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MoFo Global PE Trends 2022 and Outlook for 2023

As uncertainty looms over the global economy, what does 2023 have in store for the global PE market? In our annual report, MoFo partners from around the globe review the key PE trends from 2022 and make predictions from both global and regional perspectives for 2023.

2022 Global Trends

Most of our 2022 predictions came true. As a recap, below are some key trends that we identified and how our predictions fared.

Slower Second Half: Following the breakneck speed of transactions in 2021, the second half of 2022 saw a slowdown driven by inflation, rising interest rates, and geopolitical turmoil.

Tech M&A: We predicted that 2022 would be an exciting year for tech M&A and for PE funds, and MoFo's 2022 Tech M&A Market Survey revealed tech M&A was behind 2021's historic run but still well ahead of 2020 and preceding years.

Increasing Regulatory Challenges: Our prediction of increasing regulatory challenges also proved true. Following an unprecedented reduction in U.S. federal antitrust charges during the Trump administration, the Biden administration has significantly increased enforcement activities and signaled enhanced enforcement against private equity firms. National security and antitrust reviews in other jurisdictions, such as Germany, the UK, and China, also raised significant hurdles to cross-border acquisitions by PE funds.

Increasing Focus on ESG: As we predicted, mainstream PE funds have increased their focus on ESG in 2022 with growing investor expectations and reporting requirements. Our Asia Funds ESG Survey 2022 showed that Asia-headquartered GPs are starting to work to catch up with their U.S. and EU/UK competitors on ESG policies.

SPAC Activity Slowed to a Crawl: By contrast, our prediction about the continued SPAC wave did not come to pass, as SPAC activity in 2022 slowed to a crawl.

Future-Proofing Structures for Tax Purposes: Consistent with our predictions, in 2022 there was an increased focus on future-proofing transaction structures and IP-holding structures in light of new or anticipated tax regulations (such as minimum corporate tax rates, substance requirements, and other OECD tax reforms).

A Rise in Debt Pricing: Debt financing costs rose dramatically in 2022 due to economic instability, a lower appetite for risk, high-stakes real estate non-performing loans, and fears of a recession. This led to creative approaches, such as clubbing direct lenders for larger deals where underwriting banks had no capacity, and greater usage of lower-risk loan products such as subscription line/NAV/hybrid financings to fund investments. There was also a marked growth in ESG-linked financings and ESG documentation standards have settled.

Fundraising Slow but Still Moving Forward in Some Cases: In 2022, the fundraising market slowed for the first time in years, yet recent fund closings have proven that there is still significant interest in directing funds to leading, well-seasoned PE sponsors.

Increase in Secondaries and Continuation Vehicles as Exits: As exits via IPOs have become scarce in 2022, funds have increasingly looked to secondary sales and the use of continuation vehicles as alternative exit options.

2023 Global Outlook

How will economic uncertainty impact PE investing in 2023? The following are our predictions:

Continued Increase in Tech Investing: According to MoFo's 2022 Tech M&A Market Survey, over three quarters of respondents expect aggregate tech M&A volume to increase in 2023, with artificial intelligence and machine learning to lead the way.

PE Opportunities in Distressed Situations: With macroeconomic headwinds anticipated in 2023 and continuing stores of dry powder, we expect private equity sponsors will take advantage of the opportunities offered in distressed assets and from companies in need of capital.

Protecting Against Downside Risk: We anticipate private equity funds may pursue more structured equity investments to better protect against downside risk while still placing bets on good businesses expected to weather any sort of recessionary period.

Sectors to Watch: Agriculture/agtech, fintech, AI, and health care are hot sectors, on top of a more general rise in the more traditional consumer-led sectors.

Likely Return to China Investing: Economic growth may heat up faster in China than in the U.S. or EU/UK due to the expected lifting of COVID-19 restrictions in China and expected actions to be taken by the Chinese government to revive the market. This may result in global funds taking a 180-degree turn to significantly increase allocations to China despite continued geopolitical rumbling.

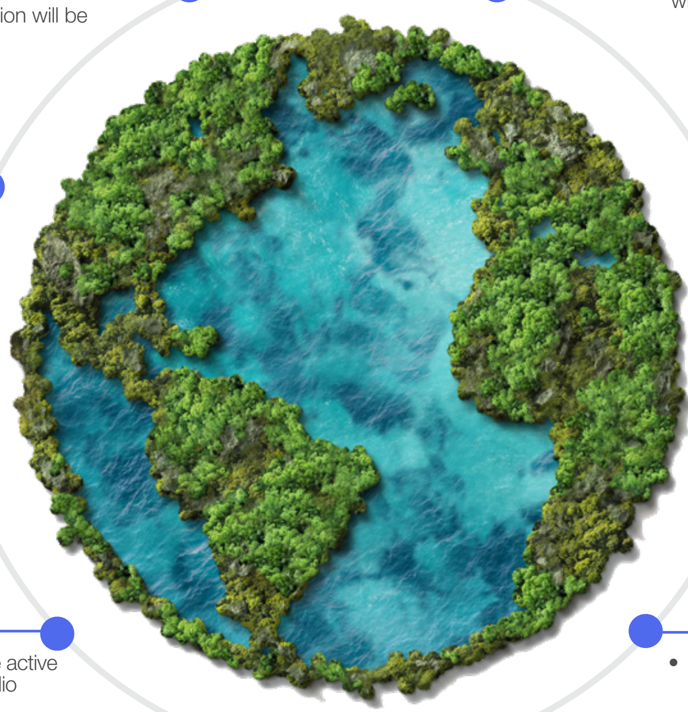
Increased Complexity in ESG: GPs will have to deal with varying and often conflicting requirements from the U.S. and EU and even varying requirements from LPs located in different states in the U.S. as some state legislatures adopt anti-ESG legislation that might impact where pension funds in those states can invest their money.

Focus on Profitability: We expect private equity funds to increase their focus on portfolio companies' profitability in light of tighter credit markets, higher insurance premiums, rising interest rates, rising raw material costs, and labor shortages.

Debt Market Terms to Tighten: Following an expected round of volatility, debt market conditions will improve during 2023, with normalization of acquisition finance lending/sub-investment-grade debt securities at higher prices. Increasing numbers of leveraged loan defaults could lead to the curtailing of covenant-lite terms in certain markets and we expect greater scrutiny on cashflows and the ability to service high-leverage multiples. Bank-led leveraged buyout deals will continue to be more conservative, and direct lenders will rise to fill the gaps and may well outpace bank deals.

Pace of Exits May Vary by Region: The pace of exits in 2023 will vary from region to region depending on the speed with which the economic situation improves. In the U.S. and Europe, exits may be more limited in 2023, as funds will be reluctant to sell in a down market. However, in China, where experts are predicting that the lifting of COVID-19 restrictions and the rollout of government policies intended to jump-start the market may result in a considerable increase in economic growth beginning in Q2 2023, exits will likely pick up steam over the course of the year.

Regional Perspective for 2023



China

- GPs will continue a considered strategy in China and seek more diversified exposure
- More Chinese portfolio companies will internationalize through re-domiciliation or JVs
- China M&A will be more integrated with local ecosystems
- Control rights and downside protection will be enhanced in China PE investments

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Southeast Asia

- Strong momentum for technology, health care, life sciences, and services investments will continue
- Real estate, infrastructure, and renewables will remain active
- Fewer buyouts and more mid-market deals will occur across the region

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UK

- Maturing National Security and Investment Act effective from January 4, 2022 will have an impact
- Opportunistic purchases of distressed assets and non-performing loan portfolios will increase
- Volatile debt markets and more creative approaches to debt financing will also increase

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U.S.

- Declining deal volume in 2022 is no predictor for 2023
- Regulatory scrutiny will affect all angles, including the demise of the SPAC market
- Creativity and patience will pay off in 2023; sponsors will look for inventive ways to deploy capital

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Europe

- Tech and software will continue to be active sectors for PE investment and portfolio optimization transactions
- The prevalence of continuation funds in the secondary market will increase
- ESG will continue to receive more attention in Europe

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Latin America

- While below 2021 levels, 2022 venture capital investments outperformed 2020
- Technology remains the sweet spot for investments, with a focus on Brazil
- High risks with high rewards in Latin America will attract investors in 2023

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Japan

- PE Investment in Japan will increase partly due to lower corporate valuations caused by the sliding Japanese yen and political stability
- Carve-out deals will continue to grow
- Real estate will be a hot sector
- GP/sponsor-led transactions will be on the rise

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United States

Unpredictability: Following historic highs, transaction volume slowed in 2022 Q3 and Q4. A theme among sponsors is that the market is unpredictable. Perhaps the only certainty is that nobody knows what 2023 will bring.

Adaptable Playbook: Given market uncertainty, with fewer assets coming to market, debt financing less available, and the slow down of deal volume, sponsors will continue to look for new strategies for deploying capital, including through the use of alternative transaction structures, take privates, and structured equity solutions.

Demise of the SPAC Market: Market-driven and regulatory factors halted the SPAC market in 2022. SPAC IPOs are much less common and deSPACs are challenging, typically dependent on structured securities to raise capital.

U.S. Regulatory Environment: There will continue to be increased regulatory scrutiny on transactions across sectors, especially for add-on transactions.

Weathering the Storm: The year 2023 will continue to see a focus on portfolio companies, including some add-on activity and reinvestments, especially in industries most impacted by the economic slow-down.

Latin America

A Return to Normal: Through June 2022, venture capital investments reached $5.4 billion, down from $15.8 billion deployed throughout 2021. However, 2022 investments still outperformed the $4.2 billion invested in all of 2020, and we will be watching to see if 2023 maintains the robust activity levels of 2020 or continues a significant downward trend.

The Lure of Tech: Investors remain focused on information technology, health care, and consumer products. Targeting a youthful, emerging middle-class market, technology innovators are looking to solve market inefficiencies in bureaucratic, slow-moving financial systems and improve an incomplete digital infrastructure. Brazil is expected to receive the lion's share of emerging market attention, as one of the last-standing "BRIC" markets attractive to investors.

Ongoing Balance of Risk and Reward: High-risk, high-reward opportunities will attract investors in 2023. During 2022, currency fluctuations, high inflation, interest rate increases, and regime changes were factored in risks in many markets. Presidential elections in Colombia and Brazil have concluded, but Peru's recent political and social upheaval elevates concerns. Such economic headwinds challenge both valuations and exits. Because publicly traded technology companies performed poorly in 2022, there may be further retrenchment by private equity firms, presenting valuation challenges for privately held companies looking for exits in the short term.

UK

Maturing National Security Regime: The UK government issued 12 UK National Security and Investment Act "final orders" in 2022 with three prohibited transactions and nine subject to remedies. PE firms must continue to consider the impact of this legislation on transaction timelines and whether target businesses and fund structures will raise national security concerns.

Increased Opportunistic Purchases: Geopolitical volatility, high inflation, and challenging debt markets will continue in 2023, creating opportunities for PE funds to purchase distressed businesses/assets or non-performing loan portfolios. Valuations of venture-backed companies will also be impacted, resulting in an increasing number of bridging and down rounds, and the need for portfolio company restructurings will increase.

Volatile Debt Markets: Tech and health care – including agtech and foodtech – continue to attract some of the highest valuations from PE houses.

Europe

Tech and Software Continue to Be Active: Market uncertainty will have less impact on tech and software deals than other sectors. With digitization as a driver of efficiencies, software businesses that are transitioning to the cloud will remain sought-after targets. However, there may be a contraction also in tech, compared to 2022.

Market Uncertainty and Higher Funding Costs Change Deal Landscape: Big ticket transactions will slow, with sellers reminiscing about high multiples and PE buyers struggling with market uncertainty and higher funding costs. However, market uncertainty will be used for portfolio optimization through add-ons and carve-out transactions. Also, with exits considered difficult due to market conditions, secondaries with continuation funds will increase.

ESG on the Rise: While European PE firms will continue to incorporate ESG KPIs as a compliance consideration, they will also take the further step of incorporating them as part of their overall investment strategy. ESG KPIs in financing agreements will become more and more ambitious, given the increased scrutiny and reporting requirements imposed on funds and banks by the regulators. Measuring and benchmarking portfolio ESG metrics will remain challenging.

China

Considered Approach in China: Geopolitical tensions and the ongoing U.S. audit dispute led to yearly China M&A transaction values plunging by 35% to US$266 billion in Q3 2022—the lowest since 2013. There are, however, early signs of post-COVID-19 restrictions economic recovery.

Chinese GPs Expansion into New Markets: Chinese GPs are seeking more diversified exposure and are keen to attract new capital in Southeast Asia, particularly from family offices in Singapore.

Internationalization of Portfolio Companies: PE funds will internationalize their China-headquartered portfolio companies through re-domiciliation and carrying out bolt-ons and restructurings.

More Integration with Local Ecosystems: The Chinese government's preference for local social media platforms and digital pay ecosystems means that data sharing, IP, and technology export issues are critical in all China PE investments. PE-backed unicorns are likely to emerge from relevant sectors.

Enhanced Control Rights and Downslide Projection: Management-led failure of once high-flying startups has resulted in PE/VC funds becoming less comfortable with a relatively passive minority interest in portfolio companies. More investors will gravitate towards control-stake buyouts and significant minority deals with enhanced control rights and downside protection.

Southeast Asia

Sector Momentum: Strong momentum for technology, health care, life sciences, and services (including financial services) investment will continue into 2023. Consumer, manufacturing, and industrial sectors will feature prominently on sponsors' radars as multinational corporations are shifting manufacturing and supply chains away from China to countries such as Vietnam, Indonesia, and Bangladesh.

Real Estate, Infrastructure, and Renewables to Remain Active: The infrastructure needs of rapidly developing countries, as well as mature assets in developed countries, will continue to attract significant investment. We expect continued growth in deal activity in the renewables sector as businesses explore ways to transition to sustainable energy sources and reduce their carbon footprint.

Fewer Buyouts and More Mid-Market Deals: While buyout activity across Southeast Asia in 2023 will be less frothy, mid-market deals, across the growth, late-stage, and pre-IPO spaces, will continue. A record amount of dry powder in APAC-focused funds needs to be deployed but, given the likely challenges of obtaining financing for large buyouts, we anticipate seeing more mid-market transactions and minority deals, possibly funded all, or mostly, in cash.

Japan

Increasing PE Investment in Japan: As predicted, major international PE sponsors continue to launch new funds specializing in Japanese investments and expand their existing operations in Japan, seeing Japan as a stable market compared to others in Asia. We have seen an uptick in Japan-based M&A activity (by deal value) by U.S. PE/VC firms, with aggregate transaction values exceeding 2021 amounts, driven by the sliding Japanese yen and low corporate valuations.

Corporate Carve-Outs and Real Estate: Carve-out deals continue to increase, particularly in real estate. There has been a wave of big PE players entering Japan's property market, attracted by yield spread, low interest rates, underutilized assets for sale, and an absence of legal restrictions on foreign ownership of real estate. J-REIT and property management companies have been the target of recent buyout activity.

Exits: While sales to strategic investors have historically been the preferred PE exit in Japan, we are seeing a growing number of secondary buyouts and fund-to-fund sales. There are also signs that GP/sponsor-led transactions are increasing, with some funds finding these transactions attractive for concentration limit management and investor return maximization.

Focus on ESG

Dedicated ESG Resources: Today, GPs are creating structures and firm philosophies that are embedded in operations and internal systems that demonstrate ESG integration throughout the investment process. PE firms in 2023 will increasingly implement operational change to ensure that ESG metrics are truly implemented and accurately measured.

Increased Greenwashing Scrutiny: We anticipate the global regulatory crackdown on greenwashing will continue in 2023, with a focus on misleading "green" or "sustainable" marketing claims. In 2022, U.S. and European regulators have imposed fines against investment advisors, banned advertising tied to greenwashing, and proposed anti-greenwashing measures, including ESG investment product labeling regimes. In 2023, greenwashing scrutiny will likely extend to securities, with the SEC increasing efforts to monitor investment practices and securities labeled as green or sustainable. In Asia, enforcement against funds and listed companies with regard to greenwashing lags far behind the U.S. and the EU, but changes are expected.

Continued ESG Skepticism: In the last two years, 31 anti-ESG pieces of legislation and policies were introduced in 19 U.S. states. We anticipate that asset managers will need to granularly substantiate the economic drivers for ESG investment philosophies, highlighting how ESG considerations are critical to enterprise value and the real risks posed to assets if companies fail to take into account ESG considerations.

Mandatory ESG Disclosure Regimes Crystalize: In 2023, corporates, asset managers, and investment funds are expected to ramp up sustainability data gathering and redefine internal policies and procedures to integrate sustainability-related metrics in their own operations and throughout their portfolios. In 2022, the SEC announced proposed rules on climate, cybersecurity, and enhanced disclosure requirements on ESG investment practices. The EU adopted its Corporate Sustainability Reporting Directive (CSRD), which will require robust annual ESG reporting for in-scope companies. The Stock Exchange of Hong Kong (HKEx) adopted the revised Corporate Governance Code, which enhances requirements for gender diversity at the board level and requires ESG reporting to be included in each annual report. In 2023, it is expected that (i) the SEC will finetune its ESG-related proposals, (ii) the EU will adopt the final European Sustainability Reporting Standards pursuant to the CSRD, and (iii) the HKEx will align Hong Kong's regulations with the Task Force on Climate-Related Disclosures' recommendations and the International Sustainability Standards Board's focus on climate disclosures.

For More ESG Insights:

Focus on Distressed Situations

It is likely that the distressed market will be more active in 2023, with private equity experiencing greater activity in liability management and distressed asset acquisitions.

Liability Management: PE firms and their portfolio companies should focus on maintaining liquidity.

Liability management is important for portfolio companies that experience reductions in cash flow, especially in markets where debt and equity investors are becoming more conservative.

Companies and their sponsors should resist the urge to tread water (and hope the business environment will improve) and instead should proactively take steps to enhance liquidity and improve operations as early as possible. They should stay focused on their liquidity positions and be proactive in operational optimization.

Distressed Asset Acquisition: PE firms will have increased opportunities to make targeted acquisitions of assets from distressed market participants. And there will likely be opportunities to provide capital to companies through structured investments which can provide attractive returns, with more limited risk, all while positioning the investors to achieve attractive risk-adjusted returns.

PE clients should be ready to act quickly to conduct due diligence and be committed to move swiftly on closing distressed acquisitions.

Often bankruptcy processes can offer great opportunities while improving the liability position of potential targets.

MoFo Global Contributors

How Can MoFo Help?

- For more information on our insights into global PE trends and the outlook for 2023, please contact Marcia Ellis, Global Co-Chair, Private Equity Practice, Patrick Huard, Global Co-Chair, Private Equity Practice, or Mitchell Presser, Private Equity Partner and Co-Chair, Food + Agriculture Practice.
- Subscribe to MoFo's PE Briefing Room to stay up to date on the hottest topics in the global PE space.

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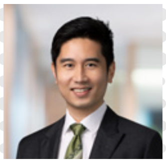
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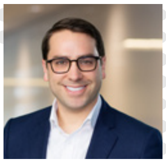
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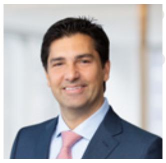
Distressed Situations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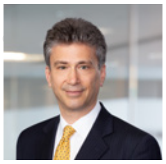
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