

SLAUGHTER AND MAY /

CAPITAL FLOWS



Part of the Horizon Scanning series



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M&A: OVERVIEW OF 2023 AND 2024 OUTLOOK



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Although 2023 has seen a decrease in both transaction volume and average transaction value, this has largely been driven by the decline in private equity activity. By comparison, the volume of corporate-to-corporate transactions has stayed more stable, with just a 15.9% decrease globally and a 6% decrease in the UK (for the first three quarters compared to 2022).

The outlook for 2024 is looking healthier. While we expect market uncertainty to continue as high interest rates remain, M&A activity is likely to increase, driven by distressed M&A, an abundance of PE dry powder, corporates seeking strategic acquisition opportunities and ESG and digital transformations.

M&A TRENDS IN 2023

Fears of a global recession in the early part of the year (exacerbated by the turmoil in the banking sector following the collapse of Silicon Valley Bank and merger of Credit Suisse and UBS), and the impact of high interest rates, led to market uncertainty for much of the year. Deal value was down globally, with few mega-deals announced in 2023, but deal volume for corporate-to-corporate generally remained strong.

Some sectors, in particular, saw plenty of M&A activity throughout the year. Energy and power was the busiest sector (accounting for 14.5% of deal value in Q1-Q3) while the healthcare sector saw a 29% increase in deal activity compared to 2022.

The slow-down in private equity M&A saw the take-private boom of UK-listed companies of recent years drive to a near halt as sponsors sit on their capital and await market stability. Instead, acquirers have generally been peers looking for strategic acquisition targets. Across the board, the increased cost of debt led corporates to consider structuring transactions as all-share mergers or by way of equity funding, as an alternative to debt financing.

As we look ahead to 2024, although not expecting a return to 2021 levels, we are optimistic that we will see a rise in M&A activity driven by the following factors.

DISTRESSED M&A

Distressed M&A is predicted to increase in the first half of 2024 as high interest rates remain and companies are forced to siphon off under-performing non-core assets to raise funds for operational capital. Thinly capitalised growth companies will be especially affected, which could have a knock-on effect on corporates dependent on such companies for outsourced services.

DRY POWDER

The slow-down of PE activity in 2023 has resulted in unprecedented levels of dry powder for sponsors. As the market becomes less volatile with the expectation that higher interest rates are here to stay, sponsors are likely to take advantage of lower valuations and seek to deploy capital on new opportunities. Similarly, we expect to see a number of PE exits in 2024 as the market begins to stabilise and sponsors look to crystallise their investments.

STRATEGIC ACQUISITIONS AND DIVESTMENTS

2024 is likely to see even more strategic acquisitions, particularly bolt-ons and peer-to-peer M&A, as companies look to synergise and reduce ongoing costs given the current economic climate. Well-capitalised companies may take advantage of current market conditions to consolidate targets in their core businesses. In a similar vein, public companies may look to the high synergy potential of all-share combinations to provide some valuation flexibility in a difficult market.

As companies look to streamline their strategy with a focus on reducing costs, we expect to see more complex carve-outs (with de-mergers as possible dual tracks) allowing corporates to exit non-core businesses and creating opportunities for PE sponsors to acquire mid-sized standalone businesses.

OTHER FACTORS

We expect to see more ESG focused transactions in 2024 as the energy transition drives corporates to reconsider their sustainability goals and as governments look to provide financial support to material infrastructure projects.

We also expect digital transformation and AI to be a key driver of M&A activity as companies consider how to digitalise their offerings. However, regulatory hurdles may deter material transactions by Big Tech and other players seen to have a dominant position, especially in retail sectors where the authorities are increasingly focused on the less affluent consumer as the cost-of-living crisis continues.

MORE SOPHISTICATED M&A

As a result of these factors, we expect many of the M&A transactions in 2024 will involve experienced counterparties and be targeted in nature. As debt financing will not be a viable option for many purchasers, transactions may require alternative financing (whether equity or vendor financing) and are likely to be more complex as a result. We expect well-capitalised buyers to have a strong hand in negotiations of price and terms.

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CHINA OUTLOOK 2024



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MACROECONOMIC OUTLOOK

2023 was a year characterised by above-average global inflation and rising interest rates, tepid domestic demand, structural stresses in the property market and geopolitical tensions for China.

The first quarter of 2023 saw only US\$3.2 billion of new greenfield investment deals, a decline of 34% compared to the same period in 2022 and a fall of 75% relative to 2021. This trend continued in Q3 2023, as China reported a foreign direct investment deficit of US\$11.8 billion, the first quarterly deficit since figures were first published 25 years ago.

Unsurprisingly, dealmaking activity was subdued with Greater China (including Hong Kong, Macau and Taiwan) recording 702 M&A deals worth US\$62.3 billion for the first eight months of 2023, with total deal volume declining by 124 deals and an aggregate decrease in transaction value of 13% versus the same period in 2022.

Analysts predict that similar macroeconomic factors will continue to inhibit M&A activity in 2024 with China's GDP forecast to grow by 4.6%. This matches forecasts for slower GDP growth in Asia's developing economies in 2024.

RECENT DEVELOPMENTS IN CHINA

Notwithstanding the economic headwinds, recent developments in China offer some optimism of a rebound in M&A activity in 2024.

“China + 1” Approach but Continued Significance of China

China remains the top trading partner for more than 120 countries. Its share of global GDP in 2022 was around 18.8%, and China is forecast to contribute around 35% of global growth in 2023, after the annualised GDP growth of China exceeded expectations in the third quarter of 2023.

Against this backdrop, many foreign investors still view access to China's market as crucial to their growth, even though they are increasingly looking to manage their exposure by diversifying their geographical footprint. This was reflected in the recent survey by the European Union Chamber of Commerce in China, which revealed that only 0.2% of respondents are looking to divest fully from China and that one in 10 respondents report that they plan to diversify their future supply chain-related investments but will not make changes to their existing supply chains in China.

Foreign investors are increasingly adopting a “China + 1” approach in a bid to diversify and strengthen the resilience of their supply chains. Countries such as Vietnam, Thailand, Indonesia and India are popular destinations for establishing alternative destinations. There are, however, some lingering concerns in some of these alternative destinations, including tariffs, the experience and skill of the labour force and the quality of the logistics infrastructure. It is probably unreasonable to expect, at least in the short to medium term, that any single country would be able to match the scale of China as the “world's factory”.

While a “China + 1” approach suggests a reduced dependence on Chinese producers, due to the diversification of supply chains and reduced direct trade with China, data suggests that reliance on - and exposure to - Chinese producers may not have changed materially. The transshipment of goods through third party countries have correspondingly risen and Chinese companies have been embedding themselves in Southeast Asian supply chains. As an example, the Vietnamese government reported that Chinese firms invested in 45 new projects in Vietnam in the first 50 days of 2023 alone. The reduction of dependence on China’s producers resulting from the “China + 1” approach may not have been as significant as expected and might only seek to deepen the links between China and its new trade partners.

China’s Initiatives to Attract Foreign Investment

The Chinese government has rolled out a full range of initiatives in 2023 to attract foreign investment, boost the economic growth and improve investor confidence.

In March 2023, the “Invest in China Year” campaign was launched to give foreign investors a better understanding of the investment opportunities in China.

In July 2023, the Communist Party of China and the Chinese government vowed to improve conditions for private businesses, primarily by treating them in a similar way to state-owned enterprises.

In August 2023, the State Council released a new policy framework, titled “Opinions to Further Optimise the Environment for Foreign Investment and Increase Efforts to Attract Foreign Investment” which seeks, amongst other things, to improve the foreign business environment and ensure fair treatment of foreign investors so as to achieve an optimal investment environment and boost investor confidence. Key measures include: exempting foreign investors from taxes if the profits earned in China are reinvested; ensuring that foreign enterprises enjoy equal treatment as local enterprises; and clamping down on intellectual property rights infringements.

President Xi also pledged in November 2023 to remove foreign investment barriers and foster a market-oriented, law-based and world-class business environment.

While it remains to be seen how the slew of policies will be implemented - and while it will take time to restore the confidence of foreign investors - in a country where top-down signalling is both vital and effective for clearing of roadblocks, the developments in 2023 are a positive sign from the Chinese government to investors that it is open for business again.

Stabilising US – China Relations

Against a backdrop of tariffs, export controls and sanctions, both countries have recognised the need for stabilising their relationship following a prolonged period of heightened political tension. An agreement by the Chinese and US heads of state to continue on a path of diplomacy and co-operation, following a meeting which took place in November 2023, is an encouraging sign for investors.

Investments by New Economic Partners

A fall in foreign direct investment from companies in the US and nations with strong ties to the US, may allow other nations and economic blocs to partner with China. It is estimated that the Gulf Cooperation Council countries, whose sovereign wealth funds total around US\$4 trillion in collective capital, will increase their investment in China, and may reach as much as 10% to 20% of total foreign direct investments by 2030. The signing of bilateral agreements worth US\$10 billion between China and Saudi Arabia (a nation with traditionally close ties with the US) at the Arab-China Business Conference in 2023 is an indication of their willingness to deepen economic cooperation.

CAUTIOUS OPTIMISM FOR THE RETURN OF CHINA’S M&A MARKET

The macroeconomic difficulties are apparent but the continued significance of China to the global supply chain and recent developments such as the raft of policy measures introduced by the Chinese government to bolster an economic recovery and a recent Xi-Biden meeting do represent some reasonable bases for some cautious optimism for China’s M&A dealmaking in 2024.

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REGULATORY HEADWINDS FOR M&A

M&A deals are facing greater regulatory scrutiny, hurdles and delay than ever before. In 2024 we expect this trend to persist as the consequences of recent developments in the fields of merger control, foreign investment and subsidy control continue to unfold.



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MERGER CONTROL

Competition authorities worldwide are increasingly sceptical about the benefits of mergers, especially in concentrated industries. The UK Competition and Markets Authority (CMA), for example, intervened in over half of the mergers that were subject to a formal review in 2023, i.e., the transactions were prohibited, abandoned, or required remedies to secure clearance. Across the channel, the European Commission (EC) intervened in around a fifth of the non-simplified procedure cases it reviewed in 2023.

This interventionism is being driven by:

- concerns around previous under-enforcement, particularly in the tech sector
- a focus on the impact on innovation, particularly in tech and life science mergers
- renewed interest in vertical and conglomerate effects, and on non-price theories of harm
- uncertainty no longer being seen as a reason not to intervene

Increased interventionism is playing out both in terms of competition authorities adopting ever broader approaches to claim jurisdiction over global transactions, and through novel approaches to substantive reviews.

The CMA, for example, is willing to adopt creative approaches to establish its jurisdiction over cases where the target does not generate any turnover in the UK. One party acquiring

‘material influence’ over another is sufficient to intervene, giving the CMA further flexibility. Moreover, in 2024, the Digital Markets, Competition and Consumers Bill will **introduce** a new jurisdictional threshold to allow the CMA to review more vertical and conglomerate mergers.

In Europe, the EC now has a policy which allows it to examine deals where the jurisdictional thresholds are not satisfied in Brussels or the Member States. The EC used this policy to block Illumina’s \$8 billion acquisition of GRAIL - a US/US deal which did not satisfy the thresholds for merger control review anywhere in the EEA. The EC announced in August 2023 that it had accepted referrals of two further below-threshold transactions using this policy (*Qualcomm/Autotalks* and *EEX/Nasdaq Power*). We anticipate more of these referrals in 2024 and beyond as ‘gatekeepers’ are required under the Digital Markets Act to report transactions in the tech sector to the EC.

From a substantive perspective, in addition to intervening in respect of horizontal mergers, authorities are increasingly ready to intervene on the basis of complex theories of harm across vertical or adjacent markets. For example, the EC's recent prohibition of *Booking/Traveli* showed a willingness to depart from established guidelines and consider novel 'ecosystem' theories of harm. This interventionist trend is likely to continue meaning we can expect in 2024 further uncertainty in respect of merger control outcomes for complex cases.

A final hurdle that is here to stay is the need to make parallel notifications in some cases in both the EU and the UK. This requires careful management given that over one quarter of the cases notified to both authorities have seen some form of divergence in the outcome. In particular, conflicting approaches to remedies have seen the two authorities disagree on the necessity or acceptability of remedies in major cases like *Broadcom/VMware*, *Facebook/Kustomer* and *Microsoft/Activision Blizzard*. More generally, authorities around the world are taking a stricter approach to remedies. Proposals are being subject to detailed review, up-front buyer commitments are required in many cases, behavioural remedies are unlikely to be accepted and there is increasing scepticism about the acceptability of carve-out remedies.

FOREIGN DIRECT INVESTMENT

Recent years have seen a significant increase in countries equipping themselves with foreign investment screening regimes. Most recently Belgium, Estonia, Ireland, Luxembourg, the Netherlands, Slovenia and Sweden adopted legislation to establish new regimes. This trend is likely to continue in 2024 and beyond given geopolitical tensions, security of supply concerns and the presence of state-funded investors amongst other factors. Bulgaria and Greece, for example, are reported to be working on the development of screening regimes. The EU Foreign Direct Investment Regulation is also subject to revision soon. Since coming into force, it has led to more cooperation between European and national authorities, greater awareness of FDI issues and an increased prospect of national authorities tipping off their counterparts in other countries about transactions that may not have been notified.

The scope of investments that come under these regimes has also increased in many countries meaning that more transactions are now subject to mandatory reviews. Depending on the jurisdiction, reviews may cover direct and indirect stakes, minority investments, acquisitions of assets, real estate transactions, and joint ventures, among others. New technologies such as AI, data infrastructure, quantum computing and semiconductors, have joined traditional sectors for screening such as defence and energy.

Although more deals are now subject to foreign investment review, most transactions do not require remedies to secure clearance and only a handful are blocked each year. The UK government's **analysis** shows that, among the 866 notifications made under the National Security and Investment Act in the period between April 2022 and March 2023, around 1% of deals required some form of remedy, around 1% were withdrawn by the parties, and less than 1% were prohibited. In the EU, the EC's **analysis** shows that among the approximately 800 cases that were formally screened by EU Member States in 2022, around 9% were subject to a remedy, around 4% were withdrawn and around 1% were prohibited.

SUBSIDIES

The EU's **Foreign Subsidies Regulation (FSR)** came into effect in July 2023. The FSR regime is intended to address distortions in the EU internal market caused by foreign subsidies.

Beginning in October 2023, the FSR introduced a new suspensory regime for acquisitions of companies with EU turnover of at least €500 million involving parties in receipt of substantial financial contributions from non-EU governments (at least €50 million across all relevant parties in the previous three years). Financial contributions are defined widely and include measures such as revenue from provision of goods/services, tax concessions, soft loans, support for the development of production facilities, funding for R&D initiatives, etc. Once a notification is made, the EC assesses whether the financial contributions entail a "subsidy". If the subsidies are found to distort the internal market, the EC can block or impose conditions on the transaction.

The FSR also includes a 'general market investigation tool', which allows the EC to investigate lower-value concentrations and all other market situations where a distortive foreign subsidy may be involved. In 2024 we will continue to see the effects this new regulation has on the market.

IMPACT ON TRANSACTIONS

The increased number of regulatory hurdles that now apply to many transactions calls for the careful planning and execution of an appropriate regulatory strategy. This is crucial to avoid unforeseen delays and uncertainty. It is important for parties to analyse their position under all applicable merger control, foreign investment and subsidy regimes at the early stages of transaction planning. This exercise should be carried out for acquisitions of minority holdings, as well as acquisitions of control.

Various factors can have an impact on the likelihood of intervention, including the structure of the transaction, the identity of the merging parties, the impact on competition or national security, and the prevailing political context. Careful attention should also be given to the relevant gun jumping rules which apply to a wide range of transaction structures.

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CAPITAL MARKETS



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A year ago, the Chancellor launched the “Edinburgh Reforms” with the stated ambition of making the UK “the world’s most innovative and competitive global financial centre”. Regulatory zeal for reforming London’s capital markets continued throughout 2023, most notably with the **FCA’s proposed changes to the listing regime**, which were outlined in May and further developed in December, and the HM Treasury-commissioned **independent review of financial services investment research**.

The reiterated recognition in the Autumn Statement that improvements to the legal framework and broader financial markets ecosystem are necessary to attract new companies to list in the UK - and to encourage UK-listed companies to retain their UK presence - is shared across government departments and regulatory authorities. Encouragingly, in light of the upcoming UK election, the reform initiatives enjoy bipartisan support from the two main political parties.

The 2024 outlook is one of cautious optimism: with the expected introduction of long-awaited reforms, and continuing government support, we are hopeful of renewed equity capital markets activity in the coming year. Increased debt market activity is also expected to be generated by many of the companies that tapped into the equity markets during COVID-19 and now face increasing refinancing pressures in the coming 2024/25 financial year which cannot be met by shareholders again.

ATTRACTING AND RETAINING EQUITY LISTINGS

In late December the FCA announced that it will press ahead with the proposals it consulted on in May 2023 in respect of collapsing the premium and standard segments into a single segment for Equity Shares in Commercial Companies (ESCC). The ESCC rules will be based mainly on the current premium segment rules, but some requirements will be modified or dropped entirely. Final rules will be published “at the start of the second half of 2024” and come into force two weeks later. Existing listed companies will be “mapped” to one of the new listing categories that will be created.

In a move which will significantly improve London’s competitiveness vis-à-vis other listing venues, there will be greater flexibility on dual class share structures, which are common in overseas markets and popular with founders who wish to retain post-IPO control of their creations. Companies that currently have a premium listing will no longer need to obtain shareholder approval for significant or related party transactions, which will improve the competitiveness of London-listed bidders for assets in cross-border transactions relative to peers around the world.

The new regime will place greater emphasis on disclosures driven by, and tailored to, the shareholder base and investor expectations for individual businesses by encouraging proportionate and thoughtful disclosures, rather than prescribing a “one-size-fits-all” approach. This may result in greater scrutiny on how directors discharge their duties in relation to decision-making on transactions. Until now, the need to obtain shareholder approval for significant and related party transactions has provided a measure of legal and practical protection; once such approval is no longer required, boards will need to decide for themselves whether a proposed transaction will be welcomed by shareholders and how much information should be publicly disclosed.

In addition, the positive impact of the FCA reforms in attracting both homegrown talent and overseas businesses seeking liquidity remains contingent on FTSE Russell concluding that the current eligibility criteria for inclusion in the FTSE indices will remain broadly the same for the new ESCC segment. No timeframe has been given for FTSE Russell’s deliberations. Institutional investors are generally limited to investing in companies with a market indexation, and it remains to be seen whether the traditional strength of the UK FTSE regime over its less predictable US counterparts will be maintained.

Concerns in 2023 about the state of UK capital markets were fuelled, in part, by the decision of UK-grown and headquartered ARM to list in New York. Although a handful of companies announced they would transfer their primary listing to the US, each had business-specific reasons for doing so, and the vast majority of UK-listed companies have retained their primary listing in London.

SUPPORTING LISTED COMPANIES

The efficiency with which much-needed funds were raised by LSE-listed companies during COVID-19 prompted the Pre-Emption Group to update its Principles in November 2022 - as recommended by the Secondary Capital Raising Review (SCRR) - to allow companies to seek annual authority to issue up to 20% of their share capital on a non-pre-emptive basis (instead of the 10% previously permitted). While take-up of the additional headroom during the first year of implementation was cautious, particularly among FTSE 100 constituents, we expect take-up to increase during the 2024 AGM season.

Many other recommendations made by the **SCCR** are yet to be implemented. There is general consensus among listed companies, regulatory authorities, market practitioners and other stakeholders that, while London has a good track record of supporting equity capital-raising, the documentation and process requirements for raising larger amounts of equity through a rights issue,

an open offer or other documented placing structure is unnecessarily costly and burdensome. Consultation on reforms to the prospectus regime and other efforts by HM Treasury and the FCA to streamline the current framework is expected to continue in 2024.

DEBT CAPITAL MARKETS

The key area of focus for the debt capital markets will be the upcoming reforms to the prospectus regime. The draft statutory instrument, The Financial Services and Market Act 2000 (Public Offers and Admission to Trading) Regulations 2023 will, among other things, grant the FCA power to make rules about various prospectus-related matters: [see our December briefing](#). We have been involved in preliminary discussions with the FCA on how it will use these powers, and a formal consultation is expected in 2024. As the current debt regime functions relatively well, the FCA will be seeking to make targeted improvements to the regime, with one of its more ambitious plans being proposals to revive the retail bond market in the UK ([see our May briefing](#)).

IMPROVING THE BROADER ECOSYSTEM

Through TheCityUK Capital Markets Group and The City of London Law Society, we are engaged in industry-led initiatives to nurture London’s broader capital markets ecosystem. This includes improving the quality and availability of investment research and encouraging retail participation through PrimaryBid and other platforms, all of which contribute to valuation and the overall attractiveness of London as an investment prospect. We hope that 2024 is a positive year for confidence in the London capital market.

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PRIVATE CAPITAL: ADVERSITY AND OPPORTUNITY



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Financial sponsors have enjoyed an unprecedented era of benign market conditions. A powerful combination of cheap debt, assets in plentiful supply and comparatively light-touch regulation have supercharged investment activity, valuations and returns. However, as Oaktree's Howard Marks observed over the summer, "the easy times – and easy money – are largely over".

Harder fundraising markets, increased regulatory scrutiny and less favourable macro-economic conditions will undoubtedly present challenges in 2024. There is, however, overwhelming pressure for financial sponsors to transact. Some are under pressure to liquidate investments and return capital to investors who may be over-exposed to private equity due to the so-called denominator effect triggered by the sell-off in public equities. The value of un-exited assets is at a record high, with limited partners increasingly impatient and pushing sponsors to achieve realisations rather than waiting longer for valuations to rise. Others will feel recently raised funds burning a hole in their pocket, as the industry as a whole seeks targets for more than \$1 trillion of dry powder. For many, it will be both.

ADVERSITY

As the private capital industry looks to 2024 and beyond, there are a number of significant challenges on the horizon:

- **Uncertainty:** The macro-economic environment remains volatile. Ongoing geo-political instability is a source of great concern; upcoming elections in the UK and US introduce considerable uncertainty; and fiscal and financial

policy agendas to combat inflation, implement extensive quantitative tightening and manage ballooning national debt all reduce conviction in financial models, requiring more prudent assumptions at the expense of up-front valuations.

- **Availability of capital:** For many, it is proving harder to raise new capital as investors are increasingly selective about who they choose to back. A trend towards fewer, larger funds, raised by an elite group of sponsors, will fuel consolidation amongst asset managers. We saw several of these transactions in 2023, including TPG's acquisition of Angelo Gordon and Bridgepoint's acquisition of Energy Capital Partners, and anticipate more over the next 18-24 months.
- **Increased regulatory intervention:** The private capital industry is high on the regulatory agenda. Financial regulators are seeking to improve transparency and impose more extensive protections for investors. Competition regulators have a stated agenda to investigate so-called 'platform' or 'roll-up' strategies involving the acquisition of multiple, smaller businesses

that would not typically trigger regulatory approvals. We have already seen direct intervention in some markets, such as dentistry, laundry services and veterinary clinics, and may see more as regulators broaden their focus. All of this in addition to a harder stance on the application of general merger control powers. Since its commencement in October 2023, the EU's FSR will also add a new, complex, and potentially onerous dimension to the scrutiny and clearance of larger deals.

- **An evolving financing market:** Although the end of the cheap debt era has not yet resulted in the wave of casualties gloomily predicted a year ago, we have seen both borrowers and lenders reassessing previously available borrowing multiples. The high interest rate environment has led to a focus on free cash flow and a borrower's ability to meet higher levels of debt service now operates as a constraint on borrowing (alongside financing EBITDA). Whereas previously, interest cover covenants (if included in documentation) did not attract much commercial attention, we now see both borrowers and lenders focusing on these covenants much more closely (and the potential for breach of existing covenants arising). The challenge for dealmakers will be to find the means to bridge the gap between the valuation multiples attaching to assets and available borrowing multiples.

OPPORTUNITY

Over the next 12-18 months, we anticipate a significant increase in the volume of transactions backed by private capital. Within these deals, we expect to see a number of themes emerge:

- **Competition for quality:** Current market conditions favour the strongest operating businesses. This will, in our view, renew focus on true 'alpha' investing, requiring detailed operational due diligence and post-acquisition enhancement as the primary route to generate value, rather than buy-and-build strategies reliant on multiple arbitrage (in effect, buying low and selling high). We expect real competition for assets displaying these characteristics, as we saw recently when acting for Inflexion on its sale of Chambers and Partners.
- **Smaller deals, harder fought:** We anticipate a trend towards comparatively smaller deals – something we have already observed in the P2P market as interest in FTSE350 and AIM companies has intensified, including from larger sponsors through acquisitions funded entirely by equity. We may also see greater complexity in transactions as sponsors seek to realise arbitrage opportunities. This may occur at the asset level (e.g. complex carve-outs) or through the capital structure of investments (e.g. increasing use of complex capital instruments such as convertible preferred securities in lieu of more conventional mezzanine finance).

- **Investing through the stack:** Sponsors with multiple strategies covering private equity, tactical/strategic opportunities and private credit are likely to be well-positioned to take advantage of current conditions. As seen in several recent, larger deals (EQT and ADIA's £4.5 billion offer for Dechra Pharmaceuticals plc and Permira's £703 million offer for Ergomed plc), sponsors have shown a willingness to deploy capital from different pockets across their business to support investment throughout the capital stack. This arguably simplifies underwriting and execution, minimises fee leakage and supports sponsors' global AUM.
- **Fund liquidity solutions:** With a period of slow market conditions, sponsors will continue looking for innovative solutions to generate liquidity for their investors while the M&A market slowly picks up, such as through NAV facilities and other fund financing products or GP-led secondaries transactions. This is more likely to provide shorter-term solutions, as LPs put pressure on asset realisations and increasingly assess sponsors on performance measures (such as distributed paid in capital) that seek to assess returns generated by the asset rather than relying solely on IRR.
- **Financing:** The wave of financing activity that occurred during COVID-19 is now approaching maturity, with a number of borrowers expected to need to refinance, or seek an amendment and extension package, within the next 12 months. This presents opportunities across the credit spectrum. In particular, we see the growth of funds targeting 'special situations' and 'hybrid capital' as offering opportunities for private capital to step in and provide risk-adjusted bespoke solutions to complex or stressed credits.

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PENSIONS DERISKING: PLANNING FOR AN ACCELERATED JOURNEY



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Levels of activity in the UK pensions derisking market in 2023 are on course to eclipse previous records, both in deal size and overall volumes (the previous record being £43.9bn in 2019). Projections are that market volumes could exceed £60bn in 2024 and continue to rise. This reflects trends in other jurisdictions including the US, which has also seen record volumes of pension risk transfer in recent years.

Activity in the UK market has also been supported by US and Canadian groups seeking to insure the liabilities of their UK defined benefit pension schemes (as we have seen in our work on transactions involving Intact and Walgreens Boots), which in some cases can be viewed as paving the way for potential M&A activity.

Dramatic improvement in scheme funding levels, in the wake of the 2022 mini-budget and subsequent gilt crisis, mean that many UK defined benefit pension schemes are now fully funded or above a funding level of 90% on a “buy-out” basis.

Scheme trustees may now intend to transfer risks to an insurer on an accelerated timeline, compared to previous journey planning. A well-advised corporate sponsor of a pension scheme should consider taking an active role in this process and appointing its own legal and actuarial advisers. This will help to ensure that it can shape the process and outcome, with its interests being reflected in the deal shape and terms, rather than leaving the Trustee and its advisers to progress a potential transaction independently.

By doing so the sponsor can overcome what are otherwise two material unmitigated risks. Firstly, the Trustee shaping and negotiating the asset size and terms solo, with the sponsor continuing to have the contingent funding liability for the scheme. Secondly, the governance and analysis of the underlying risks and their mitigation being contracted out to the Trustee board. Involvement from an early stage, with the governance that the sponsor would normally bring to bear on material asset acquisitions (through its board and

treasury, legal and other functions), will help to ensure that the sponsor’s interests are taken into account.

INSURING SCHEME RISKS AND SPONSOR'S ROLE

A corporate sponsor of a defined benefit pension scheme needs to consider whether its objectives are truly aligned with the trustee’s, both in terms of whether, when and how much to insure and the process, pricing and terms for the insurance transaction.

A large derisking project is akin to major M&A. The trustee is the transferor of assets and liabilities pursuant to a ‘buy-in’ policy, selecting a preferred insurer with which to transact from a competitive process and agreeing price and other terms for the deal. Once the premium is paid, the trustee has no assets beyond any contingency reserve established for the scheme, so the Sponsor is contingently liable for the consequences of these terms. This includes liability if the insurer defaults prior to issuing individual annuity policies to scheme members (known as ‘buy-out’), as well as for any uninsured unknown liabilities that emerge in the future.

A sponsor will also need to ensure that the trustee’s plans align with its own objectives, including on residual risks, the accounting impact and the approach to any surplus in the

scheme, which may be trapped if the sponsor continues to make contributions after buy-in. From a governance and reputational perspective, the sponsor needs to not only be aware of, and support, these consequences, but also to

influence their outcome by being front and centre of a joint working approach from the outset of the project, rather than becoming engaged at a later stage when the shape of the transaction is already formed.

"BIG BANG" APPROACH

RSA/Intact case study

- Single buy-in covered **40,000 members** and **c.£6.5 billion of liabilities** across two RSA schemes (February 2023)
- Pensions Insurance Corporation selected following competitive process
- c.£500m contribution from Intact
- Significant issues of timing and complexity, including structure to accommodate existing longevity and asset swaps and illiquid assets
- Sponsor-led process, working collaboratively with both trustees and their advisers to agree insurer-facing position

Key features of a "big bang" process

- Focus and engagement by principals akin to a major M&A process on a similar timeline
- Maximises competitive tension pre-exclusivity
- More flexibility on very large deals to negotiate terms beyond what is "market"
- Accelerated timetable to capitalise on market pricing windows
- Commitment of resources (internal and external) necessary to achieve this
- Collaborative approach required to develop and test innovative solutions rapidly

STRATEGIC PARTNERSHIP APPROACH

Tata Steel UK case study

- Four buy-ins under umbrella terms took cover to **c.£7.5 billion of liabilities** and **c.67,000 members** (Nov 2021 to May 2023)
- Coordination between insurer, trustee and sponsor throughout period to optimise pricing, asset and data preparation, transitioning investments and due diligence
- Scheme's investment management transferred to insurer's in-house asset manager prior to full insurance
- Sponsor and advisers fully engaged in negotiations throughout to ensure a satisfactory outcome for the corporate

Key features of a strategic partnership

- Soft/non-binding commitments from insurer to facilitate future transactions
- Often alongside umbrella terms / tranches, but could be used for single large buy-in
- Prioritised within insurer's business plan, (e.g. sourcing best assets, accepting illiquid scheme assets, bespoke terms)
- Increased transaction readiness, resources and transparency from the insurer
- Requires sufficiently strong relationship with insurer and support from advisers to mitigate reduction in competitive tension

Key things to manage for derisking transactions with very large pension schemes

- Illiquid assets of a scheme (e.g. property, derivatives) – insurer's ability to accept these assets and scheme's ability and optionality to maximise their value
- Existing scheme arrangements (e.g. insurance arrangements, asset swaps)
- Appetite for and availability of certain deal terms (e.g. residual risks cover, security from termination rights/collateral, deferred premium)
- Insurer ability to transition scheme assets / source sufficient assets and reinsurance capacity
- Regulatory engagement/scrutiny for insurers on very large deals
- Right-sizing internal and advisory teams, including to facilitate insurer due diligence process
- Governance, preparedness and managing expectations – including sponsor/trustee dynamics

CONTACT US TO FIND OUT MORE

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