



MACFARLANES

Private Capital Solutions

The macroeconomic backdrop to the private capital industry

This article considers our views on how certain macroeconomic developments may impact the private capital industry in terms of fundraising and deployment.

Macroeconomic overview

How is demand expected to hold up in 2024?

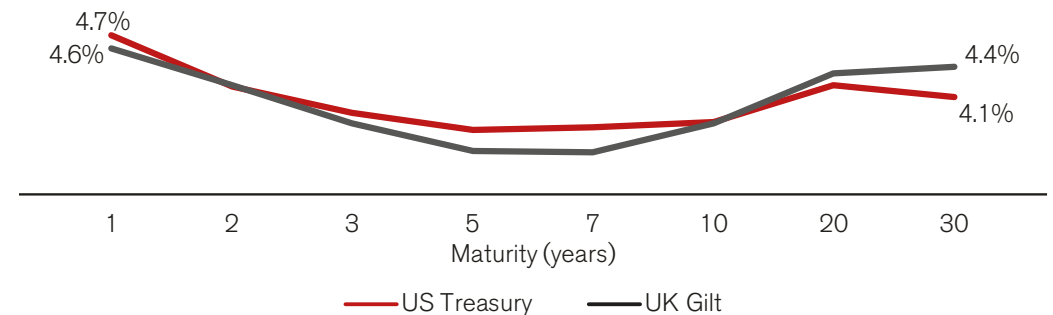
The International Monetary Fund's (IMF) World Economic Outlook stated that whilst global GDP growth had fallen from an annual rate of 4.5% over the past decade, it had remained remarkably resilient, trending down from 3.5% in 2022, to 3.1% in 2023, with the expectation of the rate of growth to remain at 3.1% in 2024.¹

The rates of growth diverged significantly in 2023 between advanced economies (with the US at 2.5%, UK at 0.5% and Europe at 0.5%) and emerging/developing markets at 4.1%. Forecasted growth rates for China, Brazil and India have been revised upwards for the next two years.

Interest rates and inflation

With UK inflation in December 2023 at 4.0%² (December 2022: 10.5%) and the comparative US rate at 3.4%³ (December 2022: 6.5%) there is the expectation of a downward trajectory in interest rates, reducing fears of a recession. However, recent rate announcements from both the US Fed and Bank of England have cooled expectations of such revisions occurring imminently. With short-term bond yields exceeding long-term yields ("an inverted yield curve") in the US since September 2022 and in the UK since March 2023, history suggests that there is still a risk of an economic downturn. Notably, every US recession in the past 50 years has been preceded by an inversion of the yield curve.

Yield curves – spot rate (%)



Source: Capital IQ

Impact on private capital industry

Fundraising

2023 was undoubtedly the toughest fundraising environment in recent times. As reported by PitchBook, this has resulted in longer fundraising cycles and first-time fund sizes being halved.⁴ As LPs rebalance their portfolios to reflect the value of other instruments they hold falling, there has been a flight to “stability first” investing with larger private markets managers being the beneficiaries.

However, the improving economic signals in the final quarter of 2023 have created optimism for 2024. This is supported by the increase in the aggregate capital raised by European private market funds in January 2024 standing at \$41bn, exceeding the \$36.1bn raised in the entirety of Q4 2023.⁵

Despite this, 2024 will still be a challenging fundraising year with managers focused on returning capital to investors to facilitate them re-upping into new funds.

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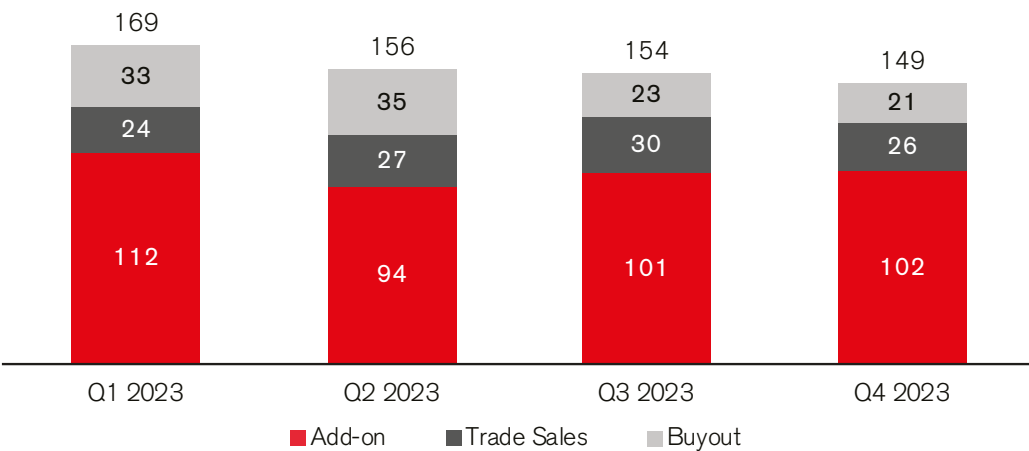
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Deal activity

Global dealmaking hit a 10-year low as a result of market sentiment, perceived valuation bubbles and the cost of finance. The impact has been most stark in large deals worth over \$10bn with these transactions seeing a 42% fall over the first nine months of 2023 compared to the same period in 2022.⁶ Reduced credit availability caused by fears of an economic downturn and more expensive debt financing terms has made large buyouts less feasible and desirable.

Private equity houses have been extending their investment holding periods and pursuing bolt-on acquisitions to generate further value. Bolt-ons have been the most popular deal type over the last year accounting for 43% of activity, followed by buyouts at 12% and trade sales at 11%.⁷ Trade buyers that built up strong cash reserves over recent years have taken advantage of the less competitive acquisition market of 2023 and have been able to take a strategic long-term view to investments. As trade buyers tend to not rely as heavily on debt to finance their transactions, they have been less encumbered by unfavourable debt markets. This has led to trade sales being one of the more popular exit routes for private equity.

Private markets – number of deals by type



Source: Preqin Ltd.

The use of NAV facilities

As private market realisations stutter as a consequence of a stagnant deal market, fund managers have sought different methods in which to repatriate cash to LPs. This has led to a number of Net Asset Value (NAV) financing solutions cropping up.

NAV facilities can provide additional liquidity to support:

- a portfolio company through a liquidity crunch;
- fund value creating bolt-on acquisitions; or
- distributions to investors.

As the whole portfolio is used to secure the loans, NAV financing offers a cheaper option compared to debt financing for individual portfolio companies and extends the investment horizon. However, any subsequent drop-off in performance or failed exits could put the whole portfolio at risk. Investors are also, in some cases, sceptical about their use, particularly when used to return cash to them at what they might perceive to be an expensive cost of capital.



The use of NAV facilities will grow in 2024 given the turbulent fundraising environment, with ever increasing competition between lenders.

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Growth of private credit

Capital scarcity created by the increased pressure on banks combined with interest rates in the UK rising by 1.75% since the beginning of 2023, has enabled private credit lenders to earn higher origination fees and negotiate higher floors. Although fundraising levels have been down across both private equity and private debt, the slowdown in private debt has been less pronounced and the recovery is expected to be faster as currently two-thirds of managers are looking to fundraise and intend to raise larger funds.⁸

Some consider the current environment as a “Goldilocks moment” for private credit, given the favourable combination of high interest rates and low defaults leading to double digit returns. Mid-market lending in the US proved particularly attractive, delivering an annualised return of 11.15% in 2023 (trailing five years: 8.86%).⁹ However, there is some concern that the rates of default may increase as consumer demand weakens. Fitch Ratings has forecasted that rates of default in 2024 will rise to 4% (2023: 3%) and 3.5% to 4.5% (2023: 3% to 3.5%) for European and US high-yield bonds respectively. A large debt wall is approaching with a quarter of European high-yield bonds maturing in 2025, resulting in many issuers potentially lacking the cash reserves to repay the principal at maturity. This may pose an opportunity for private credit firms to negotiate improved terms with the issuer.

Real estate debt

One particular segment to benefit from the “golden age” of private credit is real estate debt, which grew significantly in 2023 as the number of funds launched tripled from the previous year and at least 10 fund managers launched their debut real estate debt fund in 2023. Falling property prices have caused loan-to-value (LTV) ratios to increase to a level which banks are uncomfortable lending at, leading borrowers to look towards more flexible lenders. Real estate debt funds have tended to focus on mezzanine or subordinated debt. However, as banks have become less competitive, fund managers have been able to access new opportunities in the more senior end of the real estate debt financing market to fund the lending gap.¹⁰



Real estate debt lenders will increasingly look to maximise the opportunities offered in this space by employing back leverage through a variety of repo and loan-on-loan structures.

Sector spotlight

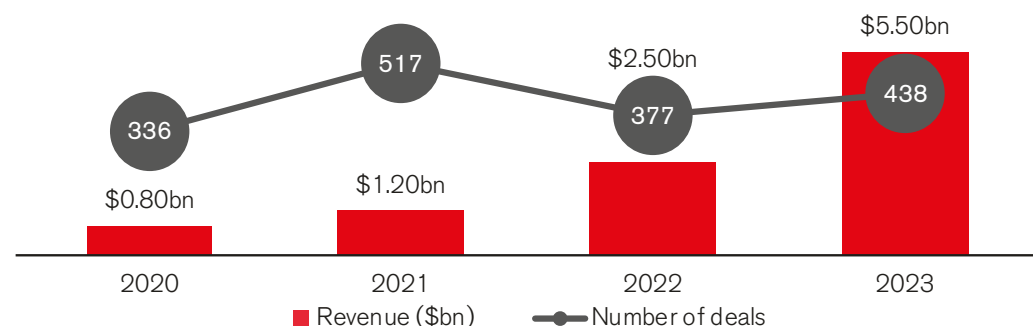
Artificial intelligence

AI was the dominant theme in the technology sector in 2023, driving the impressive performance of US-based stocks and leaving the UK market behind. The S&P 500 and NASDAQ indices soared by 25%¹¹ and 43%¹² in 2023, respectively, while the FTSE 100 gained a modest 3.8%¹³, reflecting the scarcity of tech companies in the UK. The AI app sector's revenue more than doubled and deal activity rose by over 14% between 2022 and 2023.^{14 15}

Growth of AI

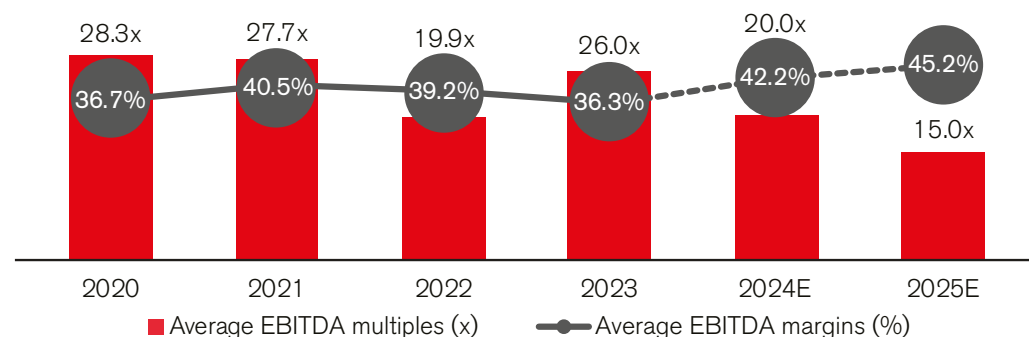
Nvidia, the leading producer of graphical processing units (GPUs) for AI applications, saw its share price skyrocket by 240%.¹⁶ The company benefitted from the influx of \$27bn¹⁷ into generative AI start-ups, which use AI to create new content such as text, images and music. One of the most successful AI products of 2023 was ChatGPT, a chatbot that attracted over 100 million users in less than two months, setting a new record for consumer adoption.¹⁸ However, the rapid growth of AI also sparked legal and ethical challenges, as some of the generative AI start-ups faced lawsuits and regulatory scrutiny for potentially infringing on copyrights and violating privacy. For example, Universal Music sued Amazon-backed Anthropic¹⁹ and the New York Times sued OpenAI²⁰, one of the most prominent AI research organizations. OpenAI also suffered from internal turmoil, as its CEO, Sam Altman, was briefly ousted and then reinstated after a revolt by hundreds of its employees.²¹

Growth of artificial intelligence



Source: Vantage Market Research, Preqin Ltd.

Semiconductors – sector multiples and margins



Source: Capital IQ.

AI companies rely on the advanced chips produced by semiconductor manufacturers to develop their products. The legal and governance controversies surrounding AI, combined with trade tensions, 5G rollout delays and weak consumer confidence, have led to a slowdown in the semiconductor sector in 2023. Many of the big players saw their revenue and EBITDA decline, with the notable exception of Nvidia. The high EV/EBITDA multiples seen between 2020-2023 (excluding 2022 due to the impact of the Russia-Ukraine crisis on supply chains) may be explained by the expectations of exponential future growth from the substantial investments into the sector on the back of the AI boom. As the growth curve begins to flatten in 2024 and 2025, the EBITDA and enterprise value growth rates for the market leaders are expected to stabilise, resulting in a moderation of multiples.

The outlook for the AI sector remains positive with investment forecast to surpass \$200bn²² this year. AI companies are aiming to create artificial general intelligence (AGI), a level of intelligence that can generate new scientific knowledge and perform tasks that currently require human involvement. The development of AGI will have wide reaching political, scientific and ethical ramifications. On the one hand, it could accelerate scientific progress towards creating the cures for illnesses, such as cancer and Alzheimer's, and find solutions to slow down or reverse global warming. On the other hand, it could have unintended consequences including its misuse for committing crimes, creating more destructive and targeted biological weapons with humans no longer being able to override or shut it down. Clear guidelines and regulations for the industry will be essential to ensure the responsible development and use of AI.

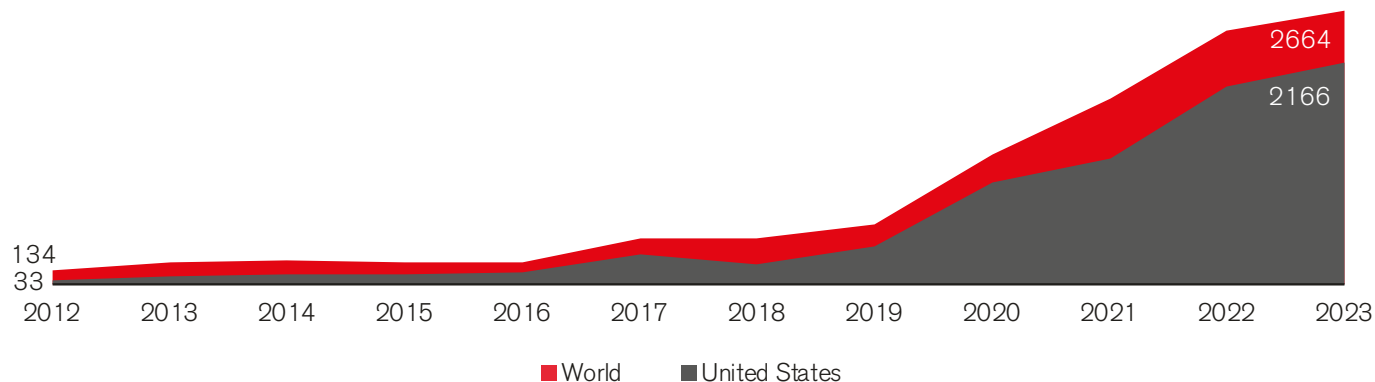
Aerospace/space

Lower costs due to technological advancements have made launching satellites and space activities more accessible and encouraged new start-ups to enter the sector. One of the key drivers of this growth is the development of reusable rockets, which have reduced the launch cost by around 70%.²³ With 81% of launches in 2023, the US is the market leader, far ahead of the UK and China, which are the next best countries with under 6% each. Satellite constellations, which consist of multiple satellites that enable global coverage, are expected to be a major feature of space enterprises in the near future.

The industry's revenue is projected to triple by 2040 and surpass \$1tn, driven by the rising demand for data and bandwidth from emerging technologies such as AI, virtual reality and autonomous cars.²⁴

The space domain has also become more militarised, as evidenced by the creation of the US Space Force in 2019, the first new branch of the US armed services since 1947, and the 19.5% increase in the national security space budget in the US in 2023.²⁵ ²⁶ Private equity firms are pivoting from speculative space opportunities to defence related investments to capitalise on the militarisation of space fuelled by rising geopolitical tension and recent conflicts. Government funding provides a large and dependable recurring revenue stream as these companies look to scale up.

Growth in launches into space



Source: United Nations Office for Outer Space Affairs (2024).

Endnotes

1 Data sourced from the International Monetary Fund. **2** Office for National Statistics. **3** U.S. Bureau of Labor Statistics. **4** Emerging managers' fundraising slump is a blow to smaller VC ecosystems, PitchBook. **5** Data sourced from Preqin Ltd. **6** Dealmaking languishes at decade low on private equity drought, Financial Times. **7** Data sourced from Preqin Ltd. **8** Key trends shaping the future of private debt, Private Debt Investor. **9** Data as of 30 September 2023 sourced from the Cliffwater Direct Lending Index. Returns are unlevered, gross of fees. **10** The growth of real estate debt, Macfarlanes. **11** According to Yahoo Finance. **12** According to Fortune. **13** UK's FTSE 100 gains for third year, but lags global peers, Reuters. **14** AI App Revenue and Usage Statistics (2023), Business of Apps. **15** Deal data sourced from Preqin Ltd. **16** Nvidia Stock (NVDA): What to Expect in 2024, Nasdaq. **17** Generative AI's wild 2023, MarketScreener. **18** ChatGPT sets record for fastest-growing user base, Reuters. **19** Universal Music Group sues Amazon-backed AI startup Anthropic, Quartz. **20** New York Times Sues Microsoft and OpenAI, Alleging Copyright Infringement, The Wall Street Journal. **21** Sam Altman: Ousted OpenAI boss to return days after being sacked, BBC News. **22** According to Forbes. **23** Investing in Space Exploration, Morgan Stanley. **24** Data sourced from United Nations Office for Outer Space Affairs (2024). **25** United States Space Force. **26** Funding the final frontier: A look at the FY23 national security space budget, Avascent.

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