USIS REVIEW

The University Of Sheffield Investment Society
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E D I T O R ' S N O T E S

Welcome to the fifth edition of the USIS Review.

The Review is one of the three pillars of the University of Sheffield Investment Society which has the potential to link the Twikker Fund and the wider society.

This edition of the USIS Review is brought to you by a range of students from a wide variety of degree backgrounds. The financial world does not exist in isolation and geographical, political, and scientific developments frequently have a huge impact on the way that markets operate. We are proud of how the diversity of our writers allows us to fully engage with this complex interrelation of factors in order to create a review of the world of investment for students at the University of Sheffield.

In our fifth edition of the Review we start by looking at the private equity markets and the challenges and innovations firms are taking on. Following on from this, we cover the interesting topic of real estate dynamics and the affordability of housing. Yue Zhao will then take us through the fairly recent and fast growing area of digital banks before our Editor-in-Chief will finish off the USIS Review by talking about globalization and its challenges.

Desmond Chen
Editor-in-Chief

W R I T E R S

Joshua St Clare
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THE TRAJECTORY OF PRIVATE EQUITY

Spanning since the 2008-2009 financial crisis and the slashing of interest rates by central banks to levels of zero, Private Equity houses have seen lucrative dealmaking conditions with the markets zenith arriving in 2021, where around £1.2 trillion worth of deals were completed. This collective period of prolonged success of deal activity of the industry has played out against a backdrop of declining interest rates, which saw times of raising asset values and reducing the cost capital. Deal activity was on for another record setting year – until we saw the wheels well and truly fall off.

The divergence of Q1 in 2023 compared to the post June 2023 rate hike proves a stark difference from the plenitude of exits and commitments made from a substantial number of funds we saw in the first period of the year. Amidst these recession fears and seemingly never-ending rate hikes, Banks began to rapidly reduce leveraged loans, making the cost of buying companies using leverage difficult – crushing most year-ending prospects for total deals, exits and fundraising. The speed at which we saw these hikes has essentially placed a pause on cheap debt in these buyout markets.

How are these companies approaching this “pause”?

Financial Engineering Tactics

A recent short-term fix for the difficulty in PE markets has been the increase in volume of net asset value (NAV) loans by general and limited partners. A NAV loan essentially can allow private equity managers to take out loans secured against the underlying assets in their portfolios, essentially providing an atmosphere for cheaper debt compared to what standard debt raising levels are at now. NAV financing saw 50% growth in deal volume and 40% in transaction size for the 12-month period ending September 2022 which has also translated over to this year, seemingly in Q1 2023 where we saw exit value totaling $55.8bn.

Companies signing on to these longer lasting deals in the market from PE’s great growth period has meant organisations have found it necessary to utilise NAV financing in turbulent times. Due to longer duration hold dates, additional liquidity may be necessary to see their assets through a rough patch – like one of what we are witnessing currently– or to wait until a better exit opportunity arises for dispatch at a stronger value. One other pressure inducing the need for these NAV loans are that these sponsors are already in the market raising their next fund before they have even returned previous capital to Limited Partners from past funds, causing this necessity to generate short term liquidity for a return to prior investors. Whilst this cross collateralisation

provides beneficial short-term recovery, interest on these NAV financing deals spans 10%-18%, which can prove costly in the long run as the internal rate of return is likely to diminish the longer the company holds a company.

Margin loans emerge as another financial engineering mechanism for securing liquidity. Private equity firms employ margin loans to bolster their capital for strategic investments without the necessity of liquidating existing assets. This entails leveraging specific assets as collateral, thus amplifying buying power. Unlike Net Asset Value (NAV) loans, which involve leveraging an entire portfolio, margin loans focus on individual assets, meaning associated costs are generally lower, reflecting the risk tied to the selected collateral. The risks associated with market fluctuations and potential forced liquidation due to declining asset values remain integral considerations in the prudent utilization of margin loans, however these are likely to be less than the featured 10%-18% NAV financing interest rates, more in tune with prevailing interest rates.

Are these investors really going to make solid returns when there is borrowing on the fund's vehicle level?

The increasing default rates globally make this precarious considering if the fund itself has borrowed money, this will be needed to be paid out – leaving investors straggling for a couple of percent return on a company that realistically at a fund level, investors would not want to sell for such a price. These climbing default rates, forecasted to reach 6% in the US in 2024 and 3.75% in the EU, prove PE funds belief that they won't be able to obtain a solid price at shifting companies due to difficult business operations because of situational debt and the current pricing gap between buyer and seller remaining and acting as an impediment to deals, meaning we could see a similar deployment of financial engineering tactics this year.

European PE

With deals on the horizon such as the takeover of Norwegian group Adventia from a consortium led by Permia and Blackstone, European PE markets have shown resilience in some formats throughout the year compared to other regions. Whilst PE deal value was down 4.7% QoQ, exit value picked up again for the 2nd consecutive quarter, increasing 18.4% QoQ. In Europe, megadeal (deals over €1 billion) volume is only at 28 in Q1-Q3, tracking the lowest levels for a decade. However, 56.8% of deal value YTD has come from deals between €100-500 million, the highest percentage in any given year. This translates to the average PE deal size which follows this size bucket – increasing sequentially from €124.1 million in Q1 to €289.6 million in Q3, exhibiting potential green shoots within the market.

Europe's close focus on ESG practices, specifically targeting "green" funds that comply with the highest levels of Europe's regulatory framework on sustainability progress, as well as investor expectations have led to the openness of EU PE and VC towards new opportunities due to its nature of value creation. The equity financing of H2 Green Steel, including large PE houses Altor and GIC managed to raise €1.8 billion since launch in 2021 and secured renewed commitment letters in July 2023. With the plan to deliver steel with up to 95 percent less CO2 emissions compared to steel produced with traditional blast furnace technology, Europe's lean in strong direction towards the 2018 Action Plan on Financing Sustainable Growth is also providing itself new opportunities to the private equity market.

Whilst a broad-based recovery in private equity may still be a long way off – private equity firms are still finding ways to bear dividend from previous times with a hope of new methodologies forcing a push towards value creations bringing new opportunities.

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REAL ESTATE DYNAMICS: AFFORDABILITY CEILINGS AND THE INCIDENCE OF PROPERTY TAX

The dynamics of real estate markets are shaped by various factors, including property taxation and affordability constraints. Property taxes not only influence financial feasibility of real estate investments but also affect returns for potential sellers and housing affordability for prospective buyers.

Understanding the interplay between affordability ceilings and the incidence of property tax provides insight into market dynamics and the risks faced by stakeholders.

Property taxes contribute to the overall cost of homeownership, affecting both buyers and sellers in distinct ways.

The economic burden of property taxes can be borne by different stakeholders, including property owners, tenants, and consumers, depending on market responsiveness to supply and demand and tax policies. Meanwhile, affordability ceilings represent the maximum price threshold that potential homebuyers can afford, depending on:

I. their income levels,
II. II. borrowing capacity,
III. III. the cost of living,
IV. IV. governmental policies, and
V. V. prevailing market conditions.

Therefore, this ceiling acts as a major determinant of housing demand, as prospective buyers seek properties within their affordability range.

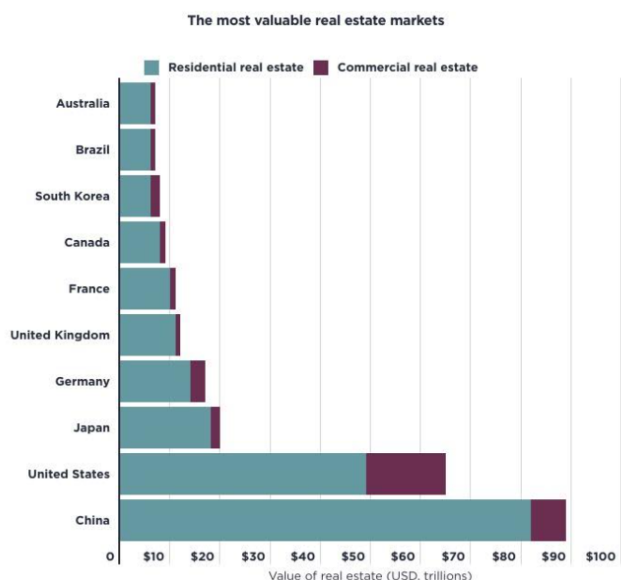
The incidence of a tax refers to the distribution of the tax burden among different economic agents, such as consumers, producers, or factors of production. In this case, the incidence of tax, specifically referring to the property market, refers to the distributional burden between property owners, tenants, and other stakeholders.

The incidence is an important phenomenon because, irrespective of whether it falls primarily on sellers or buyers - it can influence affordability dynamics which in turn drives domestic consumer confidence and economic growth.

If sellers bear the brunt of property taxes, they may adjust prices downwards to attract buyers, potentially enhancing affordability within the market. Conversely, if buyers bear the economic burden of taxation, they may face higher overall homeownership costs, potentially limiting their purchasing power and constraining their affordability margins.

In times of economic growth and low interest rates, property values tend to rise, widening the gap between the affordability ceiling and actual property prices. While this scenario poses challenges for prospective buyers by making homeownership less accessible, it also results in greater wealth accumulation

for existing property owners. This appreciation in property value is significant, considering that property remains the world's largest store of wealth.



Rental prices worldwide provide valuable insights into broader economic trends and market dynamics. Irrespective of location, rental prices are indicative of housing market conditions, investor sentiment, and consumer confidence. Changes in rental prices can ripple through global markets - as the 2007/08 financial crisis demonstrated, affecting global economic stability, investment strategies and migration patterns.

The 39% surge in Lisbon's rental prices, the strongest in Europe, underscores the interconnectedness of global real estate markets. This increase reflects growing demand and supply constraints, impacting investor sentiment, capital flows and housing affordability trends, not only in Portugal but also across Europe. Such trends have been mirrored in the UK's private rented sector (PRS), where rents also surged by nearly 6% in just the first eight months of 2023, representing a 26% increase since the pandemic's onset. This demonstrates how countries operate in sync on the global stage.

In the UK, property transactions are subject to two significant taxes: Stamp Duty Land Tax (SDLT) and Value Added Tax (VAT).

SDLT is imposed on the purchase of residential and commercial properties above a certain threshold, with rates varying based on property value and higher rates applied to additional homes or investments.

Taxation plays a pivotal role in real estate investment dynamics, exerting a substantial influence on property values and investor behaviour.

Higher tax rates, particularly on real estate transactions, can diminish after-tax returns on investments, reducing the appeal of real estate assets compared to alternative Real Estate Dynamics: Affordability Ceilings and The Incidence of Property Tax 3 opportunities. Consequently, investors may demand lower purchase prices to maintain desired returns, exerting downward pressure on property values.

When tax rates increase, sellers typically adjust property prices downwards to offset a higher tax burden, thereby expanding the pool of properties within the affordability range of buyers. Conversely, reductions in property taxes may lead to upward pressure on housing prices, potentially pushing properties beyond the reach of certain buyers, thereby constraining affordability.

To mitigate market discrepancies, created by market participants with higher bargaining power - governments often introduce subsidies and tax reliefs. For example, initiatives like the Help to Buy Scheme and the Stamp Duty Holiday aim to alleviate the financial burden of property transactions.

The impact of such tax reliefs and subsidies, particularly evident during the SDLT Holiday in response to the pandemic, stimulated demand and led to a surge in housing market activity. However, the subsequent end of the scheme, in September 2021, resulted in a market slowdown.

While the initial increase in market activity is generally positive, it may lead to excessive price growth and housing market imbalances, such as housing bubbles or shortages, with potential long-term economic consequences. As the wealth gap widens between property owners and non-property owners, it therefore becomes crucial for stakeholders to monitor affordability trends and implement strategies to ensure that housing remains accessible to a broad range of income levels within a given market.

In summary, affordability ceilings and property tax incidence are vital components of the global real estate market. Whether it's rental prices abroad or domestic tax reliefs, these factors deeply influence housing affordability, market dynamics, and investment decisions. Policymakers, investors, and stakeholders must understand the link between affordability constraints and tax burdens to develop effective strategies for fostering inclusive and sustainable real estate markets worldwide.

Moreover, the interconnected nature of the global real estate market means that developments in one region can have significant rippling effects across the globe. Therefore, monitoring global trends is essential to ensure sustainable growth and stability.

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THE NEW NORMAL IN FINANCE: THE PATH TO CO-EXISTENCE BETWEEN DIGITAL BANKS AND TRADITIONAL BANKS

Digital banks have been used interchangeably with virtual banking, or internet banking, the fundamental difference is the existence of the physical branches. Digital banks just offer online-only services. As a result, it cuts the service costs, particularly all services traditionally carried out in a branch (Fathima,2020;Sha & Mohammed, 2017). Investors are pouring in substantial funding, anticipating sustained expansion in the foreseeable future. According to CNBC, Monzo recently secured $430 million in a fresh funding round led by CapitalG, the independent venture capital division of Alphabet, Google's parent company. This influx of capital is earmarked to fuel Monzo's ambitious expansion initiatives, notably its renewed endeavor to penetrate the US market. Some media outlets may label digital banks as challenger banks, suggesting they aim to leverage modern technology to directly compete with or challenge traditional banks. However, I beg to differ. Present digital banks do not present a challenge to traditional banks.

User Groups

The primary users of this type of banking are the younger Generation Z group, as this group is already familiar with internet usage and receptive to new technologies. By 2024, more than two-thirds of Britons (36%) will have a purely digital bank account, equating to around 19 million people, according to findings from the financial research site Finder. The number of people with purely digital bank accounts has increased significantly since last year, jumping from an estimated 12.6 million at the start of 2023 to 19.2 million by the start of 2024. One in ten Britons (10%) intend to open a digital bank account in the next five years, with 6 per cent wanting to do so by 2024. However, consumers may view purely digital banking as an additional account for benefits such as low-cost overseas payments or convenient transfers, but do not necessarily consider it their primary account.

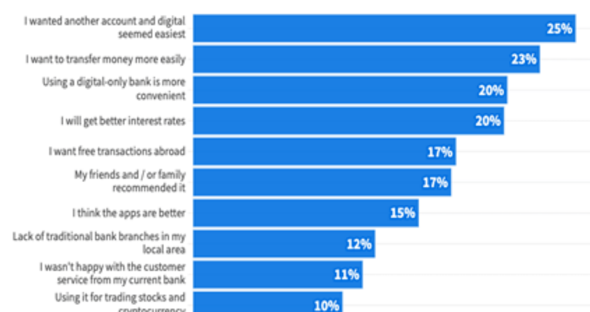

Figure1:Reasons for opening a digital bank (finder.com,2024 survey)

The motivations for opening purely digital accounts can be categorised into four primary groups. Firstly, some individuals seek an additional bank account that offers easier

management compared to traditional accounts. Secondly, there is a need for simpler money transfers. Thirdly, convenience plays a significant role in the decision-making process. Finally, a notable portion of users opt for digital banking to secure better interest rates. Other factors driving the transition to digital banking include the desire for free overseas transactions, a preference for digital banking apps, the absence of local traditional bank branches, dissatisfaction with existing bank customer service, and the intention to engage in stock and cryptocurrency trading. Additionally, some respondents highlight the decline in traditional bank branches as a reason for embracing digital banking.

Business Risk

As the profitability of digital banking is currently immature and in the early growth phase of the market, most challenger banks in the market are currently struggling to make a profit, as their low-fee operating model exposes them to more losses per customer. The main focus of digital banking is on personal payments and travel, as well as retail banking. However, when it comes to large payments, as well as major savings, most users still use traditional banks as their primary account, with digital cards only supplementing traditional cards. As well, digital banks face financial compliance risks, such as banking licences. For example, although Revolut was facilitated by the Bank of Lithuania to obtain a specialist banking licence from the ECB authorising it to accept deposits and provide consumer credit, Revolut does not currently have a banking licence in the UK and is only an e-money institution in the UK, which means that users do not have access to the protection of the £85,000 funds offered by the FSCS. Unlike Monzo, which was granted a UK banking licence earlier, Revolut announced its application for UK banking licence in January 2021, but the process has not gone smoothly and it has not yet been granted permission for a banking licence in the UK. If Revolut delays the approval of a UK banking licence in the future, the market share could be captured first by other digital banking unicorns such as Monzo and Starling Bank, to the detriment of Revolut in the UK.

Furthermore, even if digital banks were to obtain a banking licence and operate legally in a given region, large traditional banks already have a monopoly on large-scale, international and trusted lending channels, with a solid market share lead. When it comes to large-value payments and savings, the vast majority of users still view traditional banks as their primary accounts, while digital banks are only an adjunct to traditional banks. As a result, the primary business focus of digital banking is limited to small retail banking services. According to Finder, Monzo's customer deposits are expected to reach nearly £6 billion by 2023, with 7.4 millions customers at the end of the 2023 financial year. However, there is still a significant gap compared to the big four UK banks. In August 2023,the top five UK banks by market capitalization were HSBC, Lloyds, Barclays, NatWest, Standard Chartered.

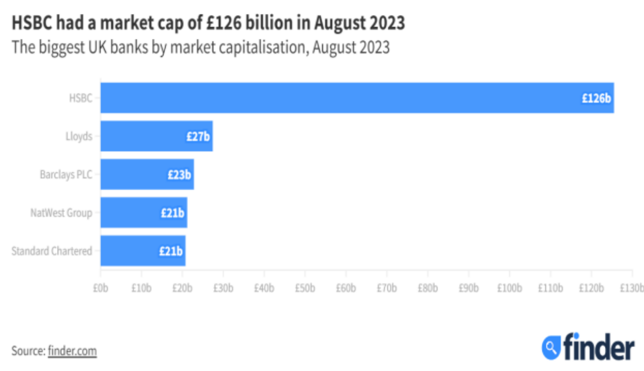

Figure2:Market capitalization of the top five banks in the UK （finder.com,August 2023)

Moreover, traditional banks are actively undergoing digital transformation and launching their own banking apps to retain their original market share and customers. The Financial Times has reported that HSBC plans to launch a payments app in the UK called Zing, which will offer retail consumers cheap foreign exchange services, allow customers to hold funds in 10 different currencies and spend them overseas at lower prices, offer international transfers in more than 30 currencies to compete with fast-growing digital rivals such as Revolut and Wise. Overall, digital banking models effectively reduce service costs, particularly those associated with traditional bank branches. The primary user demographic for digital banks consists of the Generation Z. However, digital banks encounter challenges such as low user retention rates and an ongoing struggle to achieve profitability. While successful in sectors like personal retail banking, most users still prefer traditional banks for large transactions and savings. Additionally, digital banks face regulatory hurdles, including obtaining banking licenses. Concurrently, traditional banks are aggressively embracing digital transformation, rolling out their own banking apps to safeguard their market share and customer base. Consequently, although digital banks have brought innovation to the financial sector, they currently do not pose a challenge to traditional banks.

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THE FALL OF THE GOLDEN AGE OF GLOBALISATION

Today, there remains inconclusive evidence regarding the deglobalization of international trade. While global trade growth slowed post the 2008-09 global financial crisis and plummeted sharply at the onset of the 2020 pandemic, it has since surged to its highest value yet when measured in US dollars. However, as a percentage of GDP, global trade has seen a modest decline, primarily influenced by China's "dual circulation" strategy focusing on domestic consumption while maintaining openness to international trade and investment, alongside India's actions. This shift signifies the conclusion of the exceptional export booms experienced by these countries in prior decades and a decrease in imports of intermediate goods. Nevertheless, imports of intermediates by the rest of the world continue to rise as a share of GDP.

Regarding trade dynamics, the imposition of American and Chinese tariffs in 2018 didn't diminish trade overall but redirected it, particularly affecting trade between the US and China. However, trade in tariff-affected products flourished among other nations, indicating a reshuffling rather than a reduction in trade volumes. Furthermore, despite the tariff conflicts, numerous countries, including those within the African Union, the Association of Southeast Asian Nations, and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, persisted in advancing regional or plurilateral trade agreements.

While the COVID-19 pandemic prompted temporary restrictions on medicine exports and disruptions in food shipments due to heightened prices following Russia's actions in Ukraine, many governments remain committed to economic integration efforts. Examples include initiatives facilitating the movement of professionals across borders or streamlining the flow of consumer goods through unified safety standards.

The era of "hyperglobalization," which emerged in the 1990s, was marked by significant economic progress on a global scale. This period saw a substantial reduction in extreme poverty, as defined by the World Bank, with the hopeful anticipation of its complete eradication in all but a few vulnerable nations, largely propelled by the remarkable economic growth witnessed in East Asia. Across the globe, living standards, gauged by income per capita, experienced a notable uptick, signifying a tangible improvement in the quality of life for many individuals.

One of the pivotal aspects of this hyperglobalized era was the unparalleled openness to international trade. This openness not only broadened the horizons of consumers but also granted them access to an expansive array of goods sourced from diverse corners of the world, ranging from cutting-edge smartphones to advanced electronics. This influx of globally sourced products not only enriched daily life but also catalyzed productivity gains, enabling individuals to achieve more and enjoy a broader spectrum of entertainment options than ever before. Moreover, the steady decline in the cost of air travel democratized international mobility, allowing a

larger segment of the population to explore foreign lands, immerse themselves in new cultures, and engage with novel ideas—an opportunity once reserved for the privileged few.

While numerous factors contributed to the prosperity witnessed during this period, it is undeniable that market-oriented policies and a steadfast commitment to openness played pivotal roles. The integration of low-wage countries into global trade networks exerted a palpable influence on prices and wages in advanced economies, resulting in tangible benefits for both consumers and workers alike. Even in the face of significant economic challenges, such as quantitative easing and mounting debt levels in the United States, inflation remained remarkably subdued, a testament to the robustness of the global economic framework.

Furthermore, the unprecedented level of global interconnectedness achieved by the close of the 20th century fostered a historically rare period of peace. The mutual interdependence engendered by robust trade ties incentivized cooperative behavior among nations, mitigating the likelihood of conflicts that could disrupt the global order.

However, beneath the surface of this seemingly idyllic scenario, tensions were simmering, eventually culminating in a pronounced backlash against globalization, which unfolded in three discernible phases.

The first phase, which began to manifest around 2015, was characterized by mounting apprehension surrounding globalization and the perceived threats posed by competition from low-wage countries. This period witnessed the emergence of significant events, including the Brexit referendum, the imposition of tariffs by the United States, and a resurgence of extremist ideologies in various parts of Europe. While the average global citizen continued to benefit from economic progress, many individuals in advanced economies, particularly those residing in regions exposed to heightened import competition, found themselves feeling economically marginalized and left behind.

The second phase of the deglobalization movement emerged with the onset of the COVID-19 pandemic in 2020, which served as a catalyst for calls to prioritize resilience in the face of unprecedented disruptions to global supply chains. However, defining and measuring resilience in the context of such a multifaceted shock proved to be a complex endeavor. While the pandemic indeed exposed vulnerabilities within international trade networks, markets demonstrated remarkable resilience, with the diverse array of trade partners contributing to the swift recovery of supply chains.

The third and most recent phase of deglobalization commenced with Russia's invasion of Ukraine in February 2022, serving as a stark reminder of the risks associated with overreliance on specific countries for critical imports. This period also witnessed a notable shift in mindset, with an increasing number of policymakers adopting the view that international welfare is a zero-sum game. Consequently, export bans and geopolitical tensions have further fueled sentiments favoring deglobalization, posing significant challenges to the future trajectory of global trade and cooperation.

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B A C K G R O U N D

The review is a quarterly student run publication and is read by a range of students and staff from different disciplines. It covers developments in banking and finance, investments andstrategy, technology, economics, and global affairs and has contributors from a range of backgrounds.

For students, the review allows them to fully research and develop a reasoned argument about a relevant topic in finance. An article can open up topics to debate, challenge paradigms formed by only getting information from similar sources, and help inform studentsabout recent issues. We also hope that it is helpful for students to show their interest in different sectors at interview.

J O I N US

The Review now has a huge range of sections dealing with every aspect of the business andinvestment world. Our contributors study a diverse range of degrees from Engineering to Medicine, Economics to Politics and History to Management, so we have no specific requirements or prerequisites.

A developed interest in business and finance is a pre-requisite for an enormous number of careers. Making the transition from reader to writer will allow you to develop your skills andknowledge, whilst gaining tangible evidence that can set you apart from the crowd in any interview.

If you are able to keep to deadlines and can work effectively, both independently and as partof a team, then you are warmly invited to contribute your own unique articles to our publication. If you are interested in contributing, or would like further information, please don't hesitate to contact us using the following email address:

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You can find us on our society Instagram page and sign up using the Google form using the link in the bio.

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USIS
Review

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