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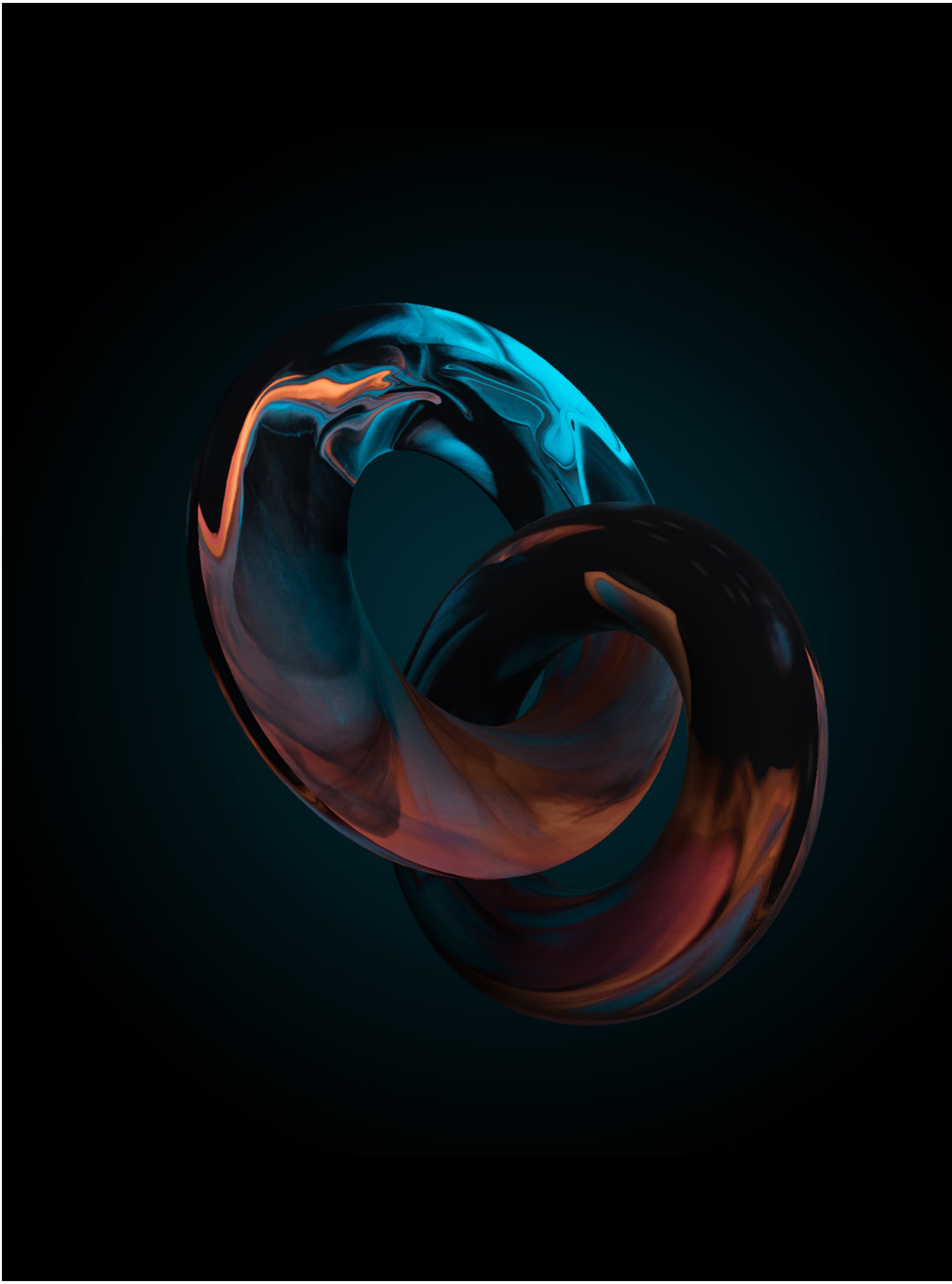
Future Forces 2023:

the megatrends shaping the private capital industry

Outpacing change

Based on research by ECONOMIST IMPACT



Key takeaways

The prospects of prolonged economic uncertainty led by financial market instability (35%) and protectionism (38%) present the top two risks that weigh heavily on executives' minds in the financial industry.

Despite a challenging environment, private capital is likely to continue flowing to high-tech sectors, including start-ups developing artificial intelligence (AI) and renewable energy solutions.

In the meantime, automation, the Internet of Things (IoT), and cybersecurity figure as the top technologies likely to have the biggest positive impact on the industry.

Executives from private capital firms harbour deep concerns about portfolio companies' ability to secure needed talent and skills. Skills will be the biggest challenge (42%) their businesses face in the years to come.

The fortunes of private equity (PE) firms and other private capital institutions changed abruptly in mid-2022 when central banks, led by the US Federal Reserve, launched the first in a round of successive interest rate increases.

Senior fund partners suddenly faced the end of the low-cost deal financing that had fuelled transaction growth for over a decade.

This article focuses on equity investing (PE and venture capitalism) within the private capital industry and draws on the results of Economist Impact's survey of 60 global banking and private capital executives. Among different megatrends examined in this study,[1] the impact of changing global dynamics—and macroeconomic policy specifically—has weighed especially heavily on this sector and is likely to continue doing so for the next year at least.

Nevertheless, the engine of technology change remains strong and will continue to offer attractive growth opportunities to private capital firms. And their role will be instrumental in funding the drive across industries to achieve net zero carbon emissions.

Megatrend	Implications for Business
Changing global dynamics	Organisations must develop their risk management capabilities and build resilience to adapt to the growing frequency of political, macroeconomic and public health shocks, among others
Net zero transition	Organisations will need to decarbonise their operations and mitigate their climate risk
Digitalisation	Businesses will fall behind if they fail to derive greater value, efficiency and convenience from technological innovation and the digitalisation of their products and services
Demographic change	Remaining competitive requires businesses to adapt their products and services to meet the needs of diverse groups of customers while accommodating workforce ageing, the younger generations' changing preferences and a growing focus on social sustainability
Skills for the future	Amid workforce ageing and continued shortfalls of critical skills, organisations will need to prioritise reskilling and upskilling to fill the gaps
Resilient cities	When cities become denser, more congested and increasingly impacted by climate change, organisations can help them remain productive and able to cater to the community's diverse needs; cities must also be safe and affordable places for people to live and work

Macroeconomic uncertainty

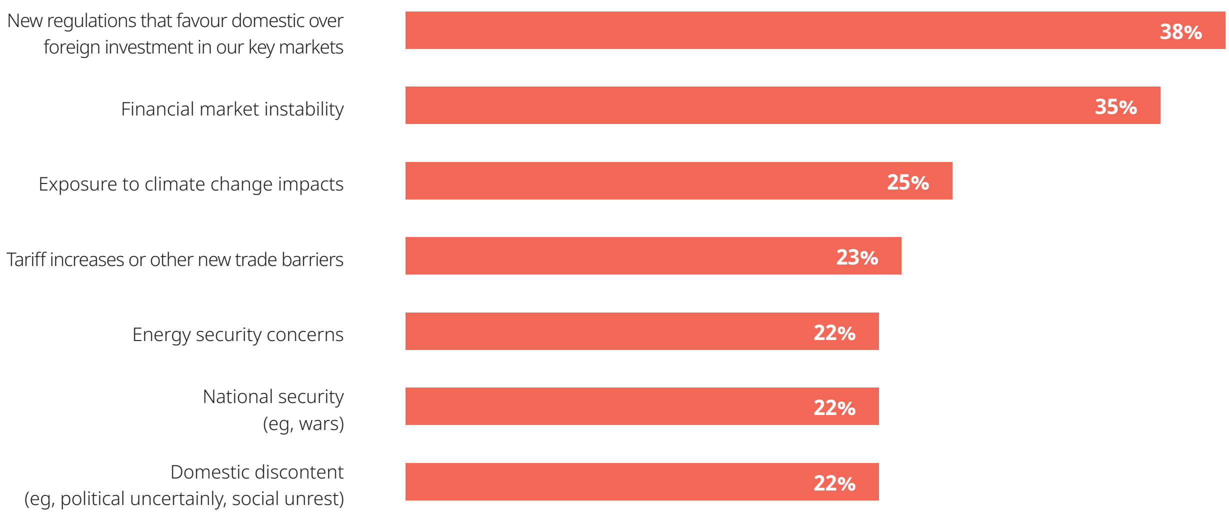
It is difficult to overstate the impact that inflation and interest rate rises have had on private capital flows and deal-making in the past year. Global PE deal-making, for example, decreased in the second half of 2022 and reportedly fell to its lowest level in four years in the second quarter of 2023, a decline that analysts attribute to high interest rates, fear of recession and expectations of lower corporate earnings.[2] The OECD expects interest rates to remain high in many of its member countries until well into 2024 due to persistently high inflation.[3]

Among the different categories of external risk that are long-term concerns for executives in our survey, financial market instability (cited by 35%) ranked second on the list. At the top of the list is protectionism (38%)—specifically regarding countries favouring domestic over foreign investment.

Should advanced technology fields such as AI remain a focus of such protectionist policies, as is the case currently in the US and China, venture capital (VC) and other funds that have been driving technology innovation in global markets would likely suffer. The US CHIPS and Science Act, for instance, imposes growth restrictions on Chinese chipmakers that receive American federal funds to build in the US.[4] Considering their importance for most upcoming technologies, including AI and 5G-enabled smartphones, many others such as Europe, Japan and India have also introduced investment incentives for domestic semiconductor production.[5] China, on the other hand, has recently started banning iPhones in several government agencies it considers sensitive, a move likely indicating a push back against US tech.[6]

Figure 1: Finding growth amid protectionism

The categories of geopolitical and macroeconomic risk that cause banking and private capital executives the greatest concerns for their businesses



Source: Economist Impact survey

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The digital growth engine

While macroeconomic conditions weigh on financial markets in the longer term, growth opportunities for private capital investment will remain attractive in several fields.

Financing continued technology growth and innovation is one such area. Generative AI, for example, has been attracting growing volumes of VC investment,[7] bucking the broader trend of subdued dealmaking in other fields. Capital flows into companies providing the technology to build generative AI models is likely to continue, as enterprises across different industries race to develop such capabilities.

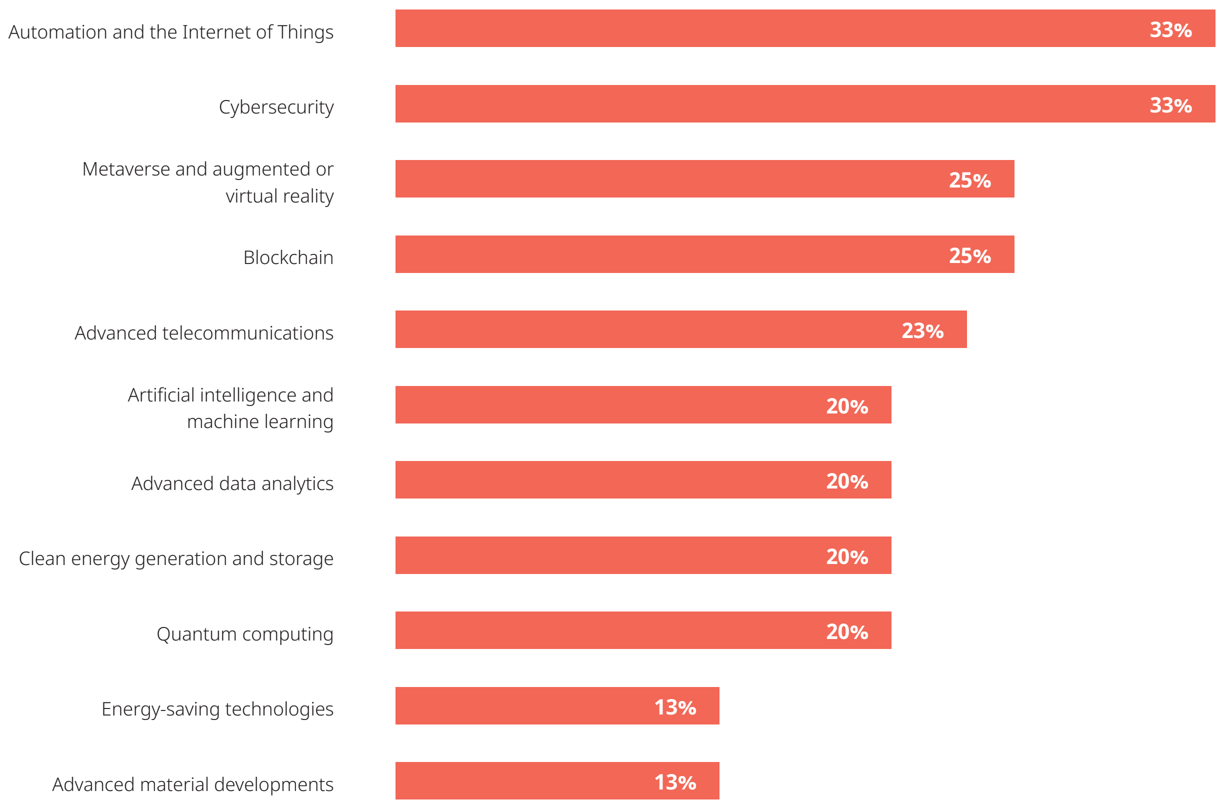
Ewan Kirk, a technology entrepreneur and founder of Cantab Capital Partners expects considerable volumes of private investment to flow into AI and other deep-tech start-ups over the next few years. He believes, however, that investor enthusiasm in generative AI may wane. "It's not clear yet how generative AI models can be used to make money," he says. Success will depend on organisations across sectors understanding the business need for generative AI. Clarity in its use-cases will then help drive the necessary targeted innovation and investment with fewer missteps.[8]

As a VC investor, Mr Kirk's attention is drawn to a number of niche technology fields that can help advance environmental sustainability. One example is AI-powered drones that inspect wind farms and other renewable energy infrastructure. Another is photonic computer processors, which use light rather than electricity for energy. "Photonics could have a big impact on data centre power consumption," he says. Asia-Pacific is becoming one of the fastest-growing markets for agricultural technologies like drones and robots in farming as a result of rising labour shortages in the sector.[9]

PE firms, meanwhile, are likely to be investing to help portfolio companies automate more of their operations and processes. The prospect of persistent talent shortages in many disciplines[10] heightens the urgency for such investments to help maintain productivity levels. The Economist Impact survey finds automation and the IoT to be gaining traction among executives—a third of survey respondents selected these technologies among the top three they expect to have the biggest positive impact on their business in the coming years. Another third say the same about spending on cybersecurity, which will be increasingly important as businesses deal with rising threats.

Figure 2: Focus on automation, sensors and security

Technology investments likely to make the biggest positive difference to banking and private capital respondents' businesses over the next decade



Source: Economist Impact survey

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Skills to drive growth

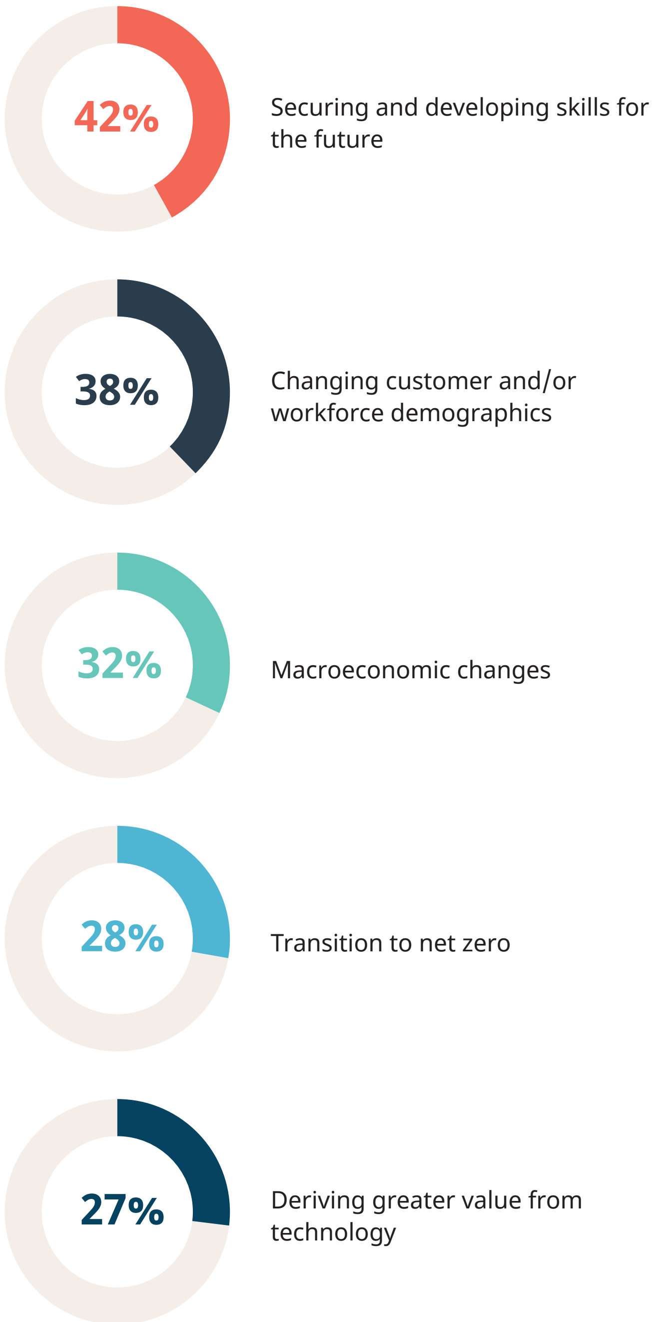
Financial institutions, including private capital firms, harbour deep concerns about future constraints on the availability of talent. Of the banking and private capital respondents to our survey, 42% say that securing and developing the needed talent and skills is among the biggest challenges their firms will face in the years ahead.

VCs and PE firms are likely thinking about the talent their portfolio companies will require to deliver targeted long-term growth and returns. When asked what skills are needed to support future growth, leadership and managerial skills are mentioned by the respondents more often than others, with the exception of data science (each cited by 28%). Entrepreneurial skills are also high on the list (27%).

Mr Kirk's observation is that talent gaps are not ubiquitous globally, as the availability of skilled professionals differs from region to region. He is more concerned about mobility constraints. "Less restrictive immigration policies would do much to alleviate some of the talent gaps that companies we invest in face."

Figure 3: Worries about finding the talent and skills needed to grow

The megatrends that will pose the toughest challenges to banks and private capital businesses over the next decade



Source: Economist Impact survey

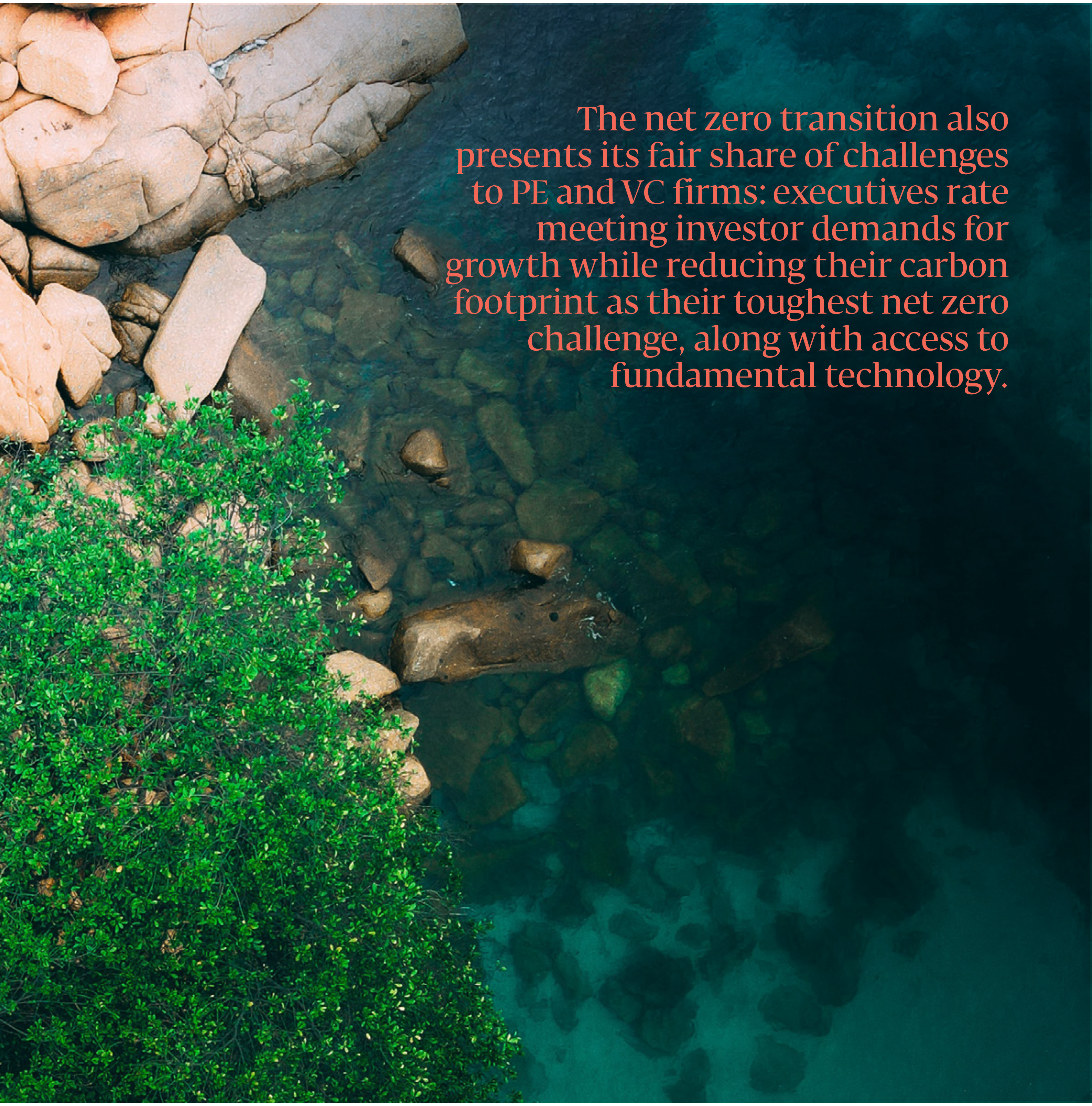
> “Less restrictive immigration policies would do much to alleviate some of the talent gaps that companies we invest in face.”

Ewan Kirk, Founder of Cantab Capital Partners

The net zero challenge

Private capital has a vital role to play in supporting efforts to transition to net zero carbon emissions. "Addressing climate change will drag a lot of investment capital into the technology and energy sectors," says Mr Kirk. "If start-ups and other innovative companies can help solve some pressing environmental challenges, this is a fabulous place for an investor to be." One of those solutions is improved battery technology. According to Mr Kirk: "Advances that give us batteries that are twice as powerful as today's in terms of energy density will, for example, transform electric cars, transform electric planes and transform electricity storage. That's a very attractive proposition for investors."

However, the net zero transition also presents its fair share of challenges to PE and VC firms: executives rate meeting investor demands for growth while reducing their carbon footprint as their toughest net zero challenge, along with access to fundamental technology.



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Looking to the future

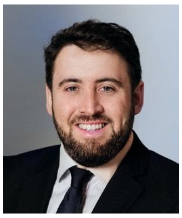
For private capital businesses, macroeconomic uncertainty, tight labour markets and—related to the latter—concerns about securing skills point to a more uncomfortable period ahead.

Although it will not eliminate this discomfort, a laser focus on technology—investing in promising young businesses with capabilities in AI and other advanced fields as well as in green technologies, and helping portfolio companies to digitalise further—can secure growth and returns for funds well into the future.

Changing demographics, highlighted as the top opportunity among businesses in the financial market (40%), will present room for growth as larger than historical volumes of wealth are passed down to younger generations. According to EY, US$18.4trn of wealth will be transferred by high-net-worth individuals by 2030.[11]

The growth in family offices is also giving rise to fresh investment perspectives. They are increasingly investing in start-ups, driving new innovations, and gaining value from impact investing.[12] Even amid slower economic growth worldwide, helping finance the net zero transition and the technologies that enable it will provide ample opportunities for portfolio growth for years to come. The world's ability to adapt to climate change hinges partly on this industry's success.

Partner Perspective



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Economic uncertainty, inflation, and interest rates not seen in a decade have made for a more challenging environment, however deal-making has remained buoyant.

Threats of looming regulation and protectionism have meant that global private equity ("PE") deal-making and fundraising across all asset classes have become more complex. The Cabinet Office report analysing the first full year of the UK's National Security and Investment Act illustrated the wide scope of the regime and the large number of deals (approaching a thousand) subject to notification requirements and review. Similar regimes have been introduced across Europe in recent years.

Meanwhile, the war for talent within the 'new normal' continues to impact the PE industry. Succession planning has been a concern for many established GPs and finding the people to fill their shoes rightfully remains a top challenge. Current economic headwinds have resulted in managers becoming ever-creative in finding liquidity solutions and maximising returns.

Tech investment will certainly be one avenue to drive fund management costs down but also open the market to wider fundraising solutions. Digitalisation and resulting retaliation have dramatically lowered the barrier to entry with numerous platforms, helping retail investors outside the usual institutional base access markets.

Ultimately, as the industry adapts to these new conditions, realigning asset valuations and market expectations will become the key to re-igniting deal flow. Many sectors will be hoping to attract private capital while fundraising sources remain scarce, investors' risk appetite will too remain low; so sticky assets that can ride out current uncertainty will be the ones to watch.

Endnotes

[1] The megatrends are: the net zero transition, demographic change, digitalisation, skills for the future, resilient cities and changing global dynamics. See Future Forces 2023 Report: The megatrends shaping business over the next decade

[2] Bain & Company, "Private Equity Outlook in 2023: Anatomy of a Slowdown", February 2023, and Reuters, "Recession risk, rate rises drive down private equity deal volumes to 4-year low", June 26th 2023

[3] OECD Economic Outlook, June 2023: A long unwinding road.

[4] Bloomberg, "Biden Stunts Growth in China for Chipmakers Getting US Funds", 21st March 2023, https://www.bloomberg.com/news/articles/2023-03-21/us-tightens-china-rules-for-chipmakers-getting-federal-funding-from-chips-act#xj4y7vzkg

[5] The Economist Intelligence Unit, https://viewpoint.eiu.com/analysis/article/572005040

[6] The Guardian, "China reportedly extends iPhone ban to more workers as tensions with US rise", September 8th 2023, https://www.theguardian.com/world/2023/sep/08/china-iphone-ban-government-state-owned-firms-workers-apple-us

[7] TechCrunch, "VCs continue to pour dollars into generative AI", March 28th 2023, https://techcrunch.com/2023/03/28/generative-ai-venture-capital

[8] The Economist Intelligence Unit, https://viewpoint.eiu.com/analysis/article/1573296340

[9] World Economic Forum, "AI and drones are revolutionizing farming across Asia", March 18th 2022, https://www.weforum.org/agenda/2022/03/asian-farmers-drones-apps-labour-climate-challenges/

[10] See Economist Impact, "Future forces 2023 report: The megatrends shaping business over the next decade", https://ashurstcd.azureedge.net/-/media/Ashurst/Documents/SXA-documents/Ashurst-EIU-Future-Forces-Report.pdf?rev=467c6ff891e64d63b7b88077fc842b0c&sc_lang=en&hash=03979AB3CCEC570CC49CBAE57385A1F7.

[11] EY, "Are you harnessing the growth and resilience of private capital?", August 21st 2023, https://www.ey.com/en_gl/private-business/are-you-harnessing-the-growth-and-resilience-of-private-capital

[12] PwC, "The evolution of family offices: the family capital business of tomorrow is taking shape", December 14th 2022, https://www.pwc.com/gx/en/services/entrepreneurial-private-business/emea-private-business/evolution-of-family-offices-family-capital-business.html

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