls.

In these situations, firms must carry out a delicate balancing exercise, weighing up regulatory expectations and obligations against the risk of an employment law claim from an individual facing a potentially career-ending decision.

## Mitigating the risks

Firms should be thinking now about changes and enhancements they might need to make to their policies, processes and practices to ensure that they are aligned with the FCA's expectations in this area.

Key focus areas should include the following.

- **Detection and escalation of NFM incidents** – it is vital that firms have in place adequate systems and controls to detect and, where appropriate, escalate NFM incidents. Effective whistleblowing policies and procedures are crucial, as is fostering a "speak up" culture, which encourages employees to come forward with any concerns about the behaviours of others (including senior management). The FCA has indicated that a low number of whistleblower complaints at a firm is a possible indicator of poor culture. The new duty to take reasonable steps to prevent sexual harassment further emphasises the need for appropriate processes and, in many areas, formal assessments of risk.
- **Tone from the top** – board members and senior managers should emphasise the importance of good conduct in the business, including a culture of zero tolerance of serious misconduct, particularly in relation to NFM.
- **Appropriate internal training** – firms should consider whether additional training is required to support and educate staff on D&I and culture issues, with specific reference to the risk areas identified by the FCA.
- **Regular communications between HR and compliance** – complaints involving allegations of bullying and harassment that may historically have been dealt with solely by a firm's HR team will now need to involve the compliance function where individuals are within the regulatory framework.
- **Appropriate handling of complaints** – complaints should be handled fairly, promptly and confidentially, with appropriate consequences for staff who are found to have committed NFM.
- **Accurate recording of NFM incidents** – firms should ensure that they are keeping accurate and detailed records of NFM incidents (including how they were detected, escalated, managed and dealt with) so that they can respond to any regulatory inquiries appropriately.

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# Regulatory considerations for the sale of interests in investment managers

The sale of a GP stake, whether a minority or controlling stake, raises a number of complex regulatory issues. Aside from the obvious required filings with financial services regulators such as the FCA, other potentially important regulatory notification requirements must also be considered (even if they are ultimately ruled out), particularly those arising from: i) regulatory regimes dealing with foreign direct investments (FDI); ii) the EU Foreign Subsidies Regulation (FSR); iii) merger control; and iv) potential operating company level change of ownership obligations.

## FDI

In recent years, there has been a significant increase in FDI screening regimes which typically impose mandatory notification obligations on the acquisition of interests in businesses operating in a range of sensitive sectors (e.g. defence, the manufacture of military and dual use products) and/or which are in control of critical infrastructures.

These regimes have common themes, but the details of any analysis will be jurisdiction and business-specific. The following factors are important when determining whether notifications are required.

- FDI regimes can capture non-controlling investments and be engaged by a direct or indirect interest in the equity, voting or capital rights as low as 10% or even 5% for certain defence-linked businesses in some jurisdictions.
- It is necessary to understand in some detail the activities of each portfolio company in each jurisdiction in which that company: a) generates sales; b) has a physical location; or c) has a subsidiary.
- The relevance of nationality of the ultimate acquirer and any intermediate entities varies by jurisdiction, with some regimes (such as the UK's) being acquirer agnostic for some or all transactions, whilst others are only engaged by investments from certain jurisdictions e.g. non-EU investors.
- The extent to which a portfolio company falls within a mandatory notification sector can turn on specific details in relation to both the precise scope and scale of a company's activities - detailed information from portfolio companies is often required to complete the analysis.
- The regimes are inherently political and are applied flexibly - it can, at times, be difficult to rule out definitively filing obligations or predict outcomes.
- The sanctions for failing to make a mandatory notification can be severe, and include transactions being automatically void, serious fines, and potential criminal sanctions.

In the context of the sale or acquisition of a GP stake, these considerations can give rise to a broad and often complex review that will need to be anticipated to ensure it can be managed efficiently for all parties.

## FSR

The FSR grants the European Commission investigative and enforcement powers aimed at addressing the potentially distortive effects of "foreign financial contributions" (FFC) granted by non-EU governments to companies operating within the EU's internal market.

The definition of an FFC is broad and not limited to direct monetary transfers from foreign governments, but includes all investments made through publicly controlled entities, including sovereign wealth funds and public pension schemes. As such, investment firms which are recipients of such investments (whether made into funds managed by those firms or channelled into the portfolio companies of those funds) risk being caught and could be required to notify the acquisition of a controlling GP stake if the FSR's financial thresholds are met.

The FSR is also relevant for potential sellers. In particular, in order to identify whether a notification is required, it is necessary to understand whether FFCs (including non-EU government contracts, loans, grants, guarantees and tax exemptions) have been received by portfolio companies in the previous three financial years and where triggered the notification form requests information about FFCs received by both portfolio companies and the relevant investment funds (which includes LP capital commitments).

Investment firms should therefore adopt reporting mechanisms to track all the FFCs received by their portfolio companies. This is important not only to determine whether an acquisition or disposal could hit the relevant financial thresholds under the FSR, but also to have access to all the information which could be required for completing a notification in the event a filing is required. While it is possible to seek derogations from the obligation to provide certain information, that will not always be easy to secure; although it is hoped that the process will become more straightforward in the future once the European Commission has acquired sufficient experience of dealing with transactions involving investment funds.

## Merger control

Firms will no doubt be well-acquainted with the merger control aspects of their acquisitions, but those same aspects also need to be considered where a firm is itself the subject of an acquisition or a stake sale. In particular, firms must consider the following:

- the activities and turnover of all companies controlled by each of the purchaser and the target;
- a firm's revenue includes not only those generated by the investment management activities of the firm but also those related to the activities of all controlled portfolio investments[1]; and
- firms that more commonly take passive or debt interests, or who invest in pre-revenue projects, will need to be prepared to gather this information from their portfolio investments.

## Other regulatory filings

Businesses active in certain sectors are also likely to be subject to sector-specific regulation, for example via national telecoms, energy, or other relevant industry regulators. Where licence conditions require changes of control to be notified, these obligations should be identified alongside the above assessment.

## Conclusion

The sale or acquisition of a GP stake can call for a complex and involved regulatory analysis, requiring significant input not only from the investment firm but also from its underlying portfolio companies. Early engagement with such an analysis is therefore recommended to ensure that notification requirements can be identified at an early stage and that steps can be taken to prepare such notifications efficiently to avoid potential delays to completion.

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[1] The precise definition of control varies by jurisdiction but includes not only majority control but also the acquisition of negative control rights that go beyond mere minority shareholder protections.

# GP stake sales

**Over the last 12 months we have been fortunate to work on an outsized share of acquisitions of investment management businesses, acting for both the target and incoming investors. These transactions have offered a fantastic insight into some of the key value drivers and governance issues for these businesses, whilst drawing upon our expertise in M&A, tax, private funds, regulation and anti-trust.**

It's true that you will often hear lawyers say that no two deals are the same, but that notion particularly resonates with these transactions as they are so dependent upon the personal (and therefore varied) dynamics of founders, alongside other key team members within the business, existing LPs and the incoming investor, who together share both an alignment and potential conflict of interests. That said, we have briefly detailed below how these transactions are often structured to highlight some key issues in an effort to draw out some commonalities.

Transactions are typically for a minority interest of at least 20%, although we have also often seen investors acquire an interest which is more bespoke in nature and not a simple equity percentage (e.g. structured as a revenue share, so immune to cost fluctuations in the business).

Finding the right structure of the stake being acquired for all stakeholders to preserve on-going alignment is critical, as parties grapple with key issues such as:

- whether the investment should provide primary new funds into the business or liquidity to current stakeholders through a secondary (depending on the driver for the transaction in the first place, which can range from a need to fund increasing GP commitments or wanting capital to seed new business lines and fund growth, to founders' desire to take some money out of the business and "prove their concept" whilst retaining control and future upside);
- the balance between maximising the day one amount being paid by the investor and the size of the stake they are acquiring and not giving up too much of the future upside;
- appropriately incentivising rising stars to generate future value (e.g. through the creation of a new MIP) whilst holding on to founder expertise;
- retaining sufficient control for existing decision makers, whilst also giving investors sufficient protection over their investment;
- ensuring LPs are content that the incoming investor will be accretive to the business; and
- navigating an ever-increasing regulatory landscape with parties whose investments span multiple jurisdictions.

It is this aim of appropriately managing the differing perspectives of the various stakeholders that makes these transactions so interesting yet complex.

Looking forward to the next year, we expect an increase in transaction volume as more firms seek to navigate generational change and investors seek to invest further in this asset class to diversify their portfolio and take advantage of the returns available from this proven successful sector. One big question that remains at this stage is what the next phase will look like when these investments start to be realised, as to date there have been relatively few exits for the investors acquiring these minority stakes.

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# Fundraising

## Fund formation

# Raising multiple funds simultaneously

## Multi-strategy GPs have for many years grappled with the challenges of raising capital for more than one fund at the same time.

However, it is now also increasingly common to see GPs:

- looking to raise multiple pools simultaneously within the same strategy, albeit on different terms or with a different liquidity profile (e.g. raising an evergreen fund alongside a flagship closed-ended fund);
- setting up vehicles such as ELTIFs, LTAFs or Luxembourg Part II funds to attract retail capital into or alongside their flagship institutional fundraises;
- raising capital for top-up vehicles or co-investment funds alongside their flagship fundraising; or
- stapling the establishment of continuation vehicles (or similar transaction or asset-specific vehicles) to a flagship fundraising.

Each of these scenarios brings its own challenges that GPs must navigate to achieve successful parallel fundraisings. Examples of issues that GPs in these situations can find themselves managing include:

1. **Resource constraints.** Raising multiple funds can involve significant effort and time dedication from the GP's personnel, not just the IR team. LPs, too, have limited resource and may not have capacity to conduct due diligence on multiple fundraisings simultaneously.
2. **Subscription cannibalisation.** GPs must be mindful that simultaneously raising multiple pools could risk a dispersion of subscriptions; this can be especially sensitive where the pools have different fee profiles and capital is subscribed to lower-fee paying pools (or the pools with shorter lock-ups) at the expense of other pools.
3. **Timing pressures.** The timing pressure to close a single fundraising can be exacerbated in a multi-fund environment, particularly if one or more of the fundraisings is stapled to a secondary transaction or if the GP is looking to put in place a single financing facility for, and secured against all the assets of, multiple funds. Timelines may also need to be extended to accommodate the establishment of vehicles raising retail capital, which typically require obtaining regulatory approval (as to which, see more below).
4. **Unfamiliar regulatory environments.** For a GP accustomed to raising institutional-only funds, launching a retail sleeve or feeder can involve getting to grips with a new and unfamiliar set of regulatory requirements, including compliance with fund-level investment and leverage restrictions, regulator scrutiny of fund documents, retail distribution rules and so on.
5. **Investment allocation.** If the GP is raising multiple funds within the same strategy, or with a degree of strategy overlap, implementing a robust investment allocation policy for allocation investments between the funds will be essential. The policy should take into account any differences in the funds' available capital, recycling rights and liquidity profiles, amongst other things. On a related point, the GP should consider whether a strategy-wide hard cap may be appropriate (rather than a fund-specific hard cap), although this needs careful thought where fundraising periods for different capital pools are not aligned.
6. **Fund operational challenges.** GPs need to think about how some of the key fundamental fund terms will operate across multiple vehicles: for example, key person provisions, MFNs, fee discounts, and also more administrative items such as equalisation mechanisms where, for example, an evergreen or vintage-style fund invests alongside a traditional closed-ended fund. The role and composition of the LPAC also needs thought given the likely differing investor bases across multiple vehicles (also a concern across multi-vintage structures).

7. **Conflicts of interest.** These are particularly acute where a fundraising is stapled to a secondary or other transaction (e.g. seeding a fund portfolio with warehoused assets from another fund or the GP's balance sheet). GPs must proactively identify conflicts and be transparent with their LPs as to how they will minimise and manage those conflicts. GPs also need to be sensitive to the optics of arranging a liquidity solution for investors in one fund (e.g. by undertaking a continuation fund transaction) at the same time as fundraising for the successor fund, and be ready to answer questions about the timing of the transaction.
8. **Strategy focus.** GPs need to be able to convince LPs that they remain focused on executing their investment strategies successfully and that they are not taking their eyes off the ball by undertaking simultaneous multiple fundraisings or, potentially, falling at risk of strategy drift.

GPs can navigate and manage all of these issues, but it is essential to plan ahead and sketch out where the critical obstacles lie. As the private capital industry matures and GPs become ever more sophisticated and innovative, we expect the trend for GPs to raise multiple pools of capital simultaneously to continue.

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# Update on Solvency II reforms

## The UK Government has, for a number of years, been conducting a review of Solvency II, the rules that govern the prudential regulation of insurance firms in the UK.

Solvency II, as it applies in the UK, is currently based substantially on EU law which has been retained since Brexit. The stated aims for the ongoing reform include encouraging an innovative and internationally competitive insurance sector and unlocking capital for investment by insurers. In April 2024, the Prudential Regulatory Authority (PRA) published proposals for Solvency II to be restated into UK law by the end of 2024. Over time – as the relevant legislation is updated – the bespoke UK rules will become known as "Solvency UK".

The reforms and their objectives have been supported by the Labour Party in opposition and so are anticipated to continue under the new Government.

One key sector expected to benefit from the reforms is the UK defined benefit (DB) pensions buyout market. The rise of interest rates and improved DB pension funding levels has already resulted in an acceleration of the buyout market, with larger pension schemes increasingly seeking to use illiquid assets to fund buyout premiums. 2023 was a record-breaking year with almost £50bn of retirement income secured across the market.

A key recent focus for reform has been the reassessment of the calculation and scope of the "matching adjustment" (MA), which allows insurers writing certain categories of business (including in the DB pension buyout sector) to use more favourable discount rates in the valuation of their long-dated liabilities where they hold matching long-dated assets against those liabilities. The intention is to permit insurers to use a wider range of assets in their MA portfolios.

MA eligible assets must comprise "bonds or other assets with similar cash flow characteristics". UK insurance firms have restructured a diverse range of income streams into the MA eligible assets often by means of securitisation structures. Since 30 June 2024, firms have been able to take advantage of a relaxation of the requirement that MA-qualifying assets must have fixed cashflows, permitting a limited proportion of the MA portfolio (deriving no more than 10% of the aggregate MA benefit) to comprise assets with a "highly predictable" cashflow.

In addition, the changes have removed the limit (known as the "BBB cliff") on the amount of MA benefit that may be claimed from sub-investment grade assets and reformed the granularity and validation of credit rating processes relevant to the MA.

The reforms to Solvency II, alongside the increased demand for illiquid assets to back DB pension buyouts, create opportunities for private debt managers that are able to design products where cashflows are structured to meet the requirements of insurers under Solvency II, in particular the matching adjustment requirements.

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# Fund and portfolio advice

## Fund finance

## Portfolio company advice and restructurings

# Fund finance

Whilst the fund finance market has suffered from a lack of liquidity over the last 12 to 18 months, there continues to be appetite for the right transaction and/or right sponsor. In particular, significant interest has been seen in the provision of net asset value (NAV) facilities (facilities which are secured against the value of the fund's portfolio as a whole and the distributions flowing up from it). Some of the key themes in fund finance that we've seen over the last year are explored further below.

## NAV financing

NAV financings continue to be the "hot topic" in fund finance. They are particularly important in providing liquidity to funds for event-driven purposes, including the funding of final acquisitions for a particular fund vintage, funding follow-on investments, distributions to limited partners and the transition of assets to secondary funds. They are therefore increasingly coming to be viewed as an integral part of a fund's financing strategy. However, there can be tensions between GPs and LPs in respect of the use of NAV financing, which (to a greater or lesser degree) relate to what some LPs observe is a lack of transparency by GPs as to NAV usage and its impact on performance. Communication is key to ensure that all participants are comfortable with the implications of the additional leverage provided by NAV financing. The Institutional Limited Partners Association (ILPA) has recently published guidance on the usage of NAV financings which includes particular focus on communication.

## Alternative credit providers

Alternative credit providers (e.g. insurers, private capital funds and others) are becoming more prevalent in the fund finance market. In the context of subscription line facilities, this has been driven by a combination of decreased appetite from commercial banks (due to regulatory capital pressures, among other things) and GPs seeking increased commitment sizes from those same banks as a result of increases in fund sizes. GPs and commercial banks have therefore looked to alternative credit providers to add capacity. In relation to NAV financings, there has been sustained appetite for committed facilities from credit funds during the early stages of the fund cycle as well as both private equity funds during the mid-to-later stages of the fund cycle and real estate funds looking to apply back leverage. Alternative credit providers are seen as providing more flexibility on terms relating to, among other things, LTV and amortisation from distributions and having broader investment mandates to be able to finance funds that might not be underwritten by banks. The greater number of participants and underlying asset classes being funded by NAV facilities (e.g., in addition to those mentioned above, special situation funds are now being financed), has given rise to ever-increasing complexity in the terms of these facilities, such as eligibility criteria, financial covenants and security over the underlying assets.

## Subscription line financings

Subscription line financings continue to be a key product for GPs/managers but, as discussed above, borrowers continue to find that they are more complex to source than historic standards. There has been some recent tightening of spreads, in line with macro interest rate movements, but a return to the environment of a couple of years ago appears to be some way off.

## Deal management

Increasingly, GPs are having to manage several fund financings at any one time as a consequence of the rise of NAV financings, GP facilities, management company facilities and single managed accounts being put in place for increasingly sophisticated and demanding LPs who require bespoke structures. In addition, reporting requirements for asset-backed financings have prompted some sponsors to develop teams at significant cost to the funds.

Against the backdrop of this increased deal management burden, there are increasing calls from GPs/managers for more innovation in this space to:

- enable alternative credit providers to participate alongside the banks typically providing revolving facilities – allowing for bigger financings for the ever-growing fund sizes (particularly in light of GP consolidation) and longer tenors;

- avoid or mitigate continual refinancing risk through the use of delayed debt tranches, umbrella facilities and a renewed focus on “hybrid” facilities to ease the progression from sub-lines to NAV debt;
- finance the growing number of evergreen credit funds being established; and
- include high-net-worth individuals (including via an aggregator of high-net-worth individuals) within a subscription line facility borrowing base, given their increasing importance to the fundraising market.

## Rating of fund finance facilities

Many banks continue to grapple with the potential impacts and interpretation of the Basel IV regulatory capital rules. In addition, in response to the tightening-up of internal risk modelling and as the number of fund finance market participants continues to increase (including insurance companies investing through rated note feeders), there is an expectation that ratings will become more important to fund financings. Private (as opposed to public) ratings appear to be sufficient for both sides for the time being, but any pricing benefit for GPs is yet to be seen.

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# Restructuring plans

## Although 2023 did not see a "wave" of large-scale insolvencies akin to the 2008/2009 financial crisis, insolvencies last year, fuelled by a turbulent macroeconomic and political climate, reached their highest level in 30 years. Indeed, despite a current improved economic outlook, the impact of this period is still felt across the economy as distress remains relatively widespread.

Therefore in welcome news to those creditors and businesses navigating distress scenarios, 2024 has been a landmark year for the restructuring plan – that powerful and innovative tool for restructuring the debts of a company afforded by Part 26A of the Companies Act 2006 (restructuring plans) – with the three landmark cases of *Adler*[1], *McDermott*[2] and *Aggregate*[3] significantly developing our understanding of how the Court will approach restructuring plans.

The key takeaways from *Adler*, *McDermott* and *Aggregate*:

1. when structuring restructuring plans which might override dissenting creditors, careful thought should be given to whether an alternative restructuring plan could more fairly distribute the benefits of the restructuring;
2. the rights of shareholders do not need to be confiscated as part of a restructuring plan, provided that it is fair for them to retain their equity;
3. it is not possible to confiscate or "zero" the rights of shareholders or creditors for no consideration under a restructuring plan, even where they are "out of the money" and would not receive anything in the relevant alternative to the restructuring plan; there must instead be some "give and take", even if the company's "give" is modest;
4. to the extent possible, creditors ought to afford the Court time to act in a considered manner, rather than going to the Court at the eleventh hour such that it must act with urgency in an expedited manner; and
5. these cases, with their fulsome disclosure, multi-day hearings, sophisticated challenges, settlement discussions and the risk of stays and appeals, have underlined that restructuring plans resemble commercial litigation. The result, today the market is much more attuned to the implementation risk attached to restructuring plans, such that we expect that going forward there will be a greater emphasis on out-of-court solutions.

For those keen to utilise the expertise of the Court, implementation risk is likely to be tempered by increasing sophistication amongst practitioners. Led by the judicial guidance from *Adler*, *McDermott* and *Aggregate*, it is likely that practitioners will aim to minimise implementation risk in a number of ways, including anticipating challenges when structuring restructuring plans and better managing stakeholders and timetables. With careful planning it is possible to guide a restructuring plan through the Court without significant challenge, which we have successfully achieved this year.

For the remainder of 2024 and into 2025 we anticipate there to be further bedding in of restructuring plans, which should further open this tool to the mid-market.

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[1] Re AGPS BondCo PLC [2024] EWCA Civ 24

[2] Re CB&I UK Ltd [2024] EWHC 398 (Ch)

[3] Re Project Lietzenburger Straße Holdco S.À.R.L.[2024] EWHC 468 (Ch); [2024] EWHC 563 (Ch)

# Update on claims against directors of distressed companies

**As the number of companies going into insolvency remains high, directors (and shadow directors) remain more likely to find themselves on the boards of financially distressed companies. Regulatory and court scrutiny of the behaviour of directors is concordantly heightened.**

The BHS (in liquidation) claims that reached judgment in Q2 of this year demonstrate the importance of directors' vigilance in exercising their duties when company solvency is in doubt. Three of BHS' former directors were found liable for wrongful trading and misfeasance. They have been ordered personally to make significant financial contributions as a result.

Directors should keep well in mind their duties, the scope of which includes keeping the financial position of the company under close scrutiny when making any significant decisions, ensuring that the right information is available to the board to allow informed decisions to be made, challenging key decisions to stress-test them fully, holding regular board meetings and seeking professional advice when appropriate.

The Court has reiterated that while the taking of professional advice is usually a key step in dealing with a potential insolvency situation, directors are not automatically absolved of blame through having taken such advice. Directors must carefully consider the advice received and take a decision whether to follow it. It is the duty of directors themselves, and not their advisers, to decide whether there is a reasonable prospect of avoiding insolvent liquidation. The Court has also stated that it is no excuse that management information (MI) is voluminous or not provided in a timely fashion; directors would therefore be wise to ensure MI is provided punctually and in a format that is digestible, as they are required to remain on top of the detail.

Directors are also reminded that, while delegation of management functions is permissible, delegation of responsibility for meeting their personal duties is not. When delegating functions, directors must adequately monitor and supervise the discharge of those functions.

It is recommended that directors maintain adequate directors and officers (D&O) cover, including run-off cover once they have ceased to be directors. In the BHS case, the Court specifically rejected an argument that the penalties imposed on the individual directors should be limited to the amount of D&O cover.

The liquidators of BHS have filed a further lawsuit (Q3 2024) against a former owner of the company on the basis he was a shadow director of BHS Group Ltd and breached his duties as a director. It may be some time before this case reaches trial, but this further emphasises the risk to individuals involved in the management of financially distressed companies. Individuals not holding formal directorships should be aware of the possibility that they become shadow directors if their level of involvement with decision-making is sufficiently significant.

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# Deployment

## Equity

## Credit

## Real assets

# LBOs

This year began with a wide-spread optimism that transaction volumes were set to increase on the back of a more settled (or, perhaps, slightly less unsettled) economic outlook and expectations that interest rates were going to come down. However, whilst our experience has been that more deals are being done, a lot of those are still private off-market deals or minority stake sales (often combined with a debt refinancing) and we are yet to see the larger numbers of full sale processes that has been predicted and so it will be interesting to see what Q4 holds.

Bolt-on acquisition activity has remained healthy throughout, however we have seen a drop-off in the numbers of continuation vehicle and fund to fund transactions, possibly as a precursor to more third party exits coming down the line.

From a sector perspective, financial services has been particularly buoyant throughout the slightly depressed overall market, with a notable new development being mainstream buyout sponsors starting to make fund portfolio investments (as opposed to strategic investments off their own balance sheets) into other private capital asset managers.

In relation to deal terms, alternative pricing mechanisms are continuing to be used frequently to bridge valuation gaps, and whilst often these are the more stereotypical earnout, deferred consideration and vendor financing structures, there is also an increasing trend for more innovative and bespoke arrangements (for example, increased rollover from sellers with ratchets built into the strip equity to protect the downside for the incoming sponsor and synthesise a higher entry price for the rolling sellers in an upside scenario).

As a standalone phenomenon, there was a somewhat artificial spike in activity levels in the run-up to the Autumn Budget, driven by concerns over the capital gains tax rate being increased, as sellers look to lock-in the existing rate where possible.

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# Capital market developments

## More room for an exit via IPO?

We have reported previously that the FCA published this year its long-awaited new UK Listing Rules, which contain changes to the eligibility requirements for listing in London and have simplified the continuing obligations regime, with the aim of increasing the attractiveness of London as a listing venue.

These changes may be of interest to sponsors holding portfolio companies for which an IPO may (now) be a viable route to raise additional capital and provide liquidity to existing investors. Time will tell how successful these changes are in attracting more listings to the London Stock Exchange, but sponsors should take note of them. For more details on this topic, please see our previous article:

Separately, HM Treasury has been consulting on creating a new trading framework for private company shares, to be known as PISCES, which would offer private company shareholders new opportunities for liquidity outside the formal IPO process. For our detailed analysis on the PISCES framework, please see our separate article:

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# Special situations

## Over the course of the year there has been significant activity across the special situations landscape, spanning both distressed and opportunistic event-driven transactions.

We have continued to see insolvencies and distress driven by high interest rates and inflation, particularly in sectors that rely heavily on discretionary spending such as consumer, retail and leisure. Real estate has also seen a high level of activity from distressed investors with commercial real estate particularly impacted by remote and flexible working and the continued digitisation of retail. This has created opportunities for investors and we expect that trend to continue given the ongoing macroeconomic backdrop and the potential dislocations resulting from ongoing geopolitical instability.

In particular, given the ever-growing size and sophistication of the private credit industry we expect to see a continuing trend of private credit managers advancing rescue financings or implementing debt for equity swaps in order to take control of distressed borrowers. In such scenarios, we have seen significant emphasis placed on go-forward operational turnaround plans and divestment strategy, which also frequently involves changes to the management team and/or the implementation of appropriate management incentivisation arrangements for those individuals considered key to value creation. This illustrates the very broad skill set required for investors operating in this space, with the ability to capitalise on opportunities being dependent on having the right expertise to handle activity across both non-controlling and controlling positions.

We also continue to see numerous instances of "good company bad balance sheet" scenarios, where companies do not face fundamental operational issues relating to their core business or the performance of their management team but are simply overleveraged. In such scenarios, special situations investors can focus on providing innovative funding solutions and balance sheet repair as opposed to requiring underlying business turnaround.

Overall, special situations remains a broad opportunity set the parameters of which are hard to define with precision. However, it is clear that the market has become increasingly sophisticated with a very broad range of participants willing to pursue bespoke and complex transactions which don't fit more traditional pockets of capital. We expect that to continue and, looking ahead to 2025, there should be plenty of interesting opportunities for our clients operating in this space.

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# Secondaries

## The rise of specialisation

**The secondaries market continues to thrive, with reports for 2023 showing another year of estimated volumes in excess of $100bn.**

As the market has materially grown in size over the last decade, innovation and evolution has led to a much wider range of transactions occurring within the secondaries universe. As a result, the broader secondaries market now covers a fairly diverse range of transaction types, including classic LP portfolio transactions, single asset and multi-asset continuation funds, NAV financings and preferred equity solutions.

In addition, market awareness of secondary transactions and their benefits to the private equity ecosystem has resulted in the expansion of secondaries into other areas of private capital, such as real estate, infrastructure and private credit.

Today's secondaries market is therefore a varied and dynamic environment which has moved well beyond its initial focus of LP interest trades in buyout funds.

The breadth of transaction type available for capital deployment by secondaries sponsors means that specialisation is increasing. Specialisation is seen as a tool to provide an edge in competitive processes and for secondaries houses to become more effective and efficient in analysing, valuing and underwriting specific types of transactions.

A move towards specialisation is also being driven by the investors in secondaries funds. As those investors assess their allocations, considerations around greater control of portfolio construction and risk/reward profiles can create a bias towards secondaries funds with a specialised focus that matches the requirements and appetite of the investor most closely.

We expect the trend towards specialisation to continue with existing secondaries houses looking to raise new funds dedicated to specific secondary strategies or creating pockets within existing funds to focus on deployment into specific secondary transaction types and also new entrants looking to stand out to, and attract capital from, investors in secondaries funds through their specialisation and focus.

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# Debt market

## Current issues and solutions

**The deal financing market at the start of H1 2024 continued in a similar subdued vein to 2023 with the withdrawal of investment banks from the syndicated loan market and of high yield bond investors and the increased presence of private credit fund clubs, which, whilst successful in plugging the liquidity gap in the upper markets, did so at the cost of debt availability in the mid-market, from which much of that liquidity was diverted.**

Encouragingly, and whilst fundraising conditions remain challenging, the outlook for H2 2024 is better. Green shoots of recovery have appeared as the markets have begun to stabilise and there is a good level of healthy optimism for an increase in deal activity for a number of reasons, chiefly that: over the course of H1 2024 broadly syndicated bank and high yield bond financing started to re-appear, displacing upper market credit fund loans; interest rates began to fall (helped clearly by slowing inflation – albeit that expectations for multiple base rate cuts this year have been thwarted) contributing to cheaper debt; and there is a sense that lenders are becoming more willing to lend again.

That said, as lenders look to deploy the liquidity that has been sitting on their books, the desire to do so into counter-cyclical sectors remains strong: business and financial services, healthcare, tech, pharma and logistics are all attractive. Less favoured sectors, such as leisure, retail and sectors exposed to the analogue economy, have to work harder to attract credit - typically generating fewer indications of interest, with processes taking longer and higher pricing and prepayment fees and add-ons such as warrants featuring in their terms.

Notably, 2024 has the potential to be a year in which private credit wins more ground from banks in non-sponsored and/or mid-market corporate territory. Traditionally financed by equity, venture debt or bilateral banking relationships, private credit fund solutions can be an option for “non-sponsored” or “sponsor-less” businesses, and mid-market or “special situations” corporate lending, where a founder does not want to take venture debt or give up equity, or a corporate may have outgrown bilateral relationship banks, been de-banked or simply be unable to find suitable bank lending.

Indeed there is no shortage of private capital to be deployed. Good credits in popular sectors continue to have access to favourable pricing and terms, which for the most attractive borrowers, including the portfolio companies of large sponsors, and borrowers into which a fund is already deployed, include cheaper pricing and a readiness to make available flexible terms such as PIK toggles, delayed draw facilities, reduced prepayment premiums and cov-lite unitranche. Conversely, credits with a more complicated story but the ability to support the higher returns expected are able to attract investment from funds with “special situations” or “capital solutions” strategies. Borrowers sitting somewhere in the middle, without a strong track record and not in a favoured sector, can struggle to obtain credit at their desired price point.

Both the ascendancy and availability of private credit is clearly marked by the significant number of credit funds in the market. LPs have become more sophisticated in their understanding of the terms available to them, often deploying to multiple managers. In addition, the slowdown in private equity exits has meant that cash tied up in those investments has not been available for re-deployment by LP allocators. Accordingly, there is increased competition amongst private credit funds, longer fundraising timelines, differentiation of fund strategies and changes in pricing driven by expected interest rate cuts may grow their reach into this area.

Origination is notoriously a challenge for private credit funds without the necessary networks. As such we anticipate that we will see an increased number of partnerships between private credit funds and (i) banks: a win-win strategy for private credit funds keen to originate more deals and banks who want to offload their mid-market corporates; (ii) Big 4 debt advisers with access to origination via audit networks; and (iii) other large managers with well-established track records and strong diversification, in each case demonstrating the trend for allocators to consolidate into larger funds in a flight to scale.

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# The continued opportunity for real estate debt and the use of back leverage as a tool to boost liquidity

There have been strong signs of growth in the market in the UK and Europe for real estate (RE) credit funds in recent years. However, data shows that bank lenders still have a greater share of the market than alternative lenders across Europe - unlike the US, where alternative lenders have overtaken banks - which suggests that there is further room for growth.

The current market conditions - where higher interest rates and lower valuations are coupled with caution or indeed retrenchment from banks in the RE sector generally - are favourable for those looking to capitalise on increasing demand for allocation to RE debt and continue that trend of growth.

## The opportunity

Transaction volumes in the RE market across the UK and Europe were far lower in 2022 and 2023 than in preceding years, although are showing signs of some modest growth in 2024 so far.

Despite that, the requirements of borrowers in the current market are not straightforward. Valuations, particularly for some asset types, have fallen significantly since mid-2022, and many asset owners are holding assets for longer as a result. The focus is on refinancing in most cases, rather than sales at current depressed values, both for stabilised assets and development projects on reaching completion.

Alongside this, banks are less active in the sector as a result of increased caution following certain high-profile bank failures over the same period, regulatory constraints in the RE sector and the focus on management of their existing loan books where higher interest rates have put pressure on interest cover ratios (ICRs) and falling valuations have put pressure on loan to values (LTV), two key metrics in most RE loans. Banks which are lending in the current market tend to be focused on existing relationships and are offering increasingly conservative LTV and ICR ratios for senior financing.

All of this presents a particular challenge on refinancings where the LTV offered on the existing senior finance was higher than that available from the same or another bank lender. As a result, and coupled with the fall in valuations that has occurred over the last two years, the financing that would be available from most bank lenders in the current market will be for a lower portion of a lower valuation, leaving a gap to be filled.

Borrowers seeking to refinance are therefore turning to lenders who have the ability to offer whole loan solutions with a higher LTV attachment point and a lower ICR requirement than senior financing and equivalent to what would be available in a senior/mezzanine structure.

With more flexible capital and without the regulatory capital constraints that banks face in the RE sector, RE credit funds able to offer these products are well placed to capitalise on this opportunity. Those which can also offer creative solutions to plug the “gap” presented by the current market conditions – perhaps including preferred equity coupled with their whole loan, or permitting an element of interest to capitalise during an asset’s stabilisation period – can offer tailored solutions which meet the often complex needs of prospective borrowers.

## Further boost to liquidity?

While market conditions are prime for RE credit funds to gain, and for banks to lose, market share, there continues to be an important role for banks in the RE debt market. Certain banks are in fact increasing their exposure to RE debt indirectly, by providing back leverage to the RE fund lenders.

Back leverage allows an RE credit fund to borrow from, typically, an investment bank, to finance part of its loan to an underlying borrower which is secured on RE assets. This can be achieved through a variety of products, the most common being loan-on-loan and repo facilities. Read more on these structures in our article, Back leverage - a deep dive. These products are an important tool for managers to increase their available capital, allowing them to grow and diversify their portfolios, as well as boosting their returns.

The choice of back leverage structure will take into account a number of factors, such as capital and risk treatment for the back leverage provider, control and security over assets, documentation cost and complexity and asset size and diversity. For example, repo structures, often suitable for larger pools of underlying assets, can allow for securitisation capital treatment and reduce direct exposure to underlying assets, while loan-on-loan structures, most commonly used for single asset transactions, typically provide more flexibility and simplicity for managers.

Particularly for new or smaller managers, the availability of back leverage to fund a portion of their commitment to an underlying borrower, can free up capital allowing them to build out their portfolio. That can also be attractive for investors, as it allows the manager to establish a more diversified portfolio more quickly than they would otherwise be able to.

Importantly, back leverage increases the potential returns for the fund lender by capturing the same level of interest income on the underlying loan, with less capital invested.

For the reasons outlined above, borrowers are generally seeking higher leverage from RE credit funds at equivalent levels to what they would achieve in taking senior and mezzanine debt. Executing a senior/mezzanine transaction remains a credible option for some borrowers, but it carries higher execution risk, which can make a financing offer from an RE credit fund able to offer a whole loan (with their own back leverage in place), more compelling.

Borrowers do not ordinarily face back leverage providers in their negotiation with RE credit fund lenders, but do benefit from the availability of finance and competitive terms that RE credit funds can offer, facilitated by the availability of back leverage.

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# Private capital ESG investment opportunities with a Labour Government

## On 9 June 2024, the new Labour Government instructed civil servants to begin work on the National Wealth Fund (NWF). It is to be seeded with £7.3bn (in their first Parliament), to invest alongside private capital in the "new industries of the future".

Labour plan on attracting three pounds of private investment for every one pound of public investment and investments are intended to be made from the fund into energy and climate related investments to "build British industry".

Now launched with the help of the Green Finance Institute and with Mark Carney (former Bank of England governor and NWF taskforce member), the NWF will have a green focus, but how attractive will these opportunities be to private capital managers?

The fund is intended to be deployed in the following areas:

- £1.8bn to upgrade ports and build supply chains across the UK;
- £1.5bn to new gigafactories supporting the UK automotive industry;
- £2.5bn to rebuild the UK's steel industry and decarbonisation programme; and
- £1bn to accelerate the deployment of carbon capture and £500m to support the manufacturing of green hydrogen.

Certain LPs are actively seeking opportunities to invest in funds which are investing in green assets that have potential to deliver an impact return (see The demand for "impact" like fund features in private capital), hence projects and assets in these areas can look attractive.

Particularly, for an infrastructure fund manager, the list of expected funded projects may fall within, or adjacent to, their existing fund investments, e.g. gigafactories which use proven technologies and which the Government claim there is a lack of supply to satisfy the UK's level of demand for batteries.

However, regarding technologies such as carbon capture and green hydrogen, many established private capital managers will likely deem these projects as less attractive to invest in, given the lack of track record of performance. Even if the Government, via the NWF de-risks the investment with its own capital, they may still find it hard to overcome the risk profile of these investments.

Either way, there are certain fundamental legal questions to be answered first to understand the scope of opportunity for private capital managers, such as, how the NWF will be structured and how the fund will flow through into the intended investments.

Even if the answers to those questions are unfavourable from a private capital perspective, the associated opportunities could be more fruitful, a significant number of technicians will need to be recruited and trained to install and maintain the expected renewable energy assets, the new green industries will require robust logistics, supply chains, recycling facilities and information technology solutions, each provided by businesses which are more likely to fit the risk profile of a private capital manager.

From a legal perspective, businesses supporting these emerging green industries are no more or less likely to be performing well from an ESG perspective, in fact, the risks of things like greenwashing are likely to increase, meaning that robust legal and ESG diligence is imperative, regardless of the perceived positive impact a target company may have.

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# Data centres

## The opportunities and challenges of booming demand

Demand for data centres is booming as a result of the exponential growth of data consumption, driven by increased internet usage, proliferation of smart devices, the advent of technologies such as the Internet of Things, generative AI and big data analytics. A recent report by JLL predicts that data centres will become a £248bn global market by 2026, representing a 107% growth from the 2020 value of $153bn.

### Market opportunities and challenges

The market has benefitted from the growing reliance on digital technologies, which ensures a steady demand for data storage and processing. This demand is bolstered by legislative trends in various jurisdictions that mandate the localisation of data, requiring businesses to store data within the country where it is generated. For instance, GDPR restricts the transfer of personal data outside the EU unless certain safeguards are in place, often necessitating the presence of local data centres. These regulations typically result in a surge in demand for data centres in specific regions.

Shortages of capacity in data centre markets in Frankfurt, London, Amsterdam, Paris and Dublin are likely to create opportunities for secondary markets such as Madrid, Rome, Barcelona or, in the US, Reno Nevada. Nordic countries will be especially well placed to benefit from the increase in data centres built for high-performance computing and AI, as a result of the reduced need for innovative cooling techniques due to the lower ambient temperatures in those areas.

Increased focus on ESG poses a challenge for such an energy intensive asset class. The EU's recast Energy Efficiency Directive, which introduces a new ratings scheme for data centres whereby EU operators must now report key performance indicators related to sustainability to the European Database, exemplifies regulatory pressures to adopt sustainable practices. Owners must consider future proofing their developments, investing in sustainable technologies and looking for innovative ways to use the excess heat generated by their data centres, for example to power neighbouring homes and developments (exemplified in Stockholm and Helsinki).

Some cities have introduced moratoria on new data centres, citing concerns over energy consumption and environmental impacts. However, some of these moratoria have been lifted with the introduction of strict criteria for efficiency and sustainability (for example, in Amsterdam and Singapore), reflecting a qualified approach to expanding data centre infrastructure. Furthermore, other locations are actively seeking data centre development, recognising the economic benefits and the role of data centres in supporting growing sectors like AI. The UK Government, for example, has shown support for data centre development by streamlining the consenting process and signalling that data centres will be recognised as Nationally Significant Infrastructure Projects.

### The future

We expect the increased need for data processing and storage to lead to a surge in demand for data centres. However, owners and occupiers must look for innovative solutions to navigate the environmental impact of these assets. As the market evolves, staying abreast of legislative and regulatory changes will be crucial for data centre owners and operators to ensure resilience and compliance.

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# Risk management and ESG

# The demand for "impact" like fund features in private capital

**Traditionally the preserve of specialised impact managers, requests for impact-like returns have been creeping into the list of requests from investors into non-impact focused managers.**

## Impact vs ESG

As a strategy, an impact fund will aim to generate positive, measurable, social and/or environmental impact alongside a financial return.

For private capital managers, most have approached ESG as a risk mitigation tool integrated into governance structures, risk management procedures and investment processes, primarily with the aim of reducing ESG risk to the fund and preserving capital for the fund's investors. Additionally, within portfolios, ESG has been seen as a value creation tool by utilising responsible stewardship and embedding ESG throughout the hold period of an investment and adding value prior to exit.

## State of play

Whilst many investors are happy with the traditional ESG integration and value creation approach, a smaller but important pool of investors have been looking for features akin to impact.

For some, depending on the strategy and region, an investor may be merely requiring the ESG practices of the underlying portfolio companies to improve, which could be in the form of improving employee benefits and engagement, reducing carbon footprint, energy usage or maintaining a more rigorous set of information security policies and accreditations.

Arguably, these are the sorts of things some houses do in a business as usual circumstance as part of their value creation strategies. However, as the ESG requests progress, the difference might be a requirement for specific thematic ESG improvements and/or metrics and targets related to such improvements, vs a generic commitment to aim to practice responsible stewardship. This may feel within the realms of possibility for some private capital managers, for others e.g. credit managers, without the support of an ESG engaged sponsor, this is far less achievable.

For others, this may manifest as a request for the fund to be investing in businesses doing something to benefit social or environmental causes or innovate products and services which aim to solve complex challenges in society or the environment (or a proportion of the fund).

## Challenges

- **Expertise** – before an agreed position is reached, both a fund and its investors need to establish if they have the expertise to determine and report the requested "impact like" features. Even if the answer to this is yes, a programme of education may also be required to be undertaken with deal teams and investor relations teams to ensure the strategy and metrics are understood in sourcing of deals and ensure that greenwashing risk is reduced in communications with investors.
- **Harmonization with existing procedures** – careful consideration needs to be undertaken to ensure that the agreed position works in harmony with existing ESG/sustainability procedures. For example, if the fund in question discloses certain sustainability-related information pursuant to SFDR or directly to investors through certain requested ESG-related reports, thought needs to be put into how these will interact with any agreed impact-like required disclosures and where these will be disclosed.
- **Defining impact** – often it is not clear what sort of "impact" or sustainable features/themes an investor is seeking and whilst one investor may have clarity, this may not be consistent with the requests of other potential investors. There are a plethora of impact measurement tools and reporting methodologies as well as infinite proprietary methods of evidencing impact.
- **Cost and returns** – the resources required to manage the process of defining "impact-like features", both from a commercial negotiation perspective, as well as from a legal documentation perspective can be lengthy and most are unwilling to do so without experienced legal support. Once frameworks and methodologies are established, resource will be required to ensure that each commitment made is delivered and reported on in accordance with the agreed commercial position. This could prove costly on an ongoing basis. Some consider that these additional costs, more limited deal opportunities and competition for assets could lead to a reduction in returns.

- **Liquidity** – if the impact requests are to invest in innovative, developing and/or new technologies to help solve complex challenges, then these investments might be unproven and not fit the risk profile of a traditional equity or debt manager and could reduce the pool of buyers and exit opportunities. However, this type of strategy could suit a manager with a venture strategy and a different risk profile.
- **Deal opportunities** – where deal opportunities are presented which are more obviously capable of fulfilling an impact or sustainable set of criteria (and without the risk profile issue mentioned above), these will often be highly sought after and competition for these assets could be fierce.

Given private markets investing is typically directly into the underlying assets as opposed to public markets investing (where often the investment is refinancing an existing investor), arguably there is a better case for additionality of impact in private markets. However outside of traditional "impact managers" there are various issues and hurdles to overcome in moving to "impact-like features". For those that can overcome these issues, certain pools of investor capital may be available where it wasn't before.

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# Anti-greenwashing

## Greenwashing

Greenwashing is the practice of making exaggerated, misleading, or unsubstantiated claims about the sustainability characteristics of a product or service.

Investors can be misled by a fund manager if the manager makes misleading, exaggerated or unsubstantiated claims about a fund's sustainability related features. Whist the reputational risks of this are well documented and clear, the risk of legal and financial penalties has increased since the FCA's Anti-greenwashing rule came into force on 31 May 2024.

Under the rule, references made to the sustainability characteristics of a product or service must be: (i) consistent with the sustainability characteristics of the product or services; and (ii) clear, fair and not misleading.

## Application to private capital managers

Many private capital managers have assumed that this applies to retail funds (which it does), however the rule applies to private capital managers as well as retail fund managers and applies to all FCA authorised firms.

The FCA has made it clear that sustainability claims should be presented with the intended audience in mind. For a private capital manager, often LPs are sophisticated professional investors and consequentially the sustainability information should be presented in an appropriate way, with such an audience in mind.

## Application to non-ESG and impact funds

The rule applies to all FCA authorised private capital firms and is not limited to those who manage funds with ESG, impact and sustainability features.

## For closed-ended private capital managers, how does the rule apply outside of fundraising?

The rule applies not only where a firm communicates a financial promotion to a person in the UK, but also more generally where it communicates with clients in the UK in relation to a product or service.

This means that investor presentations, reports, website content, updates to investors and other communications, relating to a fund are caught by the rule, regardless of the fundraising cycle.

## Application of the rule to private capital managers outside of specific managed funds

Whilst technically the rule is drafted in relation to "products or services", in guidance, the FCA has said that firms should take into account how firm level claims may be considered as part of the "representative picture" in a decision making process, hence a prudent manager should follow the rule and associated FCA guidance with respect to manager level communications and sustainability claims.

## Portfolio company greenwashing concerns

Given the financial and legal implications of a greenwashing claim, managing greenwashing risk in a private capital provider's portfolio is essential to ensure these risks don't impact returns.

The FCA's rule applies to FCA authorised firms. Portfolio companies in the financial services sector are often FCA authorised themselves and they too should follow the FCA's rule and accompanying guidance.

In addition to the FCA's anti-greenwashing rule, the Competition and Markets Authority and Advertising Standards Authority has issued guidance and codes on the subject of greenwashing to prevent the misleading of consumers in relation to sustainability related claims. For those portfolio companies to whom these apply (including FCA authorised entities) these rules should also be adhered to.

One tool for managing such risk is conducting thorough ESG due diligence on the acquisition of portfolio companies and conduct ongoing greenwashing assessments throughout the hold period of the portfolio companies.

## Practical tips for private capital managers managing the risks of greenwashing

- Create an anti-greenwashing checklist for staff to use when producing marketing materials and communications to investors.
- Provide anti-greenwashing training to all staff, however with a particular focus on those with day-to-day contact with investors (e.g. investor relations teams).

- Have any claims verified by an external third party and where data is provided by external data providers, diligence those providers to ensure they are managing greenwashing risk.
- Ensure that sustainability claims are:
  - correct and capable of being substantiated;
  - clear and presented in a way that is capable of being understood;
  - complete and do not omit or hide important information and consider the full life cycle of the product or service; and
  - fair and meaningful when including comparisons with other products or services.
- Retain evidence as to why such claims meet the requirements of the rule.

## Fines

The FCA's Head of ESG has stated that "fines will come" indicating that greenwashing is a key regulatory and legal issue to be managed both at fund level and in portfolios to preserve capital and protect returns.

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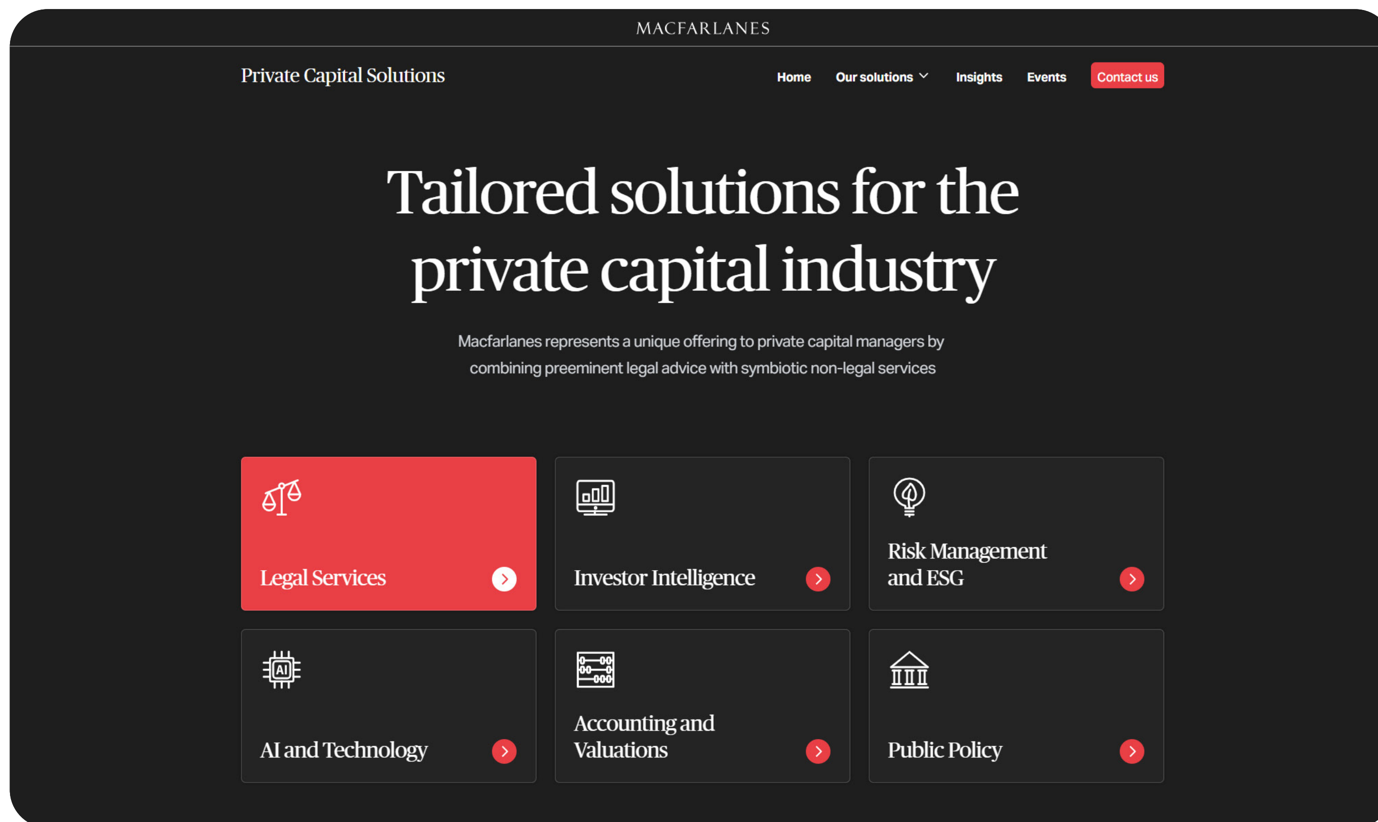
# Private Capital Solutions

Earlier this year we launched our Private Capital Solutions website. The site seeks to showcase our legal and non-legal solutions for private capital clients. Also on the site are our latest insights and upcoming events.

Insights included on the site include:

- Credit fund currency sleeves;
- NAV facilities to private equity and private credit borrowers;
- Tax distributions and carry clawback;
- Family offices and private capital; and
- Pension fund reform.



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