

Hedge Fund Alpha in Unlisted Equities

Stockholm (HedgeNordic) – Not every company has the urge to rush to be listed on a public market, or may have not yet reached the stage in their business cycle to justify such a move. This segment favors active managers who can invest in these private businesses at a potentially faster stage of growth and perhaps at more attractive valuations.

A handful of Nordic hedge funds have the ability, skill and desire to invest in attractive risk-reward opportunities in this unlisted space. Mikael Petersson (*pictured right*), who was the first investment-side employee at London-based Lansdowne Partners and later founded the long/short equity fund **Coeli Absolute European Equity**, can allocate up to ten percent of his hedge fund's portfolio to unlisted equities. "We have a mandate to invest up to ten percent in unlisted equities, but in reality, we target an allocation of five percent to this space on average," Petersson tells HedgeNordic. "We have maintained an allocation to unlisted stocks between two to four percent since the fund's inception in early 2018."

Swedish asset manager Norron Asset Management has also maintained investments in unlisted companies across its three hedge fund vehicles – **Norron Select**, **Norron Target** and **Norron Alpha**. "We have had a sub-strategy in our absolute return funds, in which we have been active in unlisted equities since 2016," Ulf Frykhammar (*pictured left*), managing partner and portfolio manager at Norron, tells HedgeNordic. "On average, we have had five percent of our funds' net asset values allocated to such strategies during that time period." According to Frykhammar, "the amount allocated by the Norron funds to unlisted investments depends on a range of criteria," including the risk mandate, UCITS-regulations, potential upcoming funding need in the unlisted portfolio, deal flow, and the maturity of the portfolio.

What Are the Risks?

While "the less crowded space and lower valuations" offer the opportunity for greater returns from investing in private businesses, "this comes with a set of inherent risks such as liquidity risk, market risk, operational risk, among others," according to Petersson. Investing in any type of equity carries significant risk for investors, however, "investing in private businesses is particularly risky due to the lack of liquidity and the usually higher risks associated with the less-mature stage of their growth cycles," argues Petersson.

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According to Petersson, another downside of investing in unlisted companies involves the "dependency on exit windows," which, in turn, depend on the broader economic environment and stock market valuations. While there are no market prices for private businesses, the market prices of public companies can impact the realization value from selling a stake in a private business.

The investment team at Norron Asset Management corroborates Petersson's views. Their "unlisted equity" sub-strategy "has less liquidity, less transparency and often higher funding needs, and the companies are often obviously at an earlier stage in their development," Frykhammar says. To guard their portfolios against some of these risks, the Norron team is "only active in relatively more mature unlisted companies that a board resolution to list within 12 months after our initial investment," according to Frykhammar. "All the above is transformed into a higher equity risk premium."

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“We hope to be able to generate excess returns by managing those risks, and obviously to compress the risk premium, so that we get the return we seek when the company is listed,” continues Frykhammar. To mitigate some of the operational risks associated with the early-stage natures of private businesses, the Norron team maintains “a very close dialogue with the companies we invest in, we try to point at certain development criteria’s that we think they should consider ahead of listing.”

Why Invest in Private Businesses?

The risks associated with investing in private businesses are wide-ranging and could have a major impact on returns and firm reputation should things go wrong (remember the ‘Woodford-gate’ episode?). So why would a hedge fund manager, who has the opportunity and possibility to invest across thousands of listed stocks across the globe, choose to invest in private companies? Because the potential rewards may more than justify all the risks involved.

Hedge fund managers are the whiz kids of the finance world who rely heavily on networking to find investment ideas. Their networks can occasionally put very attractive opportunities on the table. “After working in Europe for so many years, I have built a strong network that provides me with opportunities,” Mikael Petersson tells HedgeNordic. “We have a strong network from having worked in some of the world’s largest hedge funds and been in the business for more than 25 years,” he adds. “The funds I manage offer some characteristics that a typical investor cannot usually get.”

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Petersson, who runs a Europe-focused long/short equity fund and a long-only by-product, seeks to “produce 2-3x our original investment from unlisted companies within a period of two to three years.” This figure translates into targeted annual returns between 26 percent and 73 percent. The investment team at Norron, meanwhile, “are looking for at least 2-3x the internal rates of return that we can generate on average in the listed equity market.”

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While Mikael Petersson and the Norron team allocate only a small portion of their portfolios to unlisted companies, Petersson argues that “if you have a small but steady flow of attractive investments, it can make a difference over the years.” According to Petersson, “so far, we have had two out of three investments with a strong increase in valuation.” He goes on to say that “for the investors in our fund, it is a unique investment opportunity which they cannot do or find themselves.”

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Frykhammar tells HedgeNordic that “in today’s capital markets, a growing part of the market is affected by systematic strategies, which means that you have to engage in smaller cap companies, or even unlisted companies, to add distinctive positive value to the owners of your fund.” According to Frykhammar, “if we decide to invest in unlisted companies, we do that because we think that we can be able to circulate the higher risk premium attached to such companies to our shareholders.” He

concludes by saying that “to shareholders in our funds, it has proven to be very profitable to act as a funding bridge the year ahead of a full market listing.”