OCTOBER 2024

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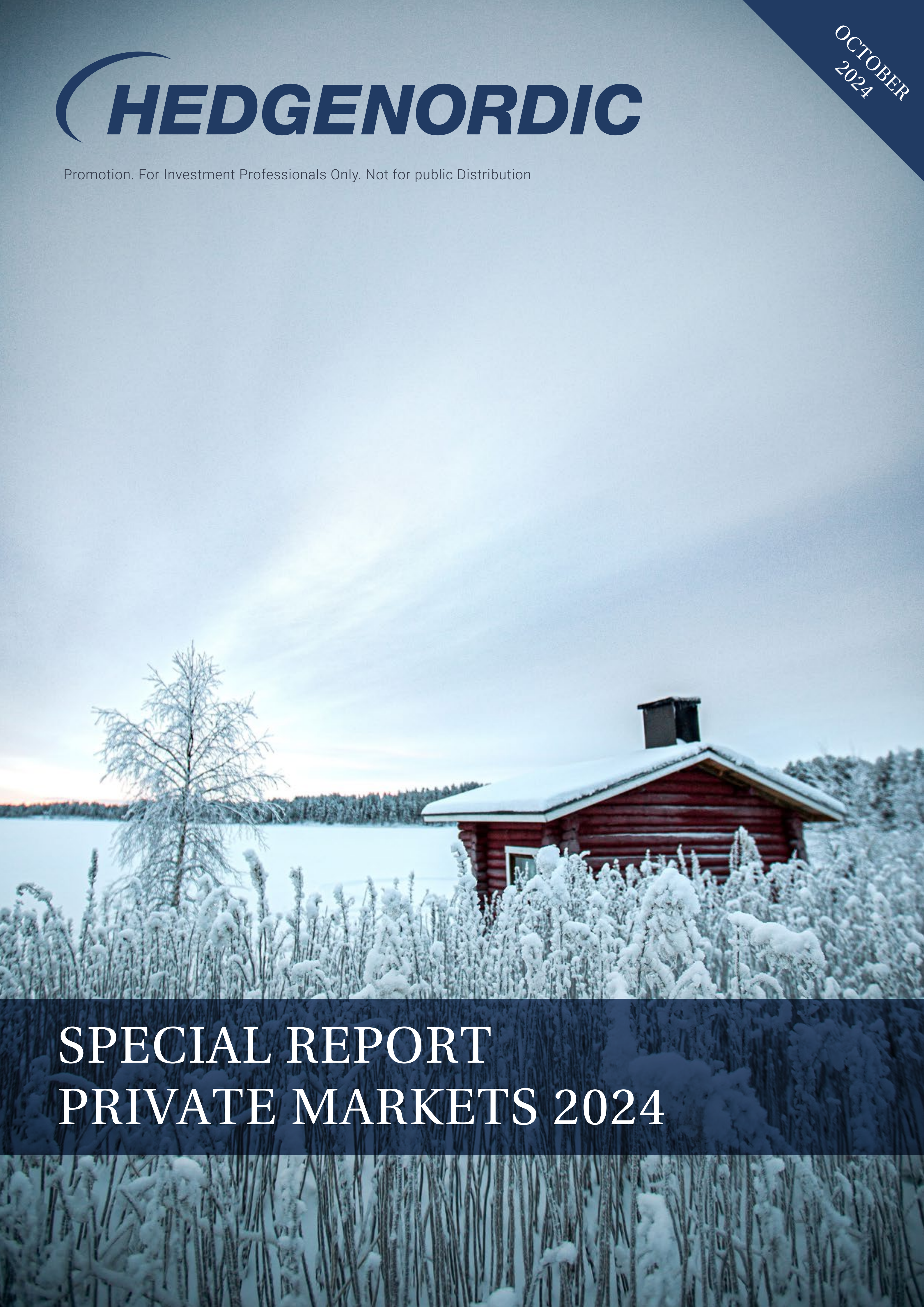

SPECIAL REPORT PRIVATE MARKETS 2024

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

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Editor´s Note ...

The Strong Run Continues ...

Following a strong run, the allure of alternative investments is still growing stronger, also within the Nordic financial community. Investors are drawn to the flexibility, diversification, and potentially higher, uncorrelated returns that private markets can offer. This magazine aims to provide insights into the strategies and trends shaping this dynamic market, offering a platform for institutional investors, asset managers, and industry experts to share their perspectives and approaches.

The Nordic region has long been at the forefront of investment innovation, known for its sophisticated institutional investors, strong emphasis on sustainability, and proactive approach to portfolio diversification. Nordic investors are pushing boundaries by exploring alternative investments maybe even more so than in other regions. This shift is reflected in the rising allocations to private assets, driven by a need to secure robust returns, manage volatility, and tap into the transformative power of private capital.

THE GROWTH OF PRIVATE ASSETS

Private equity and private debt have become critical components of institutional portfolios, gaining traction among Nordic pension funds, insurance companies and other types of institutional investors. Private equity has been particularly appealing for those seeking to create long-term value through operational improvements, strategic growth initiatives, and industry consolidation.

In parallel, private debt has emerged as an attractive alternative for those seeking stable cash flows and downside protection. With banks retreating from traditional lending due to regulatory pressures, private debt funds are stepping in to fill the gap, providing tailored financing solutions to middle-market companies and beyond. Direct lending, mezzanine financing, and opportunistic credit strategies have seen considerable growth, enabling investors to achieve enhanced yield while maintaining flexibility.

While private equity and private debt are at the core of alternative investment portfolios, the universe of private assets extends far beyond these traditional segments. Real assets such as infrastructure, real estate, and natural resources are gaining popularity, offering diversification benefits and inflation protection.

SHAPING THE FUTURE OF PRIVATE INVESTING

The private markets are constantly evolving, and as they mature, so do the expectations and sophistication of investors. The democratization of private markets is transforming access to private investments. Semi-liquid structures are emerging, providing greater flexibility and liquidity to traditionally illiquid asset classes. We also discuss how these developments are making private markets more accessible and how they could reshape the industry's future.

We aim to keep you informed and inspired by the latest trends and developments in the private asset space. Whether you are an institutional investor seeking to refine your strategy, an asset manager looking to stay ahead of the curve, or a financial professional wanting to deepen your understanding of private markets, this magazine is designed to be your trusted companion. We hope you find HedgeNordic's special report on "Private Markets" insightful as we take this journey to explore the multifaceted world of alternative investments together.

The publication opens with Raluca Jochmann of Allianz Global Investors introducing "Investing in the Infrastructure of Tomorrow with ELTIFs." Following this, Laura Wickström, newly appointed CIO at Veritas Pension Insurance, explores "The Private Equity Allocation of a Smaller Institutional Player" with total portfolio of €4.6 billion and about €500 million in private equity.

In "UB FIGG Taps Forestry Expertise to Guide Private Equity Investments," David Walker, a senior partner behind UB's private equity fund, highlights the importance of expertise in private equity investing, particularly for first-time funds. Katarina Staaf, CEO of the Sixth Swedish National Pension Fund (AP6) – which exclusively invests in private equity, describes private equity as "an Ideal Asset Class For Pension Capital."

Ian Wiese, portfolio manager at Barings Portfolio Finance, addresses the rise of the private equity secondary market in "Surge of the Secondaries: Financing Growth in an Undercapitalized Industry." Johan Strömberg, Director of Private Asset Sales at Schroders, discusses "The Rise of Semi-Liquid Funds" as "A Gateway to Private Markets."

Antti Kortela, portfolio manager of Elo's private credit program since 2014, shares his insights on Private Credit as "Both Complement and Substitute for Liquid Alternatives." Kristofer Kraus, who co-leads PIMCO's asset-based finance business, goes Beyond Corporate Lending to talk about "Specialty Finance as the Next Frontier of Private Credit." Christoph Junge, Head of Alternatives at the Danish pension fund Velliv, shares "Velliv's Take on Private Markets," with a focus on the growing appeal of private credit.

Gilles Lafleuriel, Head of Sweden at Obligo, emphasizes that "Not All Infrastructure Is Equal" by pointing out that there are other ways to invest in infrastructure. Finally, in "Alexandria Breaking Barriers to Private Markets," Toni Iivonen from a Finnish private wealth and asset management firm with around 40,000 clients discusses how access to private market asset classes is expanding to individual investors, previously limited to institutions and the ultra-wealthy.

Yours sincerely,

Kamran Ghalitschi
PUBLISHER, HEDGENORDIC

Raluca Jochmann, Head of Private Markets Solutions – Allianz Global Investors

Investing in the Infrastructure of Tomorrow with ELTIFs

By Raluca Jochmann – Allianz Global Investors

The ELTIF, or European Long-term Investment Fund, is currently the topic of the day. The European Union launched the ELTIF back in 2015 with the aim of giving private investors access to illiquid private market investments. However, while the take-up of this investment vehicle has been rather slow, the latest amendments to the law, dubbed ELTIF 2.0., introduced several simplifications as of January 2024. This is expected to lead to an increase in product supply. Scope estimates the ELTIF volume to reach between EUR 30bn and EUR 35bn by the end of 2026, with at least 20 new ELTIFS on the market within the next year.[1]

Let's look at infrastructure investments as a megatrend. In many parts of Europe, large parts of the existing infrastructure are several decades old, the limitations of which we experience on a daily basis. According to a study by the Global Infrastructure Investor Association, only 38% of people worldwide

> "Global demand for infrastructure investment is estimated at USD 94 trillion by 2040."

were satisfied with their infrastructure in 2023.[2] Whether in rail transport, on the road or in places with poor mobile network reception, large-scale infrastructure investments are badly needed not only in Europe, but also worldwide. According to the infrastructure monitor of GI Hub, global demand for infrastructure investment is estimated at USD 94 trillion by 2040.[3]

The development of new infrastructure is a key factor for the future functioning of society, both in economic and social terms. The focus of investment needs is on managing the energy transition, digitalization and demographic developments. Former President of the European Central Bank Draghi pointed out in a report for the European Commission that Europe needs additional spending of around EUR 800 million a year to remain competitive, socially stable, and to meet climate targets. The range of projects that need to be tackled includes the expansion of broadband networks, modernization of local public transport and upscaling of electricity grids for renewable energy. However, state budgets are under pressure. Private capital, including that raised by ELTIF funds, can play a decisive role in funding these important projects. Expertise and market access are required to navigate the complexity of investing in unlisted, or private, infrastructure, which is why this asset class was previously available mainly to institutional investors and very wealthy individuals. The new ELTIF 2.0 regulation opens this investment universe to a broader group of investors. Now, one can invest in an ELTIF starting at smaller amounts of money and make a long-term investment in private markets, which can be a valuable addition to a portfolio invested in liquid equities or bonds.

What are the benefits of unlisted infrastructure from an investor's point of view? Infrastructure has successfully weathered some challenging macroeconomic times in recent years, from the pandemic to the energy crisis and rising inflation.4 Critical infrastructure in particular – such as utilities, water supply, mass transportation, telecommunications networks to name just a few – provide essential services to the public and can usually generate relatively stable returns due to their strong market position (with high barriers to entry in asset-heavy, highly regulated low-competition markets) and potential for regulated or long-term contractually secured revenues. Also, often-times infrastructure revenues are directly or indirectly linked to inflation, providing a useful portfolio protection against rising prices. These features make infrastructure an attractive potential addition and diversifier to an investor's portfolio.

However, while return opportunities are attractive, one is well advised to also consider the specific characteristics and risks associated with private market investments. The illiquid nature of these investments means one should treat them as a long-term investment, not one that provides short-term liquidity. In addition to illiquidity, private markets carry specific other risks, which investors need to understand – by relying on appropriate advice and information – and properly consider in the light of their own portfolio objectives.

By investing in an ELTIF as a long-term addition and diversification to an otherwise liquid portfolio, private investors can make a threefold contribution – to a modern infrastructure, a sustainable society and their own wealth creation.

Find out more about Allianz Global Investors Infrastructure ELTIF by scanning the QR code.

1) www.scopeexplorer.com
2) www.giia.net
3) www.gihub.org
4) www.gihub.org (Page 10)

Marketing communication. Infrastructure equity/debt investments are illiquid and designed for investors pursuing a long-term investment strategy only. Investing involves risk. The value of an investment and the income from it may fall as well as rise and investors might not get back the full amount invested. Past performance does not predict future returns. ADM3594294

The Private Equity Allocation of a Smaller Institutional Player

By Eugeniu Guzun – HedgeNordic

Alternative asset classes have gained popularity during the decade-long low-interest-rate environment as investors sought higher returns and diversification. However, the recent shift towards a higher-for-longer interest rate environment has reshaped the dynamics and attractiveness of these alternative asset classes, impacting some positively and others less so. Laura Wickström, newly appointed CIO at Veritas Pension Insurance, notes that higher interest rates have changed asset allocation considerations by expanding the scope of attractive asset classes.

"The gap between cash and some assets that performed well in the previous low-rate environment has narrowed," argues Wickström, who assumed the permanent CIO role at Veritas in July after years as Portfolio Manager responsible for private equity and other illiquid fund investments. "We continually

> "Returns in private equity depend on a lot more factors beyond valuation multiples and the discount factor."

Laura Wickström, CIO – Veritas Pension Insurance

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monitor and prepare for even the smallest shifts in the relative attractiveness of different asset classes as market conditions evolve," she emphasizes. The effects of the higher-rate environment on alternative asset classes vary based on the interest rate sensitivity of each asset class and a wider range of factors.

"The transition to higher interest rates has put downward pressures on some valuations, especially on interest rate-sensitive assets such as real assets and core real estate," notes Wickström. Core real estate assets, typically located in larger or growing markets with high occupancy rates and long-term leases held by creditworthy tenants, have been particularly vulnerable to higher rates, according to the CIO of Veritas. "Quality real estate assets have suffered relatively more due to the interest rate adjustment and increased return requirements," Wickström explains. On the other side of the spectrum, private credit has benefited from higher interest rates, partly due to its floating-rate nature.

THE ENVIRONMENT FOR PRIVATE EQUITY

The influence of higher rates on private equity is more nuanced and multi-faceted, according to Wickström. While interest rates had an impact on company valuations, she explains, "returns in private equity depend on a lot more factors beyond valuation multiples and the discount factor." In this environment, "the valuation lever may put downward pressure on returns," contends Wickström. However, she emphasizes that the impact of higher interest rates on private equity is much more complex, with a reevaluation that is less dramatic compared to real estate, for instance.

"It's a more subtle and longer-term process of adjustment, which can incidentally lead to a longer holding period due to reduced investment activity, translating into lower internal rates of return," explains Wickström. As companies expand their business operations and improve their top- and bottom-lines, "they can grow back into their valuations." Higher rates mean that buyout managers can no longer rely on low-cost debt and multiple expansion to generate returns. Wickström underscores that managers will now prioritize revenue growth and operational improvements to drive returns instead of relying heavily on financial engineering.

> "The ability and capacity to deliver idiosyncratic operational improvements reveal the quality and impact of managers."

"In the last ten years, a significant portion of private equity returns came from multiple expansion and leverage, factors that are definitely more muted in this type of environment," argues Wickström. "When you take out multiple expansion from the equation, the burden of creating returns shifts to operational improvements and business growth," she continues. The imperative for operational enhancements may be more important in Europe, where growth prospects are more limited. "The ability and capacity to deliver idiosyncratic operational improvements reveal the quality and impact of managers."

The ability, expertise, and track record in delivering operational improvements have been crucial criteria in Wickström's approach to building the private equity allocation. "While always important, the focus on operational improvement is now more important and perhaps more visible as well," argues Wickström. In this environment, there is a much clearer distinction between managers who can genuinely drive operational improvements and those who have merely ridden the wave of favorable conditions.

MANAGER SELECTION FOR A SMALLER PENSION PLAYER

Wickström's selection process focuses on identifying manager quality, which also reflects the ability to drive operational improvements. "First and foremost, we seek high-quality managers who can withstand various market environments and have a solid history as a firm or team," says Wickström. Veritas rarely invests in first-time funds, preferring those with a proven track record. "The team's extensive experience and history of implementing the same strategy they are proposing is the most important factor," she elaborates. "We particularly evaluate their capacity for operational improvement to ensure we invest in a more all-weather type of strategy."

However, the strong market environment for private equity investments in recent years has led to an abundance of managers with strong track records, making it more challenging to identify those focused on operational value creation. As a small institutional manager with €4.6 billion in assets under management, including about €500 million in private equity, Wickström has chosen to invest in smaller growth buyout private equity players. These managers tend to emphasize operational improvement, according to Wickström. "We don't need to invest in the larger ones for capacity reasons," explains Wickström. Instead, Veritas focuses on middle-market and lower-middle-market managers.

"We try to find a balance by leaning towards the smaller managers and smaller companies," says Wickström. While acknowledging that larger players and companies offer more safety in specific environments, providing stability and endurance during difficult market conditions, she adds, "However, smaller managers and younger companies offer more opportunities for operational improvements."

The size of Veritas' investment portfolio presents both disadvantages and advantages as a private equity investor. "The lack of resources can be a challenge because investments in private asset classes are labor-intensive and lack passive exposure," explains Wickström. The team at Veritas, therefore, carefully considers its available resources and avoids overextending its internal resources, which are smaller than those of larger pension funds. "This means we have to pick our battles wisely," she continues. However, being a smaller player also has its advantages. "Our smaller size is beneficial because we don't face capacity constraints that prevent us from investing in smaller, interesting managers," argues Wickström. "Our size allows us access to a broader investment universe."

THE ROLE OF PRIVATE EQUITY AND OPTIMAL ALLOCATION

Private equity plays a similar role to public equity for the team at Veritas, albeit with distinct characteristics and additional return expectations to compensate for illiquidity. "Although we have different teams managing public equity and private equity, as a whole, private equity is part of the total equity risk but with different characteristics," explains Wickström. "However, we require an additional risk premium or return requirement to compensate for the inherent illiquidity in private equity, which is obviously difficult to evaluate ex-ante."

Currently comprising about 10 percent of the overall investment portfolio, the optimal allocation to private equity depends on various factors, including solvency regulations, availability in the risk budget, and market opportunities. "Private equity is not an allocation that can be adjusted quickly by placing a ticket in a passive investment, for instance," says Wickström. While Veritas has already built a mature portfolio of private equity managers, the team is looking to increase the allocation to North America.

Having previously used a fund-of-funds structure for private equity exposure to the United States, Veritas now seeks more direct exposure. "The U.S. is a large private equity market, and we wanted more direct exposure as scaling our exposure with the fund-of-funds approach proved challenging," explains Wickström. The team at Veritas has taken advantage of the current challenging fundraising environment to allocate to high-quality managers. "We have been using this environment to expand our portfolio to include a larger share of quality managers, which happen to be operating mostly in North America."

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UB FIGG Taps Forestry Expertise to Guide Private Equity Investments

David Walker, senior partner – UB Forest Industry Green Growth Fund (UB FIGG)

By Eugeniu Guzun – HedgeNordic

Historically, private equity has outperformed public markets over the long term. While the allure of high returns in private equity is strong, actual performance can vary significantly depending on the strategy, expertise, and market conditions. Asset managers with deep knowledge in a specific niche are often better positioned to capitalize on unique opportunities and navigate challenges effectively. United Bankers, a Finnish asset manager with a proven track record in forestry investments, has partnered with a team of forest industry experts to create UB Forest Industry Green Growth Fund (UB FIGG).

"UB has always had a strong position in the fund management business related to forest assets," says David Walker, a senior partner behind UB's private equity fund, UB Forest Industry Green Growth Fund (UB FIGG). "It was a natural progression for us to create a new private equity fund focused on the forest industry," he adds. The team began working on the fund in 2022, completing its first close in January 2023 with over €100 million in investment commitments.

"The idea is to support innovation on the industrial side by providing growth capital and support companies exploring bio-based solutions in areas like packaging, chemicals, and building materials," explains Walker. The fund's central theme is replacing fossil-based materials with bio-based alternatives. "While fossil-based raw materials will always be part of our lives, we feel there is a huge opportunity to reduce our dependency on fossil-based materials and create bio-based alternatives," says Walker, who has been associated with forest industries for more

> "UB has always had a strong position in the fund management business related to forest assets. It was a natural progression for us to create a new private equity fund focused on the forest industry."

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"Everything that's made from fossils today can be made from wood tomorrow."

than 40 years. UB FIGG operates under the slogan, "Everything that's made from fossils today can be made from wood tomorrow."

Walker highlights the long history of evolution in the Nordic forest industries, which evolved from processing forest resources into wood products and pulp, then paper products, and then packaging products. "The evolution has always been about adding value to the fibre," emphasizes Walker. "The current phase of this evolution is about adding value particularly to the waste streams of the industry," says Walker, "and this is particularly where we are focused."

Traditionally, waste fibre from industrial processes was burned to generate bioenergy. "This has been beneficial, reducing dependence on fossil fuels," notes Walker. "But some of these waste streams can be turned into much higher value-added products with an even greater environmental impact," he continues. "We are focused on this higher value impact with our investments." While UB FIGG is branded as a forest industry green fund, the team can also selectively invest in bio-based materials beyond forestry. For instance, they have invested in a German company, Traceless, which uses corn waste to make bio-based coatings and packaging, and in Notpla, which creates similar products from seaweed. "The theme, however, remains the same – the replacement of fossil-based raw materials with bio-based alternatives."

The fund's investment strategy targets three main sectors: packaging and hygiene (driven by plastic replacement), biochemicals (removing fossil-based inputs from chemicals and replacing them with bio-alternatives), and building materials (promoting wood-based materials over ceramics, steel, and concrete). UB FIGG has made five investments across these sectors, with a total invested value of around €33 million.

UB FIGG'S TYPICAL INVESTMENT

Having made five investments to date, the fund's typical investment size ranges from €5 million to €10 million, with the potential to increase to €20 million for follow-on investments. "We invest in growth-stage opportunities, so our investment commitments are larger than those of VC-style investors, for instance," explains Walker. UB FIGG aims to maintain a concentrated portfolio, allowing the team to engage with and contribute actively to each business. "We take a board seat for every investment and play an active role in the strategy and development of the business," says Walker.

One investment Walker has been personally involved in from the start is Paptic, a Finnish scale-up addressing global plastic pollution and climate change with a wood-based flexible packaging material. "The material is based on cellulosic fibres, has the properties similar to plastic, but is renewable, recyclable, lightweight, durable, strong and soft," Walker explains. The material is used in everything from carrier bags to electronics packaging and food and vegetable packaging. "Paptic is about getting plastic products out of everyday use to reduce waste and enhance recyclability," says Walker. The funding led by UB FIGG supported product development, production partnerships, and the availability of Paptic materials globally. "The team at Paptic is great and very motivated to achieve the goals of the company and I am active on the Board helping them to continue to grow the business," Walker adds.

NICHE EXPERTISE DRIVES SUCCESS

Private equity investing in such specialized industries requires both experience and deep expertise. "When we set up the fund, our key principle was to build a team with deep experience in both investment and the forest industries," Walker emphasizes. "We felt this sector expertise was essential – as we were a first-time fund – to give investors the confidence that we knew what we were doing."

In addition to David Walker, UB FIGG has three other operating partners, including Matti Lehtipuu, former CEO of a publicly listed forest products company; Sakari Saarela, an investment banker specializing in the sector; and Rainer Haggblom, who has decades of experience as an advisor to the forest industry, and globally, very well known as an authority on the sector. Additionally, the fund has a four-person advisory board, with members from Finland, Sweden, Germany, and Latvia, all of whom have had operational and investment roles in the sector. "We built our team and analysts, associates, and managers to support the fund's operations," says Walker.

According to Walker, the team's expertise and network enable them to address a key challenge for private businesses in this niche: weak market traction and slow sales growth. "While many companies have great ideas and solid industrial processes, market traction can be weak, leading to slow sales growth," says Walker. "We look at how we can help support market traction through our networks, and we also help companies focus more on the fundamental cost competitiveness of their products," he advises. "Some companies build up huge 'research-like' organizations without thinking enough about commercial traction and relationships with customers."

ARTICLE 8 AND SUSTAINABILITY DRIVE

UB FIGG's mission to replace fossil-based materials with bio-based alternatives is rooted in clear sustainability agenda. The fund is classified as an Article 8 fund, "because of the clarity of the criteria, which we ensure we deliver on," according to Walker. "All our investments go through a strict ESG review process, and we establish very clear reporting requirements for companies on their environmental performance," he explains. UB FIGG's investment committee also includes an ESG specialist who works closely with portfolio companies to ensure they meet these objectives.

Walker stresses the importance of private equity in driving sustainability. "Improving environmental performance requires both investment and patience," he notes. "Public markets can be too short-term in their focus to support environmental breakthroughs, making private equity – especially at the growth stage – essential to support change to help achieve environmental objectives." The team believes industry expertise is essential in finding competitive solutions to real-world problems. "That is why we established the fund and why we think it will continue to be successful."

For Pension Capital, This is an Ideal Asset Class

By Eugeniu Guzun – HedgeNordic

> "The growth in private equity market is the result of a combination of value creation and increased allocations to the asset class."

The private markets universe, private equity in particular, has experienced significant growth in recent years. Private equity assets under management increased from $4.1 trillion in mid-2019 to $5.8 trillion by the end of 2023, with projections estimating they could reach $12 trillion by 2029, according to Preqin. Katarina Staaf, CEO of the Sixth Swedish National Pension Fund (AP6) since 2019 and with over 20 years of private equity experience, has witnessed this growth firsthand.

Staaf identifies two main drivers behind the significant increase in the private equity industry's assets under management. "Value creation in the form of superior returns compared to public markets has attracted significant new capital from both new investors and existing investors," explains the CEO of AP6, which exclusively invests in private equity. "The growth in private equity market is the result

Katarina Staaf, CEO – Sixth Swedish National Pension Fund (AP6)

Photo by Johan Olsson

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“Value creation is the core competency of private equity managers, or at least, it should be.”

of a combination of value creation and increased allocations to the asset class.” While both private and public equity exposure investors to equity market risk, Staaf highlights critical differences between the two.

“In public markets, activity revolves around the buying and selling of stocks,” explains Staaf, which in turn facilitates price discovery. Public markets are secondary markets, where investors trade existing shares rather than directly invest in companies. “In contrast, the private equity market is completely driven by negotiation-based transactions,” adds Staaf. Investors typically acquire stakes in private businesses, work to improve their value, and eventually sell them at a higher price to another buyer, often through a strategic sale or IPO. “This market is driven by transactions,” Staaf emphasizes, “because these transactions create realized returns and crystalize value creation.”

However, transaction activity has slowed significantly since the middle of fall in 2022. “The volume of transactions slowed down substantially, driven by risk-off in the market. There were various factors that contributed to the decline after the war started in early 2022,” Staaf notes. While public markets quickly reacted to the war in Ukraine and its consequences across economies, “not much happened in private equity due to the slower-moving nature of transactions,” she explains, pointing out that deals signed in April might only close in October. “Everything moves more slowly in private markets.”

According to Staaf, transaction activity has remained sluggish for nearly 24 months. “It’s not entirely dead, but it’s much slower than usual and far below 2021 levels,” she observes. The slowdown has had several knock-on effects: fewer distributions from private equity funds, fewer new investments, and longer fundraising cycles. “If nothing is sold and no new investments are made, we’re just in a steady state,” she says. “There’s talk that some companies are ready to be sold, but the IPO market isn’t quite open, and buyers are more cautious.” However, Staaf and her team have started to see a shift this fall. “Things are beginning to move again, correlating with the improving sentiment as central banks start to lower rates.”

PRIVATE EQUITY FOCUS: VALUE CREATION

Despite the slower pace of transactions, the private equity market remains active, with private equity managers focused on their core task: developing and growing businesses. “Value creation is the core competency of private equity managers, or at least, it should be,” emphasizes the CEO of AP6, which oversees SEK 75 billion in private equity investments through funds and co-investments. “Private equity is about developing companies and many in the industry are dedicated to improving businesses in various ways,” adds Staaf. “That’s the primary objective – value creation.”

In the low-interest-rate environment of the past, some private equity managers relied on financial engineering to generate returns. However, the recent shift to higher interest rates has renewed the focus on operational improvements and value creation. “Some managers are good at value creation, while others may have relied more on financial engineering. It’s not the same as true value creation,” Staaf acknowledges. For AP6, the priority has always been to find managers focused on genuine value creation. “That should be their core strength, and that’s what we are looking for.”

Value creation is critical because “what ultimately matters is the realized returns – the difference between the purchase and sale price of a company, which determines your return,” Staaf explains. Unlike public equities, where volatility, Sharpe ratios, and other metrics are important measures of risk and return, private equity’s performance is best gauged through metrics like cash flow multiples and internal rates of return. “Everything you know about the normal way of measuring risk and return, put that in a box, because private equity is completely different.”

Staaf further underscores that “private equity is not really comparable to public equity.” The two asset classes are uncorrelated and behave very differently. Private equity, therefore, can serve as a “perfect diversifier” for long-term investors, such as pension funds. In addition to providing higher long-term returns through value creation, “the opportunity set in private and public markets is entirely different,” Staaf concludes. “For pension capital, this is an ideal asset class.”

However, the abundance of private equity managers and funds complicates the selection process for investors. “There are many funds out there that may not deliver the returns one would expect from this asset class,” says Staaf. From a pool of over 13,000 funds, AP6 typically maintains between 40 and 60 fund relationships following a market mapping and a structured selection process. As a pension fund manager with over two decades of experience in private equity investing, AP6 has developed its own models to monitor, analyze, and select funds. “It’s truly like finding a needle in a haystack to identify the funds and managers we choose to work with.”

“What ultimately matters is the realized returns – the difference between the purchase and sale price of a company, which determines your return.”

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Surge of the Secondaries:

Financing Growth in an Undercapitalized Industry

By Ian Wiese – Barings Portfolio Finance


Ian Wiese, Portfolio Manager – Barings Portfolio Finance

"With the secondary market growing in leaps and bounds, raising capital remains top of mind for managers."

"Staggering" is the word that comes to mind when looking back at the growth of the private equity (PE) secondary market since its inception. One can only imagine whether Jeremy Coller—the founder of Coller Capital and known by market participants as the 'godfather of secondaries'—could have fathomed how this industry would grow over three decades to reach $114 billion today.[1]

Secondaries have now become an integral tool for both GPs and investors in navigating private market exposures. From 2022 to 2023, secondaries fundraising grew by 92%, even amid more challenging market conditions.[2] Although starting from a lower base, this growth notably surpassed that seen in infrastructure, direct lending, venture capital and other comparable asset classes over the same period. And, despite this impressive growth, secondaries only represent around 6.5% of the broader PE market—suggesting there is still further room to run.[3]

While fundraising has been successful, deal volumes have consistently exceeded fundraising, reaching $132 billion in 2021—and some forecasts are calling for this figure to exceed $140 billion by the end of 2024.[4] In fact, with cumulative deal volume over the last five years reaching $500 billion and investor capital representing only $294 billion, a significant capital mismatch exists (Figure 1). This raises key questions for secondary players:

- Going forward, will fundraising sufficiently keep pace with expected transaction volumes?

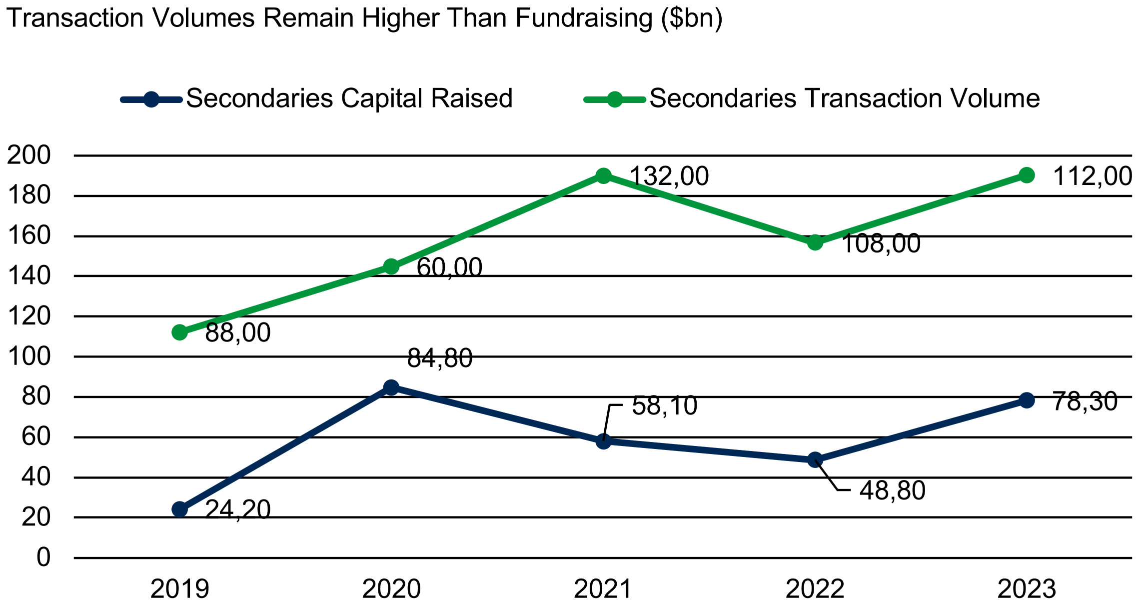
- Is the secondary market adequately capitalized for the significant growth expected in the years to come?

One indicator to determine whether an industry is adequately capitalized is the so-called capital overhang ratio:

Capital Overhang Ratio = Available capital (current dry powder + near-term fundraising) [**A**] + Level of debt available [**B**] / Secondary deal volume [**C**].

While the capital overhang ratio should not be viewed in isolation, it is helpful in assessing whether there

FIGURE 1: TRANSACTION VOLUMES CONTINUE TO EXCEED FUNDRAISING



Source: Pitchbook, Jefferies. Data on capital raised as of December 31, 2023. Data on transaction volumes as of June 30, 2024.

is sufficient supply of capital to meet the pace of investment (or demand for capital). Simply put, a large overhang ratio may lead to excess competition for new deals, potentially driving higher pricing as discounts shrink and decrease investor returns. On the other hand, a small overhang ratio may curtail further market growth.

Today, the capital overhang ratio in the secondary market has fallen to 1.8x, its lowest level since 2021.[5] This suggests that despite a strong growth trajectory, undercapitalization is a potential concern for further growth. Without additional fundraising or use of leverage, some estimates suggest there is only 12-18 months of dry powder available — which is considerably lower relative to other private market segments.

A DEEPER DIVE: BREAKING DOWN THE CAPITAL OVERHANG RATIO

A breakdown of the capital overhang ratio and the current drivers of each component provide further context:

> "With banks unable to the meet secondary sponsors' financing needs alone, many non-bank lenders, such as asset managers, have stepped in to fill the gap–essentially gaining exposure to the asset class by investing in loans underpinned by secondary investments."

FIGURE 2: FINANCING IS KEY TO SOLVING FOR THE CAPITAL OVERHANG

	2024	2025	2026	2027	2028	2029	2030
Dry powder available	135	116	93	67	35	-3	-48
Capital raised	100	116	135	156	181	210	244
Recycling available	21	24	28	33	39	45	52
Capital available	256	256	256	256	254	252	248
Estimated deal volume	-140	-163	-190	-221	-257	-300	-349
Capital available before use of debt	116	93	67	35	-3	-48	-101
Capital overhang before use of debt	1.83	1.57	1.35	1.16	0.99	0.84	0.71

Assumptions	Growth p.a.	
Capital raised	16%	CAGR 2013-2023 (Preqin Data)
Transaction volume	16%	CAGR 2013-2023 (Evercore H1 Secondary market review July 2024)
Assumed recycling	15%	

Source: Jefferies, Preqin. As of June 2024.

[**A**] Fundraising: Secondary managers have allocated significant resources to their fundraising efforts. Dedicated investor relations teams often partner with placement agents, driving the commendable growth of the market. It's also worth noting the tailwind of increasing interest in the space–as secondaries have become both a legitimate portfolio management tool and often standalone allocation for investors.[5]

[**C**] Deal volume: Secondary market volume neatly matches NAV growth offset by seven years, implying that the value of secondary transactions could triple from around $114 billion in 2023 to more than $400 billion in 2030.[6] This raises the question: How will this growth be sustained?

[**B**] Level of debt: This brings us to one of the most overlooked variables in the capital overhang equation—the level of debt available to a secondary manager. As we noted in a recent paper, private market growth is set to outpace bank balance sheet growth, resulting in a significant and growing funding gap in the coming years. In the context of the secondary market, where growth has generally outpaced other areas of the private market, this funding gap is exacerbated.

Looking ahead, our calculations suggest the capital available (before the use of debt) in the secondary market could turn negative in the next four years (Figure 2). With banks alone unable to provide the required capital, there is a growing need to fill the shortfall.

Against this backdrop, many (but not all) secondary managers have realized the importance of building out a capital markets team to manage funding needs with different sources of financing. This can include managing:

• The secondary funds' liquidity needs as part of the managers' own respective capital overhang;

• Its internal asset-liability matching strategy as longer-duration debt financing is required to mitigate the asset-liability mismatch risk for investors;

• Its lender base, by diversifying lender groups and types to guarantee a stable and reliable funding base as the need for financing increases.

Given how the secondary market continues to expand–from its origins of traditional LP-led opportunities to seek early liquidity to today's non-traditional GP-led transactions, credit secondaries and collateralized fund obligations— we believe liquidity management and access to alternative sources of financing will be key to further growth.

RISE OF THE NON-BANK LENDERS

With banks unable to the meet secondary sponsors' financing needs alone, many non-bank lenders, such as asset managers, have stepped in to fill the gap—essentially gaining exposure to the asset class by investing in loans underpinned by secondary investments. For these managers, and by extension their investors—often large insurance companies—the inherent underlying diversification and steady cash flow characteristics of secondaries are some of the key benefits on offer. In addition, these investments are typically rated investment grade.

While the trend toward secondaries has accelerated, it is not new. And in the next few years, we expect the opportunity to amount to more than $24 billion annually. The Barings Portfolio Finance platform has deployed significant amounts of capital into secondary financings on behalf of our clients. We have increasingly been seeing secondary sponsors seek financing options as an active portfolio management tool, often to differentiate themselves from their peers. Our platform can facilitate a range of financing solutions ranging from hybrid financing, acquisition financing of LP portfolios, as well as other liquidity solutions.

KEY TAKEAWAY

The secondary market continues to grow in leaps and bounds. Raising capital remains the primary consideration for managers, positioning them to benefit from the expected increase in deal volume. However, it is important for managers to also keep in mind that managing their own access to alternative sources of financing (and investors) is an important, and sometimes overlooked, variable in the capital overhang equation.

1) Source: Evercore. As of July 2024.
2) Source: Preqin. As of December 31, 2023.
3) Preqin. As May 2024.
4) Source: Jefferies. As of June 30, 2024.
5) Source: Jefferies. As of June 30, 2024.
6) Source: Preqin, Greenhill, Evercore. As of February 6, 2024.

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Johan Strömberg, Director of Private Asset Sales – Schroders

The Rise of Semi-Liquid Funds: A Gateway to Private Markets

By Eugeniu Guzun – HedgeNordic

Private markets have gained popularity and appeal in the not-so-distant low-interest-rate environment, attracting investors with the promise of higher returns and portfolio diversification. What was once an exclusive universe for institutional investors is now becoming more accessible through semi-liquid funds, also known as open-ended evergreen funds. Schroders Capital offers its own range of semi-liquid solutions that provide exposure to private equity, infrastructure, and real estate.

Historically, access to private markets was restricted to closed-ended investment vehicles, which come with significant barriers such as high investment minimums, capital call drawdown structures, and long lock-up periods. In contrast, semi-liquid funds offer investors periodic liquidity while still allowing access to private equity, infrastructure, and other illiquid alternative asset classes. Structured as Luxembourg AIF, Schroders' semi-liquid fund range offers "monthly liquidity for subscriptions and quarterly liquidity for redemptions," explains Johan Strömberg, Director of Private Asset Sales at Schroders.

Investors can subscribe and redeem at regular intervals at the prevailing net asset value (NAV), with an annual redemption cap of 20 percent of NAV, equating to five percent per quarter. One of the challenges with semi-liquid funds is managing the liquidity mismatch between the underlying illiquid assets and the liquidity offered to investors. Strömberg explains that liquidity "only becomes an issue when the redemption cap of five percent per quarter is reached." However, there are mechanisms in place not to reach the five percent quarterly cap.

These mechanisms vary depending on the fund's underlying assets but typically involve liquidity sleeves composed of cash or liquid investments such as public equities. "We keep five percent to ten

> "We prefer co-investments and secondaries due to the visibility they offer and the maturity of these investments."

percent of the funds in cash, with a very low element of listed equities in some funds." says Strömberg. For yield-generating asset classes such as infrastructure, the cash flows from the yield component further help liquidity management. More importantly, "the 90-day notice period for redemptions in all funds offer clarity into upcoming outflows, which can often be matched by monthly inflows." In times of high redemption pressure, "there is a control mechanism in place to gate the funds when redemptions exceed 20 percent of NAV," according to Strömberg. Semi-liquid structures, therefore, are designed to provide liquidity in a controlled manner.

SCHRODERS' PRIVATE EQUITY FUNDS: FOCUS ON CO-INVESTMENTS AND SECONDARIES

A well-constructed portfolio across geography, sector, type, and vintage can also engineer a level of "natural liquidity." For its three semi-liquid private equity funds, Schroders Capital focuses primarily on co-investments and secondaries rather than primary funds. "We prefer co-investments and secondaries due to the visibility they offer and the maturity of these investments," says Strömberg. "If we do invest in primary funds, we prefer late-stage primaries with high visibility on existing investments, as primary fund investments create cash flow planning challenges," explains Strömberg. The aim is to avoid J-curve effects as much as possible.

While reducing costs is not the primary goal, the focus on co-investments and secondaries does help minimize fees for end investors. "In primaries, you face the full 2-and-20 fee structure, whereas co-investments generally have no carry fee, and secondaries typically come at half the fee level of primaries," says Strömberg. Another advantage of focusing on secondaries, particularly in GP-led single-asset transactions where Schroders Capital focuses on, is the ability to purchase star assets with continued upside potential, offering both growth and risk mitigation properties. "The loss ratio on GP lead secondaries is only 2 percent, based on our measures," notes Strömberg, adding that "while the upside still is there on GP-leds, the visibility and maturity of these GP-led secondaries also make them appealing from a risk mitigation perspective."

> "Investors can simply focus on the NAV when investing, with no need for complex cash planning, gaining access to high-quality managers we have been collaborating with for years."

In addition to preferring co-investments and secondaries, Schroders Capital targets lower mid-market businesses with enterprise values between $150 million and $500 million, focusing on sectors such as technology, healthcare, consumer, and industrials. "These are our four main sectors, although almost everything today has some kind of tech angle," Strömberg says.

FINAL THOUGHTS ON SEMI-LIQUID STRUCTURES

The rise of semi-liquid fund structures has largely been driven by demand from smaller investors seeking access to institutional-grade private market investments. "The popularity of the semi-liquid structure has definitely been influenced by retail and private banking clients," notes Strömberg. However, institutional investors are also showing increased interest, particularly due to the flexibility these structures offer. In general, these structures represent a trade-off between liquidity, returns, and fees.

In contrast to traditional private market investments, which typically offer higher returns accompanied by limited liquidity, semi-liquid funds provide more frequent liquidity – often through quarterly redemption windows – while still delivering competitive returns. As Johan Strömberg, Director of Private Asset Sales at Schroders, explains: "A traditional infrastructure fund with a buy-and-hold structure might have a 20-year lifespan, but semi-liquid evergreen structures offering quarterly liquidity provide an easier way to access the asset class." However, this added liquidity may come at the cost of slightly lower returns, as semi-liquid funds maintain slightly higher cash reserves to accommodate potential redemptions.

On the cost side, Schroders' semi-liquid funds feature a simplified fee structure. Unlike many private market funds that charge performance fees, these strategies apply only an annual management fee. "Our strategies don't charge a performance fee at the fund level, though we may incur performance fees on a few underlying investments, such as primaries," Strömberg notes. "Investors can simply focus on the NAV when investing, with no need for complex cash planning, gaining access to high-quality managers we have been collaborating with for years."

At the same time, the semi-liquid structure enables investors to "ramp up investments to full exposure instantly," according to Strömberg. "These funds represent a good gateway into private markets asset classes," concludes Strömberg, "and for investors who want to expand their exposure to private markets, we help them on their journey, whether they choose fully closed-end structures or other options."


Antti Kortela, Portfolio Manager – Elo

Private Credit: Both Complement and Substitute for Liquid Alternatives

By Eugeniu Guzun – HedgeNordic

> "We have been investing in private credit for ten years now and the asset class has evolved into a core component of our fixed-income portfolio."

In the aftermath of the Global Financial Crisis, new banking regulations prompted banks to de-emphasize their focus on traditional corporate lending. This shift caused significant changes in financing markets and propelled the growth of private credit as an asset class. Elo, Finland's third-largest pension insurance company out of four, considers private credit a cornerstone of its fixed-income portfolio after a decade of investment in this space.

"We have been investing in private credit for ten years now and the asset class has evolved into a core component of our fixed-income portfolio," says Antti Kortela, portfolio manager of Elo's private credit program since 2014. For Elo, private credit offers opportunities for "high expected returns with lower observed volatility," functioning not only as a complement to more liquid fixed-income investments but also as a viable substitute. "Private credit investments have fulfilled complementary and substitution roles to some degree," he affirms.

In 2023, the private credit industry enjoyed its highest annual returns since the financial crisis, despite a decrease in investment volume and investor demand shifting toward more liquid alternatives with comparable yields. Private credit returns benefited from higher interest rates last year, owing to the floating-rate nature of the asset class. "Before the rate increases, one could expect returns ranging from six to eight percent net, reflecting a mix of higher-risk, higher-return opportunistic debt and core direct lending," explains Kortela. "In the current higher-rate environment, return expectations from private credit are two to three percentage points higher than in the zero-rate era," he adds.

Despite the appeal of attractive returns in more liquid alternatives, "the private credit allocation has reached a mature stage in our portfolio, firmly establishing its place and share on our balance sheet," according to Kortela. He underscores the risk-return appeal of private credit and the numerous opportunities in the space, stating, "We will maintain a steady deployment pace to sustain our current mature level of exposure." Kortela emphasizes that the current focus is on "fine-tuning our allocation, working with existing relationships, and figuring out the optimal setup and exposure to meet our specific needs."

MANAGER SELECTION: AIM FOR DIVERSIFICATION

Private credit has now gained widespread acceptance as a mainstream, long-term asset class for institutional investors, underscores Kortela. "A key takeaway for approaching the private credit asset class is the importance of diversification," he argues. "Investors should diversify across funds, strategies, vintages, geographical regions, and other dimensions." Diversification mitigates the need to time the market. "Timing the market for optimal allocation is quite challenging," he notes, "thus, we focus on finding managers that can deploy capital in both favorable and more challenging credit environments."

When evaluating private credit managers, Kortela emphasizes the importance of assessing factors such as underwriting quality, lender controls, documentation, and tail risks. He also stresses the need to evaluate the alignment of interests between general partners and limited partners. "During due diligence, it's important to keep in mind that the situation may not always be as good as the GP might portray, so it's essential to dig deeper," advises Kortela. This involves examining current and entry sales figures of underlying creditors, EBITDA multiples, and the development trend of the credit portfolio. Understanding the valuation policies employed by general partners and their practical application is equally crucial, he elaborates. "While everyone follows the same principles, significant differences may exist between managers."

When building the private credit portfolio at Elo, Kortela and his team seek to collaborate with managers across several vintages. "We avoid one-off opportunities, opting instead for long-term commitments that require rigorous due diligence," explains Kortela. "We want to ensure ongoing engagement and investments across vintages with managers, which requires well-resourced teams and a very strong pipeline of investments." Kortela notes increased regulation and the high cost of establishing and operating private credit platforms, underscoring the importance of "finding managers who can ensure continuity for subsequent vintages."

> "A key takeaway for approaching the private credit asset class is the importance of diversification. Investors should diversify across funds, strategies, vintages, geographical regions, and other dimensions."

Kortela observes that the private credit secondary market is relatively new but rapidly evolving with considerable room for growth. Despite increasing competition and the emergence of numerous new players, Kortela observes that "the market is less competitive than private equity secondary, for instance, and there remains a handful of managers that dominate the market." In the current challenging fundraising environment, he adds, "Investors tend to favor larger and more well-established names, making it particularly difficult for smaller players to launch new initiatives."

WATCH THE FULL CYCLE

Private credit has demonstrated its ability to generate returns in a rising interest rate environment, but the pressing question remains whether businesses can withstand these higher rates. "Borrowers have been surprisingly resilient," notes Kortela, attributing this to diligent underwriting by general partners and the ability of companies in both the US and Europe to manage and adapt to higher interest rates. However, the prospect of a higher-for-longer interest rate environment could begin to reveal ripple effects. "In our experience, borrowers can usually survive one shock at a time, because borrowers do plan for potential higher rates and have prepared well to navigate the environment," he argues.

Nonetheless, borrowers may face challenges from company-specific or idiosyncratic risks such as the loss of major customers or complications arising from large M&A integrations. "These idiosyncratic risks are always difficult to anticipate and prepare for," Kortela cautions. The private credit market is undergoing a complete credit cycle, potentially simplifying the task of manager selection.

"Once the credit cycle finally turns and more challenging times are upon us, we expect to see more dispersion between managers," concludes Kortela. Consequently, Kortela and the team at Elo consider that one of the key factors to success is that managers possess the necessary restructuring skills to manage and navigate potential credit events effectively.

Kristofer Kraus, Portfolio Manager and Co-Head of Specialty Finance – PIMCO

Beyond Corporate Lending:

Specialty Finance as the Next Frontier of Private Credit

By Eugeniu Guzun – HedgeNordic

Private credit has gained significant traction since the 2008 financial crisis, as regulatory and accounting changes led traditional banks to scale back lending. This pullback has opened the door for alternative, non-bank lenders to step in. Private credit, primarily involving corporate loans not traded on public exchanges, has attracted investors with its potential for diversification, income generation, reduced volatility, and superior returns compared to public markets. A rapidly growing segment of this space is specialty finance, which focuses on non-corporate markets such as consumer loans, equipment leasing, and aviation finance, offering additional diversification to traditional private credit exposure.

“Specialty finance typically involves an asset-based form of lending, though not exclusively,” explains Kristofer Kraus, who co-leads PIMCO’s asset-based finance business. What distinguishes specialty

> “Specialty finance largely consists of portfolios of consumer credit, whether that’s mortgages, personal loans, or solar loans. The distinction lies in the portfolio approach to managing these loans.”

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finance from traditional corporate direct lending is often its more diversified, granular pool of self-amortizing, contractual obligations. "Specialty finance largely consists of portfolios of consumer credit, whether that's mortgages, personal loans, or solar loans. The distinction lies in the portfolio approach to managing these loans," Kraus explains. "We factor in a certain level of loss when calculating expected returns." This contrasts with corporate direct lending, where the success of the investment hinges on a single large borrower. "While this doesn't make one better than the other, it's an important distinction."

Specialty finance also tends to involve shorter durations, usually around two years compared to the four to seven years typical of private credit. "What we like a lot about specialty finance is that their cash flows tend to be more front-end in nature, shorter duration in nature," reiterates Kraus. "You see the payments coming through monthly or quarterly, which include both principal and interest. This structure allows the investment to de-risk and de-leverage faster than typical corporate loans. We don't have to wait years to get our principal back." The assets' principal pays down over time rather than in a bullet payment at maturity, de-risking the investment, shortening the duration, and allowing for efficient redeployment of capital based on available opportunities.

The return profile for specialty finance can exceed that of corporate lending, with potentially lower volatility. "The expected return is a function of where the investments sit in the implied capital structure," Kraus explains. "We have built senior secured portfolios at the top of an implied capital structure generating upper single-digit loss-adjusted unlevered returns," he continues. Some clients can benefit from potential additional upside through securitization structures. "Returns can start in the high single digits and depending upon the risk appetite of the client, we can take it up from there," says Kraus. Expected returns can reach the mid-to high-teens for clients with higher risk appetites, given today's base interest rates.

> "Specialty finance offers significant diversification away from the corporate exposures many investors already hold, and it also provides a strong income component that begins de-risking the investment from the start."

GRANULAR INSIGHTS ON CONSUMER DEBT

Successful specialty finance investments require a granular understanding of the consumer and their financial health. The consumer is not monolithic, suggests Kraus. PIMCO maintains a comprehensive database covering approximately ten percent of the U.S. population. On average this includes ten credit lines per person, across auto loans, credit cards, mortgages, and student loans, among others. This database, which spans over 20 years, provides about 200 million loan-level data points monthly, giving PIMCO a unique edge in analyzing consumer credit markets.

This data helps PIMCO identify pockets of value in many consumer-related assets, including residential mortgages, home improvement, solar and student loans, or unsecured consumer loans and credit card receivables. "You can't just helicopter in this business and expect to succeed and perform well across cycles," emphasizes Kraus. "You need experience and a robust data infrastructure and analytics to unpack and identify which investments will outperform in different economic cycles, especially in a recessionary environment."

While corporate direct lending remains the core private credit allocation for many investors, Kraus recommends adding exposure to specialty finance as a complement, given its distinct risk-return profile. "Specialty finance offers significant diversification away from the corporate exposures many investors already hold, and it also provides a strong income component that begins de-risking the investment from the start," Kraus explains. "For investors heavily allocated to corporate lending, specialty finance can serve as an important diversifier."

GAINING MOMENTUM

"Historically, economies have relied on banks as the main source of credit for individuals, corporations, and governments," says Kraus. "That changed dramatically with the GFC. Regulations that followed deliberately aimed to shift risk away from the banking system and de-risk the system overall," he explains. With banks pulling back from lending, non-bank lenders such as PIMCO have stepped in as capital providers. Private non-bank lenders with access to long term institutional capital are in many ways better suited to holding this risk than traditional banks that are funded by retail deposits.

Kraus expects no slowdown in the growth of non-bank lending. "I don't see the participation of non-bank lenders slowing down anytime soon – if anything, it's gaining momentum," he notes. However, he emphasizes that this does not spell the end for banks. "We often partner with them rather than trying to displace them."

The evolution of private credit has also expanded its definition. "A few years ago, private credit was almost exclusively about corporate direct lending," Kraus explains. While the core private credit allocation for many investors remains corporate direct lending, the universe has evolved to "include several different areas of opportunities that fall under that umbrella, including specialty finance," according to Kraus. "I'd even go as far as to call it private fixed income."

PIMCO is a global leader in private asset-based lending with over $165bn deployed across mortgage, consumer, and asset-backed sectors. They have a long history of detailed loan-level underwriting, analytics, and downside risk management, and have built a far-reaching global network of sourcing channels including 60+ origination partners.*

* As of 31 December 2023

Velliv's Take on Private Markets:

The Appeal of Private Credit

By Eugeniu Guzun – HedgeNordic


Christoph Junge, Head of Alternatives – Velliv

Institutional investors, including those from the Nordic region, have steadily increased their allocations to private market asset classes such as private equity, private debt, real estate, and infrastructure. Despite a general weakening in appetite for alternative investments in a higher interest rate environment, pension and institutional clients continue to explore private assets. This interest is driven not only by the long-term outperformance of private assets compared to public equivalents but also by the broader investable universe they offer, as noted by Christoph Junge, Head of Alternatives at Danish pension provider Velliv.

Approximately ten percent of Velliv's €45 billion investment portfolio is allocated to alternative investments, including private equity, private credit, liquid alternatives such as trend-following CTAs and commodities, as well as infrastructure and timberland. Led by Christoph Junge, Velliv's alternatives team manages about €4.5 billion in these assets, excluding real estate, which is handled by a different team. "Private equity remains the largest building block of our alternatives allocation and has been so for a long time," says Junge. The second-largest component is illiquid credit, categorized into two segments: low-risk and high-risk illiquid credit.

"Illiquid credit with low risk typically includes credits such as commercial real estate debt, infrastructure debt, and asset-backed securities that are very senior in the capital structure with minimal risk," explains Junge. "In contrast, high-risk illiquid credit can include anything from senior direct lending and mezzanine, all the way to CLO equity," elaborates Velliv's Head of Alternatives. Together, these two buckets form the second largest building block of Velliv's alternatives allocation. The third largest portion of the alternatives portfolio consists of liquid alternatives, including CTAs and long-only commodities. This allocation has seen significant growth over the course of the past two years. Real assets such as infrastructure and timberland make up a smaller allocation, followed by an impact allocation.

ROLES OF PRIVATE ASSET CLASSES IN A PORTFOLIO

Every asset class, including those in private markets, plays a distinct and defining role in the broader portfolio. "Each of these asset classes has its own distinct role in our portfolio allocation," reiterates Junge. The primary role of both private equity and private credit in Velliv's portfolio is to outperform their liquid counterparts. "In private equity, our goal is to achieve the highest possible returns and outperform listed markets over the long run," explains Junge. Velliv targets a performance that exceeds listed markets by at least three percentage points per annum throughout a complete cycle. "Similarly, private credit also seeks to outperform the returns of liquid credit markets," he adds. Low-risk illiquid credit aims to outperform investment-grade credit, while high-risk illiquid credit aims to pick up additional spread and illiquidity premium compared to their listed counterparts.

"Private credit is still credit, and private equity is still equity," emphasizes Junge. "Both private and public markets are influenced by the same macroeconomic factors." While diversification is not the primary objective of Velliv's investments in private equity and private credit, "there is a bit of diversification to be had given that only a minor part of the global economy is publicly listed." Private equity and credit offer a much wider investable universe. "We get a bit of diversification by gaining exposure to a broader range of companies that would otherwise be off-limits."

Investing in real assets serves a distinct purpose. "With infrastructure and timberland investments, we are aiming for stable returns and inflation protection," points out Junge. Real assets expose investors to a different set of risk premiums. "Timberland, for instance, grows each year; trees don't stop growing just because the world is in a recession," explains Junge. "Investors get more timber on the stump year after year, which is an attractive feature of timberland as an asset class." In addition, there is no immediate need to harvest the trees if market prices are unfavorable. "Crucially, our own analysis and broader research show a strong positive correlation between timberland investments and the consumer price index, offering effective inflation protection," Junge adds.

"The same can hold true for infrastructure investments, but depends on the underlying investments and their structuring, so devil is in the details," emphasizes Junge, adding that Velliv "deliberately chose to go for the core and core-plus segments, which are the lowest-risk areas." While timberland and infrastructure are among the lowest-risk building blocks in the portfolio, "certain parts of private credit and private equity represent the more 'high-octane' building blocks."

THE EFFECTS OF HIGHER INTEREST RATES

The era of low interest rates in the decade post-financial crisis led to a surge of investment capital flowing into private markets. However, the recent shift towards a higher interest rate environment has dampened fundraising activities in this universe and has manifested varying effects on the appeal of different alternative asset classes. "There are some asset classes that should suffer from higher interest rates, with private equity being a prime example," says Christoph Junge.

He explains that with current interest rates significantly higher than before, the expected return from private equity could have declined from around 20 percent during the low-rate environment to approximately 15-16 percent today – all else equal. Junge suggests that leverage, a traditional driver of returns in private equity, will become less influential. "The focus has shifted to operational improvements," he asserts. "In the future, the general partners who will survive and fare best are those who are masters of operational improvements. It's not about financial engineering anymore."

> "In private equity, our goal is to achieve the highest possible returns and outperform listed markets over the long run. Similarly, private credit also seeks to outperform the returns of liquid credit markets."

Junge draws a comparison to the 1980s, when interest rates were above ten percent and private equity still delivered solid returns despite relying heavily on financial engineering. "However, you cannot compare today's private equity landscape to that of the 1980s, because markets were much more immature back then," he observes. Despite this, Junge anticipates the higher interest rate environment to slightly reduce expected returns in private equity and the attractiveness of private equity as an asset class. "The same might hold true for some real assets, such as timber and infrastructure," he adds, though the link is not as clear. "The discount rate is just one component of the equation."

PRIVATE CREDIT: THE PREFERRED CHOICE IN TODAY'S MARKET

Private credit, on the other hand, has benefited from the rise in interest rates. "With its floating rate nature, the base rate has gone up from zero to 500 basis points, so we are currently earning 9, 10, or even 11 percent after fees on senior direct lending," explains Junge. "This makes private credit more attractive than private equity," he asserts. Junge questions the value of opting for equity when senior lending offers returns in the teens. "If private equity offers 15 percent returns and private credit yields 10 percent, is it worth taking on the additional risk in the capital structure for that extra return?"

As a result, Velliv is maintaining its current allocation to private equity while expanding its investment in private credit. "We are not halting our investments in private equity, we still make commitments due to the runoff in the existing portfolio," says Junge. He notes that Velliv's private equity portfolio would be worth only half its current value in five years without new investments. "We are focusing on maintenance commitments."

Junge observes significant optimism surrounding private credit. "There is certainly a trend of widespread bullishness on private credit at the moment," he notes. While this enthusiasm often makes him cautious, he acknowledges the reasons behind its attractiveness. "I always consider if there are any overlooked risks that may bring down the bullishness, but it's understandable why private credit is seen as attractive currently," he continues. Nevertheless, he emphasizes that "the fun only lasts as long as borrowers can pay the debt and can sustain substantially higher interest rates."

Junge and his team at Velliv are carefully monitoring borrowers' ability to meet interest payments and maintain adequate coverage ratios. However, he notes that if "we are concerned about companies not being able to pay the interest rates as debt investors, we should be more concerned about equity positions due to their subordinate status in the capital structure." Everyone is bullish on private credit, says Junge, and "I can fully understand why everyone is bullish." Junge finds private credit to be relatively more compelling than private equity at the moment.

The interview with Christoph Junge took place in mid-May 2024.

> "If private equity offers 15 percent returns and private credit yields 10 percent, is it worth taking on the additional risk in the capital structure for that extra return?"

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Gilles Lafleuriel, Head of Sweden – Obligo

Not All Infrastructure Is Equal: Beyond Traditional Infrastructure

By Eugeniu Guzun – HedgeNordic

Traditional infrastructure investments have long been viewed as an effective hedge against inflation. These investments generally benefit from stable, long-term contractual income streams from high-quality counterparties, offering reduced economic sensitivity and high cash flow visibility. However, infrastructure assets vary widely in their nature and performance. The performance of some assets such as airports or ports can be closely tied to economic growth, while others such as renewable energy assets may depend on prevailing electricity prices.

"Traditional infrastructure has indeed been a good hedge against inflation because long-term contracts or regulated mechanisms secure stable long-term cash flows," confirms Gilles Lafleuriel, Head of Sweden at Obligo, a Nordic asset manager specializing in sustainable infrastructure and real estate. "These mechanisms are designed to adjust for inflation, so investors are not directly impacted by price movements," he continues.

However, Lafleuriel points out that there are other ways to invest in infrastructure. For example, choosing not to hedge a wind park against power prices provides exposure to merchant risk. Obligo, which manages a diversified infrastructure climate impact fund focusing on renewable energy, clean mobility, and other sectors, has taken a merchant approach for their renewable power assets.

Recent low power prices across Europe, particularly in the Nordics and Sweden during the summer, have created stress on existing renewable energy assets. "Revenues have fallen short of expectations in the last few months, which has put pressure on liquidity and future cash flows," acknowledges Lafleuriel. "We believe it may take several years for power prices to normalize to levels we thought would be achievable just six months ago," he continues. "This certainly

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creates challenges for our existing assets, but we still believe in the long-term healthiness of the power market, driven by a steadily growing demand. Patience is key," says Lafleuriel. As an investor, the short-term situation is creating both obstacles and opportunities for us."

ADAPTING TO THE NORDIC MARKET

Operating in the Nordic region has required Obligo to tailor its approach. "We are operating in the Nordics, a market that has its own characteristics," says Lafleuriel. "The Nordic infrastructure market is heavily dominated by the public sector, leading to limited opportunities for private investors, often difficult to capture," continues Lafleuriel, who has more than 20 years of experience in the infrastructure industry. This necessitates a creative approach to identifying, assessing, and executing investments.

Rather than waiting for the public sector to divest legacy infrastructure assets, Obligo has taken a proactive stance by investing early in the development of energy transition projects, including carbon capture and charging stations, among others. "We realized that we need to grab the bull by the horn, i.e. create value by building from scratch," says Lafleuriel. "This approach means that we are investing at the very beginning of these projects, during the development or construction stages, and sometimes even earlier by taking a stake into the development companies."

This approach involves taking on more corporate risk, often resembling private equity or venture capital, rather than pure infrastructure risk, according to Lafleuriel. "We've consciously decided to take on these risks," says Lafleuriel. "While the end game is to be invested in operational assets, we start by investing at the earliest stages, from development through early operations."

INVESTING ACROSS FOUR KEY SECTORS

Obligo's diversified infrastructure fund focuses on four core sectors: renewable energy, energy distribution and storage, clean mobility such as EV charging, and digital infrastructure. The fund holds both operational assets and development projects across these sectors. "We currently manage not only operational wind and fiber assets, but also development projects in solar, carbon capture, and charging stations for heavy trucks," says Lafleuriel.

As an Article 9 fund under the SFDR, the Obligo Nordic Climate Impact Fund is committed to delivering measurable impact, particularly in combating climate change. "We achieve this by either investing in existing assets to sustain their operations or by developing new ones from scratch," explains Lafleuriel. For instance, Obligo has invested in aging wind farms in southern Sweden, ensuring their longevity through efficient operations and, eventually, retrofitting and repowering when needed. "This adds value to the sustainability of the energy system."

However, Obligo's most significant impact comes from early-stage investments. "The most obvious value creation takes place when one takes a project from a concept on paper to full operations," Lafleuriel notes. One example is Obligo's investments in truck charging stations, which started as a stake in a development company and have now evolved into fully operational assets. "Our existing portfolio is a testimony of our investment philosophy: adding value by creating sustainable assets or ensuring their long-term operations."

Obligo has positioned itself as a local investor with a strong track record of sourcing, executing, and developing infrastructure projects. "These deals are also not only difficult to source, but they are also, most of the time, fairly difficult to execute," argues Lafleuriel. "Our approach isn't traditional infrastructure investing, we offer a solution to diversify both infrastructure and private equity portfolios," he continues. "But the end game remains the same and involves providing exposure to infrastructure assets that are and will be essential to the society for the long term."

> "We realized that we need to grab the bull by the horn, i.e. create value by building from scratch. This approach means that we are investing at the very beginning of these projects…"

Alexandria Breaking Barriers to Private Markets

By Eugeniu Guzun – HedgeNordic

Toni Iivonen, CEO and CIO – Alexandria Group

Access to private markets asset classes such as private equity or private credit is becoming increasingly available to individual investors, expanding beyond the traditional reach of institutional and ultra-wealthy clients. Individual investors are also showing growing interest in diversifying into private markets. Responding to this demand, Alexandria Group, a private wealth manager and asset manager with around 40,000 clients in Finland, has launched a fund that invests in semi-liquid private equity and private credit funds.

"There had been interest from both our sales force and clients regarding private equity and private debt," states Toni Iivonen, the CIO of Alexandria Group and CEO of its fund management arm, providing context for the fund's launch. "In the past two to three years, we have also observed a surge in product launches from both smaller and larger asset managers offering similar solutions," he elaborates. The recent changes in regulations under the modernized ELTIF 2.0 and UCI Part II regime have simplified access for retail investors, effectively lowering barriers to retail participation in private market investments.

However, Iivonen notes that "the biggest challenge for private clients in accessing private equity and private debt has been the illiquidity of these asset classes." While these semi-liquid structures do not completely address the liquidity mismatch between private markets and the liquidity of the funds, "they significantly alleviate this concern for many clients." Alexandria employs a Finnish fund structure akin to the Luxembourg UCI Part II regime, allowing for quarterly redemptions and monthly subscriptions. The underlying investments consist of semi-liquid private equity and credit funds "that share similar liquidity profiles with our fund."

CONSOLIDATED EXPOSURE TO PRIVATE EQUITY AND PRIVATE CREDIT

Rather than offering separate funds for private equity and private credit, Alexandria provides combined

"There are correlation and diversification benefits when including both private equity and private credit in one vehicle."

“We are building our portfolio by investing in and partnering with funds that have a proven track record, significant assets under management, and stable, mature portfolios with diversified vintages.”

exposure to both asset classes in a single fund. “There are correlation and diversification benefits when including both private equity and private credit in one vehicle,” explains Iivonen. “Private credit typically performs well in a rising rate environment, while private equity may do better in other conditions,” he elaborates. “At the same time, private credit usually exhibits shorter duration than private equity, which improves the fund’s overall liquidity profile.” Thus, the exposures to private equity and credit complement each other within a unified portfolio.

Alexandria’s fund targets an allocation of approximately 80 percent to private equity, with the remainder directed toward private credit, although this allocation can fluctuate based on market conditions. “The allocation could also shift to 60 percent private equity and 40 percent private credit; there are no strict limits,” says Iivonen. “We take a common-sense approach to adjusting our exposure.”

The private equity market has faced headwinds from rising interest rates, resulting in fewer exits and M&A transactions. However, Iivonen anticipates that as interest rates decline, M&A activity will rebound, revitalizing the private equity market. Despite decreasing interest rates, Iivonen expects the private debt and credit market to remain appealing. “While private credit may experience some impact from lower rates, this change is unlikely to significantly affect returns due to the high coupon nature of private credit,” he asserts, unless a zero-rate environment returns. “However, I do not foresee rates dropping to zero, even with many cuts priced into the current interest rate curve.”

Given the crowded private equity market and the anticipated uptick in transactions, Iivonen also expects “a rise in fundraising for private credit managers.” Overall, he expresses a positive outlook for both private equity and private credit in the current environment.

PATHWAY TO PRIVATE ASSETS VIA ESTABLISHED MANAGERS

To facilitate access to private equity and credit for its extensive investor base across Finland, Alexandria has adopted a prudent approach to portfolio construction. “We are building our portfolio by investing in and partnering with funds that have a proven track record, significant assets under management, and stable, mature portfolios with diversified vintages,” explains Iivonen, the CEO of the group that oversees €2 billion in assets under management. Among the fund’s current investments are Partners Group Global Value SICAV and Schroders Capital Semi-Liquid Global Private Equity, both of which boast long-standing records and sizable, mature portfolios of private equity investments.

As Alexandria’s fund grows, the portfolio is expected to expand to between five and 15 funds. “Down the road when we reach a higher level of assets under management, we intend to diversify the allocation further and may consider investing in funds with a shorter track record,” notes Iivonen. At this stage, however, the emphasis remains on larger, more experienced managers. “We have evaluated many different aspects as part of the due diligence process, including the usual things such as track record, consistency, performance across different market conditions, available resources, and risk management tools.”

Iivonen concludes by discussing the primary motivations driving investor interest in private equity and private credit, namely higher return potential and diversification compared to public markets. “Return-wise, private equity and private credit appear quite attractive when compared to public equity and debt markets,” says Iivonen. “Moreover, they serve as a diversifying element within a portfolio; for example, private equity valuations tend to be less volatile than those in public markets.”

Investing in private equity and private credit comes with challenges, such as the J-curve associated with the long periods for the capital calls, extended investment horizons, and limited liquidity. “Some of these issues are mitigated by the semi-liquid fund structure, which is evergreen and fully invested,” according to Iivonen, providing a pathway to private markets for individual investors.

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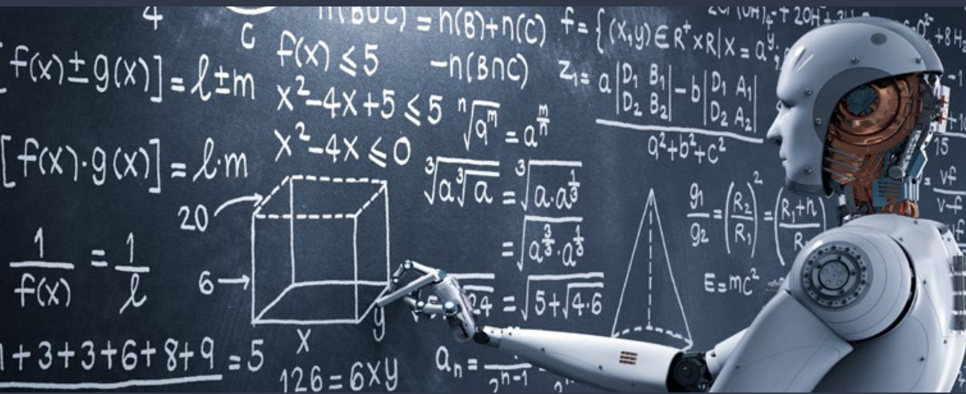

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