HEDGENORDIC

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SPECIAL REPORT PRIVATE MARKETS 2022

Contents

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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.

HEDGENORDIC PUBLICATION PLAN 2022:

September: Systematic Trading
October: Powering Hedge Funds
November: Alternative Fixed Income
December: ESG & Alternatives

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HEDGENORDIC

Editor´s Note…

The Wise Owl in Finance

In Greek mythology, the owl of Athena is said to be kept on the shoulder of Athena and reveal truths of the world to her, and thus also represents the literal wisdom and knowledge of Athena in her role as a goddess of wisdom.

Throughout antiquity, Athena and her companion owl served Athens as city symbol and primary coin type. What made the Athenian silver so popular and long lasting was its status as the definition of good money. The man on the street anywhere in the Greek world knew that he could trust the "owl" to contain full weight of the best silver.

Arguably, modern finance as we know it was invented in ancient Greece. Athens, and the many other Greek kingdoms were the cradles of currency and "movable" wealth. There lay the birthplace of banking, personal loans, securitized lending, real estate loans, credit-based trade, endowment investing, capital levies, interest rate laws, foreign exchange, annuities and many other related innovations that helped to give birth to the modern world.

Some of today's trading strategies can also be followed back to ancient Greece, along with trading rules that still apply today. "Buy low, sell high" is the core thesis of many investment strategies goes all the way back to Thales of Miletus. Thales of Miletus was a mathematician and philosopher renowned as one of the legendary Seven Wise Men, or Sophoi, of antiquity.

One winter, Thales decided to buy all the olive presses in his region – when prices were rock bottom since it wasn't olive pressing season. When spring came and everyone needed to make olive oil, he was ready to sell back the olive presses, thereby making a sizeable profit.

Another ancient example may be at the root of many hedge fund, or private equity strategies. The first recorded distressed turnaround operation was described in the 300s B.C., in Xenophon's Oeconomicus. Similarly to modern buyout managers, an investor purchased problematic properties, implemented changes to improve them and sold them to new buyers who wouldn't have purchased them before the repair.

If Ancient Greece invented finance, it also was the inventor of the financial crisis. The first one in recorded history, during the 6th century BC, was so bad that the Greek actually resorted to bringing in an academic – a poet, no less – to clean up the mess. It seems that the Greeks had engaged in a practice, en masse, in which they pledged themselves as slaves against the debts in support of their farms. It had gotten to the point that a sizeable part of the population ended up enslaved, even being shipped off abroad. The wiseman Solon was brought in to power in Attica and he began cancelling debts, freeing his fellow citizens from slavery and even redeeming some slaves who had been sold abroad. He did this by devaluing the currency, the drachma by one-quarter.

The first public stock market in contrast was not created until 1611, in Amsterdam. To raise capital, the Dutch East India Company decided to sell stock and pay dividends of the shares to investors. For many years, the only trading activity on the exchange was trading shares of the Dutch East India Company.

The argument then seems fair that trading in private assets, in what we refer to as private markets, was something us humans have been doing for millennia. It is our natural and instinctive way to do business and invest.

In this special report on Private Markets we want to take a closer look at various strategies and instruments traded in the private asset space.

Magdalena Högberg, Head of Strategic Asset Allocation and Quantitative Analysis at the Fourth Swedish National Pension Fund (AP4), explains the decision to create a separate real assets allocation – consisting real estate and infrastructure – instead of a broader alternatives portfolio in "AP4's True "Alternative". In a discussion with Mike Bessell from Invesco Real Estate we look at "European Real Estate in the New Economic Climate." Emerging markets specialist Emso Asset Management elaborates on "Speciality Finance in Emerging Market Private Credit" while Jussi Tanninen and Matias Hauru then move on to explaining "ESG Implementation in Mandatum's Private Debt Program".

Christoffer Sundberg and Mattias Lindfors discuss the objective of HCP Bricks, a by-product of the collaboration between Helsinki Capital Partners and Cobbleyard Real Estate, to serve as a "Value-Add Gate to Core Real Estate" and Kerstin Lindgren of RBC Investor & Treasury Services explains why "The Domicile Choice Shan't Raise Eyebrows" when launching a new fund in the private markets space.

From Gilles Lafleuriel we hear about "Obligo's Approach to Future-Proofing Infrastructure." and Christoph Junge, Head of Alternatives at Danish pension provider Velliv, then discusses why more investors are turning towards alternative investments in the hope to find "The Holy Grail of Portfolio Diversification."

In "Trees: a Natural Inflation Hedge," Jyri Hietala and Kari Kangas from United Bankers explain the origins of the inflation-hedging properties of forestry investments and their role in portfolio diversification. In an editorial piece, Filipe Albuquerque from NordSIP makes "The Case for Impact through Private Equity and Private Debt."

To finish off, Lars Granat Jensen of RareWine Invest and Anders Tang of Jero share their thoughts on the role and benefits of Wine as "The Illiquid Liquid Alternative."

We hope you have a good read with this magazine and will enjoy the summer months.

Kamran Ghalitschi
PUBLISHER, HEDGENORDIC

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AP4's True "Alternative"

By Eugeniu Guzun – HedgeNordic


Magdalena Högberg, Head of Strategic Asset Allocation and Quantitative Analysis – AP4.

"Real assets, for us, include assets that we feel have some sort of inflation component inherent in their characteristics. But one of the key roles of our real assets portfolio in this environment is obviously diversification."

The historically low bond yields in the decade following the 2008 financial crisis have led many institutional investors to look outside traditional asset classes in their search for yield. The current investment climate, dominated by uncertainty around slowing economic growth, rising inflation and interest rates as well as geopolitical tensions, has strengthened the case for relatively illiquid categories of real assets such as real estate and infrastructure.

"There have been two main drivers of the huge shift into alternative assets in recent years," says Magdalena Högberg, Head of Strategic Asset Allocation and Quantitative Analysis at the Fourth Swedish National Pension Fund (AP4). First, "institutional investors have been increasing their allocation to alternatives in the light of the very low bond yields, which has been driving the yields on alternatives down and prices and valuations up," she elaborates. "The other driver, the one that we have been focusing on a bit as well, is the search for inflation protection and finding assets that make the portfolio more robust for different macro regimes."

During 2021 and throughout 2022, AP4 further strengthened its investment portfolio's robustness through a continued larger allocation to unlisted real assets. This asset allocation decision has been specially adapted for AP4's main economic scenario best described as "muddling through," characterized by a gradual adjustment to an environment with relatively modest economic growth and weak productivity development from a historical perspective. At the same time, this allocation is designed to have stronger outcomes in AP4's alternative economic scenarios, one of high inflation and weakening economic growth that the world is living through at the moment.

AP4'S CATEGORIZATION OF ALTERNATIVES

As there is no one common definition for alternative investments, different investors would often have their own unique definitions of alternatives and may classify specific alternative investments differently. In its investment portfolio worth about SEK 528 billion, AP4 does not have a separate alternative assets portfolio. Instead, AP4 looks at the underlying drivers behind each asset class and does not differentiate between exposures with the same underlying factor exposures but different forms of listing.

"We look at private equity as part of the equity allocation and private debt as part of the fixed-income allocation," explains Högberg. "The allocation to private equity, for us, is about complementing the listed equity part of the portfolio and finding investments that are hard to access in the listed

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HEDGENORDIC

markets," she continues. "Investing in private equity is about getting exposure to a different sleeve of the market composed of companies that are not listed or see no benefit from a listing. We use our private equity allocation extensively to access investments exposed to our thematic research, and we also find this allocation is particularly valuable for the portfolio considering that we have seen a trend of declining number of listed companies for a number of years."

Similarly, the allocation to unlisted credits has the objective of getting access to credit risk premia beyond the listed marketplace. "AP4's unlisted credit investments are about diversification of credit risk and yield, of course," says Högberg. In the unlisted credit space, AP4 tends to "focus on middle-market segments that are not as exposed to growth compared to a general run-of-the-mill investment-grade allocation."

AP4'S SEPARATE REAL ASSETS PORTFOLIO

AP4, however, has defined real assets, such as real estate and infrastructure, as a separate asset class generally associated with long-term and comparatively stable cash flows that have a strong inflation protection embedded in them. "These assets offer stable returns and diversification of risk, and are suitable components in the portfolio of a long-term investor such as AP4," according to Högberg. "Real assets, for us, include assets that we feel have some sort of inflation component inherent in their characteristics. But one of the key roles of our real assets portfolio in this environment is obviously diversification," says Högberg.

AP4's Head of Strategic Asset Allocation goes on to emphasize that the benefits and characteristics of a real assets portfolio are more nuanced than a top-down view can suggest. "The characteristics of a real assets portfolio are determined by the type of assets and the type of contracts associated with the underlying assets," explains Högberg. "Depending on the exact specifications of those two variables, as an investor you can get an asset with more equity-like features or a more defensive asset with an inflation component embedded," she elaborates.

"The characteristics of a real assets portfolio are determined by the type of assets and the type of contracts associated with the underlying assets."

"For us, the main objective for the increasing allocation to real assets has been to get access to stable, real cash flows that are hugely beneficial in an inflationary environment, and to diversify the portfolio," says Högberg. These inflation-protection and diversification characteristics stem from "long-term contracts or regulated returns that are tied to inflation, as well as combining that with a demand that is rather insensitive to what is happening with economic growth."

For investors looking to protect their portfolios against rising inflation by allocating more to real assets, Högberg suggests keeping a close eye on valuations. "If we go into the type of environment we have been experiencing over the last couple of months, a key aspect when creating that type of exposure is keeping track of the valuation of the asset," emphasizes Högberg. "You don't want to find yourself in a situation where you have bought assets that should be good diversifiers in theory, but end up having huge sensitivity to interest rates because of extreme valuations."

SUPPORTING THE ENERGY TRANSITION

At the end of 2021, AP4 had 15.4 percent of its SEK 528 billion portfolio allocated to real assets, with about two percent allocated to infrastructure and the remaining bulk to real estate. Despite normalizing bond yield, AP4 plans to increase its exposure to real assets even further. "We are planning to increase our exposure to real assets to up 20 percent from a current level of about 15 percent even if we have higher interest rates," Högberg tells HedgeNordic.

"If interest rates normalize, the trend of investors allocating more to alternatives may revert at some point and investors will allocate money into bonds again," she argues. "If we find ourselves in a place where we have interest rates at four or five percent in a couple of years, that will obviously impact the way we allocate to alternative investments." And yet, real assets and other alternatives will have a place in investor portfolios even in an environment of higher bond yields due to their diversification benefits, according to Högberg.

"We are on the road to increasing our real assets allocation, mostly within infrastructure," says Högberg. The new investments are channeled mostly into energy transition-related infrastructure projects. Through Polhem Infra, an investment company jointly owned by the Swedish buffer pension funds AP4, AP1 and AP3, AP4 has previously invested in the Skaftåsen wind farm, one of the largest wind power projects in Sweden, and Scandinavian district heating player Solör Bioenergi. The three AP funds recently made a new commitment to Polhem Infra to invest in sustainable infrastructure in Sweden. AP4 also made a co-investment in one of the largest independent project developers in solar energy in the United States together with infrastructure private equity firm Antin. The Swedish pension fund during 2021 also made a commitment to Meridiam's latest European infrastructure fund, which will be investing in renewable energy and other sustainable infrastructure projects across Europe.

"Given that our unlisted investments are something that will stay on our books for a very long time, we always make sure that we make investments that are aligned with our long-term belief in the transitioning to a sustainable society," argues Högberg. "We are transitioning into a sustainable society, and we see a huge opportunity for investments in unlisted assets to provide support for that transition to actually happen," she continues. "We have a very long-term horizon and believe it is important to support the energy transition, also by investing in the alternative asset space."

www.hedgenordic.com – June 2022
HEDGENORDIC

European Real Estate in the New Economic Climate

By Hamlin Lovell – HedgeNordic

STAYING AHEAD OF INFLATION

Real estate has potential to at least keep pace with inflation. "Outside the British Isles, European commercial real estate rents are indexed either directly to the Retail Prices Index, or else like in France to a proxy that is pretty close, with annual uplifts. This offers medium-term inflation protection. We then aim to select assets where revenue can grow faster than inflation, due to mismatches between supply and demand, as well as price-agnostic demand," says Mike Bessell, Managing Director and European Investment Strategist at Invesco Real Estate.

On the supply side, inflation and supply chain bottlenecks could even be a benign influence for investors, insofar as they are leading to some more marginal projects being mothballed, according to Bessell.

Meanwhile, demand for last mile logistics is intensifying as the trend moves from outsourcing and offshoring to near-sourcing and reshoring, and supply chains are repositioned from just in time to just in case, based on optimizing the changing balance of costs. "Rents are only 5% of costs for a typical logistics operator, whereas transport can be 50% and labour costs are a high share too," says Bessell. On top of general wage inflation pressures, there are specific shortages of drivers who are qualified to drive lorries, trucks and other larger vehicles.

The office market is also seeing shifts in patterns of demand: "some older space is being relinquished but there is a shortage of grade A high quality space in areas such as London's West End or the Central Business District in Paris," says Bessell.

The real estate investor supply/demand balance is also favourable: "there is a finite pool of stock and capital, and planning permission is needed. Yet there are record levels of dry powder – US$443 billion on pitchbook data – to deploy," he points out.

AN OASIS OF CALM AMID STORMY FIXED INCOME

The rental revenue growth story could however be tempered if higher interest rates and/or risk premiums lead to lower asset valuations - via debt markets or discount rates or both.

Though government bond yields, swap rates and corporate credit spreads have violently blown out in early 2022, real estate has thus far seen only marginal

Mike Bessell, Managing Director and European Investment Strategist – Invesco Real Estate

impacts and seems to be largely disconnected from wider fixed income turbulence: "the swap cost component of borrowing has gone up, largely because rate options price off higher volatility. However, margins over underlying interest costs have generally been static, and sometimes even come down as underling interest rates rise. We do not expect a 50 basis point move in rates will translate into a 50 basis point rise in cap rates for property. As of March 2022, we noted Paris CBD cap rates had widened by 10-15 basis points, but logistics cap rates continue to tighten and in UK offices, London West End cap rates came down from 3.75% to 3.5% in the second half of 2021," Bessell explains.

"Many property assets anyway have long-term fixed rate debt in Europe, though we do accept that leveraged buyers will be more price sensitive. Banks may also shy away from riskier developments and require lower loan-to-value ratios," he adds.

RECESSION RISK AND COVID STRESS TESTS

Recession risks could be adverse for some property assets. Recession scenarios, especially in Europe, are being discussed by the media, hedge fund managers and Davos WEF delegates, but as far as consensus economic forecasts are concerned, nobody appears to be worried about it as of May 2022: "the lowest forecast for Europe 2023 is 0.8% economic growth, the highest is 3%, and most forecasts for 2024 are between 2-3%. Some individual countries might see one or two quarters of marginally negative growth but we do not see an overall recession," says Bessell.

Nonetheless, recessions usually come as a surprise, and are recognized in retrospect after economic data is revised. Even before Covid the economic cycle was one of the longest expansions and may need to pause for breath at some stage. If a recession does materialize, Invesco Real Estate has some confidence that its asset allocation and sector selection could be resilient in a recession scenario, partly based on the Covid slump: "During Covid we carried out a detailed review of our office holdings, covering locations, flexibility, tenant structures and demand, and this gives us confidence in the assets we currently own in this sector. We had previously undertaken a similar exercise on our retail assets. As regards residential, Europe has been structurally undersupplied for years or decades, resulting in the current tight vacancies and strong demand. Our core programmes have long weighted average lease terms. Our offices, residential and retail are focused on strong locations in gateway cities. We do not take location risk and have very little development risk," says Bessell.

GEOPOLITICS AND THE ECB

An extended war in Ukraine could increase recession risks, particularly for Europe. Invesco Real Estate has mapped out scenarios based on a faster or slower conclusion to the economic impacts of Russia's invasion of Ukraine, and is prepared for both possibilities: "the strategy is to select assets that would perform well in either scenario. And it is likely that the ECB would be more supportive, in terms of delaying or avoiding rate rises, and maintaining, resuming or increasing bond purchases, if the war does drag on," says Bessell.

SUB SECTORS TILTS

Regardless of the macroeconomic backdrop, Invesco Real Estate is an active manager in real estate and has its own views on asset allocation and individual property selection.

It is hard to universally generalize about Invesco Real Estate's asset allocation as there are multiple mandates focused on specific segments such as residential, or hotels and separate accounts where clients can determine their own requirements. That said, house views versus INREV reveal some asset allocation preferences: "we are overweight hotels where we have a specialist team and programme. We are in line on residential, and on retail where we have supermarkets for inflation targeting and luxury retail in Paris and Milan in a very bespoke product. We are very marginally underweight of logistical and industrial, partly because pricing has moved so significantly that even assets in weaker locations with looser covenants are being lifted, so in this sector we are selectively selling into strength while focusing on strategic locations linked to e-commerce," says Bessell.

"The swap cost component of borrowing has gone up, largely because rate options price off higher volatility. However, margins over underlying interest costs have generally been static."

Mike Bessell, Managing Director and European Investment Strategist – Invesco Real Estate

GEOGRAPHIC BETS AND GAPS

Geographically, the team comes close to pan-European coverage through a mixture of direct office footprints and affiliates. As well as core European locations such as London and Paris (which also covers Belgium and Luxembourg) there is a presence in Milan, Prague, Warsaw, and Madrid, which also serves Portugal. "We are generally sticking to core locations and gateway cities and are wary of broadening out the core definition to include smaller, less liquid and more volatile markets," says Bessell. Therefore, the firm has historically avoided Greece due to volatility and the Baltics due to illiquidity. It has also eschewed Norway and Switzerland owing to high valuations arising from abundant local capital. Finland in general and Greater Helsinki in particular – which both offer some yield pickup - are markets that Invesco Real Estate regret omitting and the gap could at some stage be filled.

Bessell, who sits in London, continues to have a liking for his local market: "London is still playing catch-up and there is still limited supply of grade A office space and urban logistics, which benefits from UK leadership in e-commerce. Before 2015, London traded tighter than the rest of Europe and is now 75 basis points wider in absolute terms. UK logistics, the best sector in 2021, has already matched European logistics valuations, but offices have lagged," he explains. Of course, interest rate differences between the Pound and Euro may explain part of the pickup, but he still sees valuation upside in the UK.

NEW BUILDINGS MEET ESG NEEDS

In logistics, brand new buy and build projects not only focus on the areas of shortest supply, with transport and urban location connectivity and record low vacancy rates, but also meet higher ESG standards for buildings sustainability, where older buildings may fall short. This illustrates the "brown discount" phenomenon: the capital spending needed to improve some properties to more sustainable standards is starting to get factored into valuations. "What was once a green premium for more sustainable properties is now required to attain grade A status. Invesco Real Estate has detailed and comprehensive improvement plans for its remaining non-ESG rated exposures," says Bessell.

ESG IMPROVEMENTS

Multiple Invesco Real Estate strategies have been categorised as SFDR Article 8 funds, and some may even go to Article 9. The firm is proceeding cautiously to develop confidence in the new regime and avoid any perception of greenwashing.

Invesco Real Estate's strategies mainly have 4- or 5-star GRESB ratings, though some vehicles with a higher proportion of development projects cannot currently rise above a 3-star rating, pending completion to ascertain data measurement and building standards.

ASSET SELECTION

ESG overall is one criterion among many desirable features that can make property more valuable: "office values can be enhanced by transport links, exercise facilities, green space, leisure attractions and even children's creche facilities and other attractions within a ten-minute walk," says Bessell.

Similarly with hotels very specific locations need to be assessed and they cannot be quickly and easily categorised. For instance, demarcating hotels into leisure versus business can be too binary, since many cities are working seven days a week, with both tourists and businesspeople active throughout the week. "We do not expect that videoconferencing will eliminate business travel, though it might lead to fewer but longer stays. Ultimately hotel locations need to be analysed on a granular basis because revenues per room in Gare du Nord, are very different from those on the Champs Elysees in Paris," says Bessell. Most of the firm's hotel assets are mid-level or luxury as budget is a longer lease game with less added value upside from asset management.

Indeed, the way in which properties are managed in terms of ESG, sustainability and other quality and amenity improvements can be important for both rental growth and valuations. The economic outlook now faces greater uncertainty than in late 2021, but Invesco Real Estate are confident that selected properties will be well positioned to weather a variety of economic conditions.

By Marco Lukesch and Harrison Darling Emso Asset Management

Specialty Finance in Emerging Market Private Credit: The Goldilocks Strategy

„Given the structural imbalance and attractive risk-return potential of EM private credit, we feel that global investors are starting to take notice.“

Developed markets private credit is now a mature asset class and a mainstay of diversified portfolios. Private credit in emerging markets, by comparison, is still largely in its infancy. Global investors are beginning to enter the market but are mainly focused on direct lending to corporates. In our view, a direct lending-led strategy in emerging markets is suboptimal. We believe that it is important to take a different approach and instead focus on trying to mitigate what we believe is the biggest risk in emerging markets private credit investing: the unreliable Rule of Law.

PRIVATE CREDIT LANDSCAPE

The appeal of private credit has increased in the current world of low (and negative) interest rates. Broadly speaking, private credit refers to lending outside of the traditional bank and bond markets. In North America and Western Europe, the strategy has grown exponentially over the past decade and has become a separate asset class within most institutional investors' portfolios. From senior secured direct corporate lending to other esoteric strategies, private credit in developed markets is diverse and provides investors a range of investment options. In contrast, private credit in emerging markets is still in its infancy. Within emerging markets, there exists a structural opportunity because of the mismatch between the supply and demand of capital. This dislocation has created a funding gap for EM businesses of approximately USD 700 to 850 billion per annum . Figure 1 provides a helpful illustration of this dynamic.

Given the structural imbalance and attractive risk-return potential of EM private credit, we feel that global investors are starting to take notice. A majority, however, are focused on direct lending to corporates. While this strategy has proven successful in developed markets, where 82% of DM private credit is in the form of direct lending, in our opinion, a direct lending-led strategy in EM is currently suboptimal.

We believe that contract enforceability through local courts ('Rule of Law') is the biggest risk in EM private credit investing. To mitigate this risk, we feel it is important to focus on two investment strategies:

- Bankruptcy-remote, asset-backed structured lending: instead of being secured by collateral and relying on courts in the event of default, investors should seek to own the collateral directly and outright from day one;

- Contracted sovereign risk: investors should build programs that provide liquidity/financing to citizens/companies in exchange for direct and indirect sovereign credit obligations.

We believe that these two investment strategies provide the opportunity for private credit investors to access emerging markets while, at the same time, mitigating the Rule of Law risk, and additionally adding diversification across geography, asset class, and tenor.

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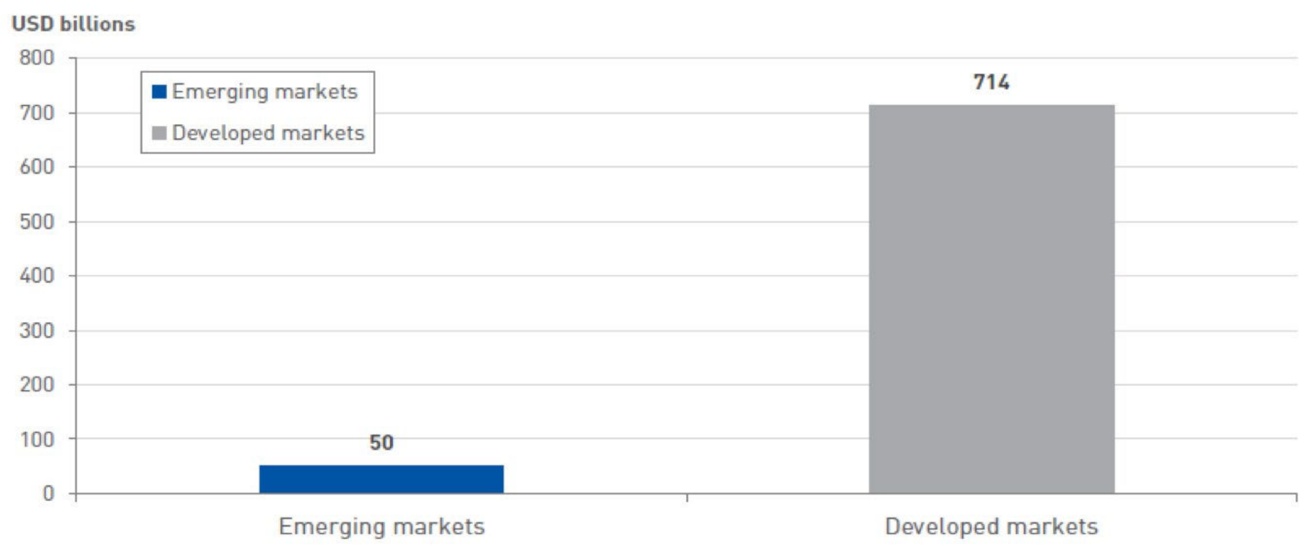
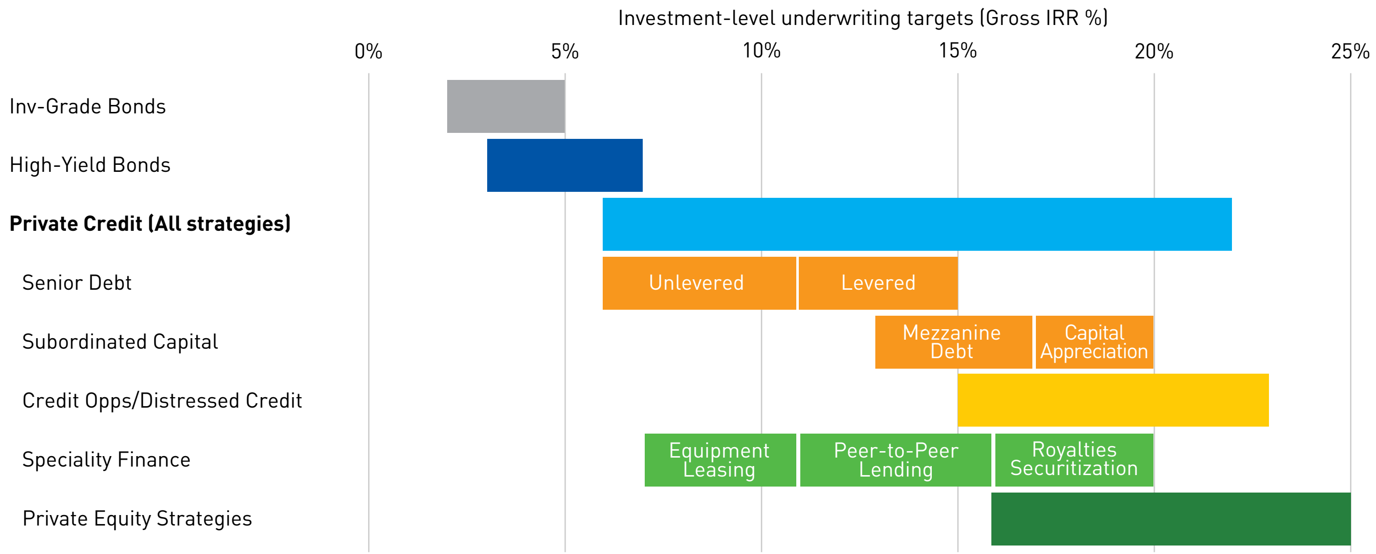
Private debt capital raised (2014-2020)



Source: Preqin, EMPEA 2021.

Figure 2: Return spectrum: private credit vs. liquid credit and private equity strategies



Source: Cambridge Associates LLC.
Note: Returns for investment-grade and high-yield bonds represent arithmetic return assumptions in equilibrium.

DEVELOPED MARKETS PRIVATE CREDIT: OPPORTUNITY SET

Institutional investors have historically been drawn to private credit due to the premium it can provide over tradeable fixed income as well as the portfolio diversification benefits. As evidenced above in Figure 2, the DM private credit opportunity set provides investors with many options and alternatives.

THE DM DIRECT LENDING PLAYBOOK: PORTABILITY TO EMERGING MARKETS?

The growth of DM private credit can be attributed to a well-established private markets ecosystem and, most crucially, highly functioning legal systems. Many emerging markets, however, do not provide these same comforts.

In developed markets, direct lenders will often mitigate the risk of loss by having the corporate borrower pledge its assets and equity as collateral. If the borrower defaults, the lender goes to the courts, enforces the pledge, converts the ownership, and sells the assets. In other words, the fundamental prerequisite to private credit investors recovering capital (in a reasonable amount of time) is a reliable and highly functioning Rule of Law. In North America and most of Europe, investors have confidence in the legal system and, as such, are focused on the recovery value of assets (i.e. sale price of assets) and enterprise value (i.e., sale price of company).

In many of the emerging markets, investors do not have a similar level of confidence in the Rule of Law. We, therefore, advocate employing an investment strategy which is focused on two specialty finance niches: bankruptcy-remote, asset-backed structured lending and contracted sovereign risk. These two niches are designed to minimize reliance on local courts and maximize the recovery of invested capital in downside scenarios.

BANKRUPTCY REMOTE, ASSET-BACKED STRUCTURED LENDING

In structured lending transactions, such as equipment leasing, the focus is on asset ownership and building scalable investment programs alongside local partners. To ensure control, in many cases, the goal is to create bankruptcy remote trusts in which we novate all assets or cashflows. In the event of a default, it is possible to directly sell the asset without the need to navigate local courts and deal with the borrower's inherent home field advantage. Assets that underpin some of these transactions include equipment, real estate, receivables, and vehicles, among others.

CONTRACTED SOVEREIGN RISK – CREATING SOVEREIGN VALUE

In many emerging markets, governments owe companies or citizens money, but are typically slow to pay. Examples span from subsidy payments due to local farmers to funds owed following court settled disputes. In example sovereign risk transactions, programs are typically built alongside local partners that purchase, service, and collect direct and indirect sovereign obligations. These programs provide liquidity to companies or citizens in exchange for short-term government risk. Given the inherent complexity and illiquidity, we believe that these types of transactions can capture a substantial premium to publicly traded sovereign equivalents.

CONCLUSION

In our view, private credit will continue to be a mainstay in institutional investment portfolios for the foreseeable future. As investors look for increased diversification, we believe that EM private credit will present opportunities for investors to increase and diversify their private credit portfolios. However, while it has historically been an uncrowded space, we believe that investors in EM private credit will need to keep downside protection at the forefront of their investment strategies by focusing on mitigating 'Rule of Law' risk.

Marco Lukesch, Head of Private Credit – Managing Director – Emso Asset Management

Marco started his career as a consultant focused on financial services at Oliver, Wyman & Co. He joined HBK Capital Management in 2005, where he was the co-head of EM. From 2013 onwards, he was co-head of EM at Pine River Capital Management, focusing on illiquid opportunities in CEEMEA and LatAm. He oversaw all aspects of investing: sourcing, structuring, trading, and management of illiquid positions. At Pine River, he was instrumental in creating a consumer-lending platform in Brazil, as well as tax-blocker subsidiaries. Marco joined Emso in 2017. Marco graduated magna cum laude from the University of Pennsylvania with a B.A. and a B.Sc., and was admitted to the Phi Beta Kappa Society. Marco is also a Chartered Financial Analyst.

Harrison Darling, Private Credit – Associate – Emso Asset Management

Harrison began his career as an equity research analyst in Sydney in both private and public markets. In 2015, he joined Glennon Capital where he covered Australian listed businesses. He joined Emso in 2016, rotating across various teams prior to joining the EM Private Credit team in 2020.

Harrison holds a Bachelor of Business from the University of Technology Sydney and is also a Chartered Financial Analyst.

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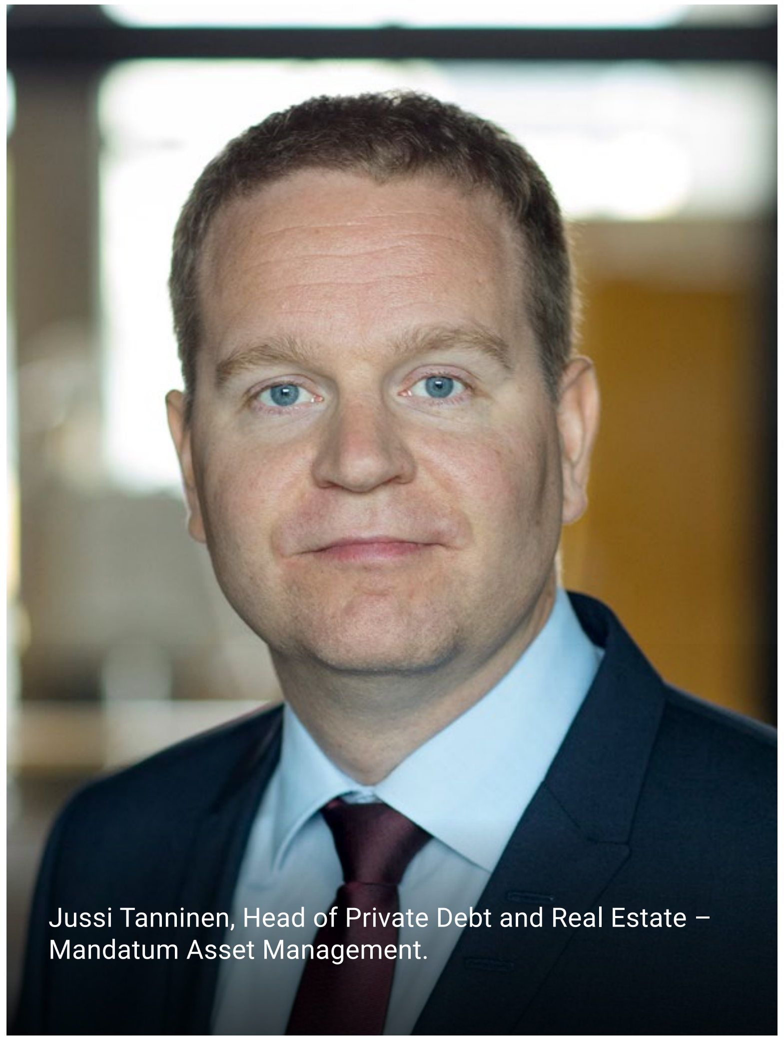
Matias Hauru, Portfolio Manager Private Debt – Mandatum Asset Management.


Jussi Tanninen, Head of Private Debt and Real Estate – Mandatum Asset Management.

ESG Implementation in Mandatum's Private Debt Program

Our approach to responsible investing ensures that we not only account for financial results, but also recognize and consider the environmental or societal impact. As a result, many of our investments and operations are committed to promoting economic, social and ecological sustainability.

Mandatum Asset Management (MAM)'s private debt program takes a unique and differentiated approach to ESG implementation steeped in the firm's deep history and experience in sustainability and private debt manager selection. We focus on understanding how a manager's strategy, geographical location and size can impact its ESG position in order to build a truly diversified portfolio and provide our investors with strong risk-adjusted returns.

PORTFOLIO DIVERSIFICATION INFLUENCES ESG ANALYSIS

MAM believes that diversification across asset class subsegments is critical to building a balanced private debt program across market cycles.

Historically, MAM has focused on direct lending and opportunistic strategies and maintained an even split between the two strategies. The direct lending strategies provide more stable coupon payments and return profile, while opportunistic strategies provide differentiated risk-return drivers and have the potential for outsized returns in periods of dislocation. As a result of its diversified approach, MAM's private debt program has generated strong performance and clear alpha compared to its most relevant public market equivalent, the Euro High Yield Index.

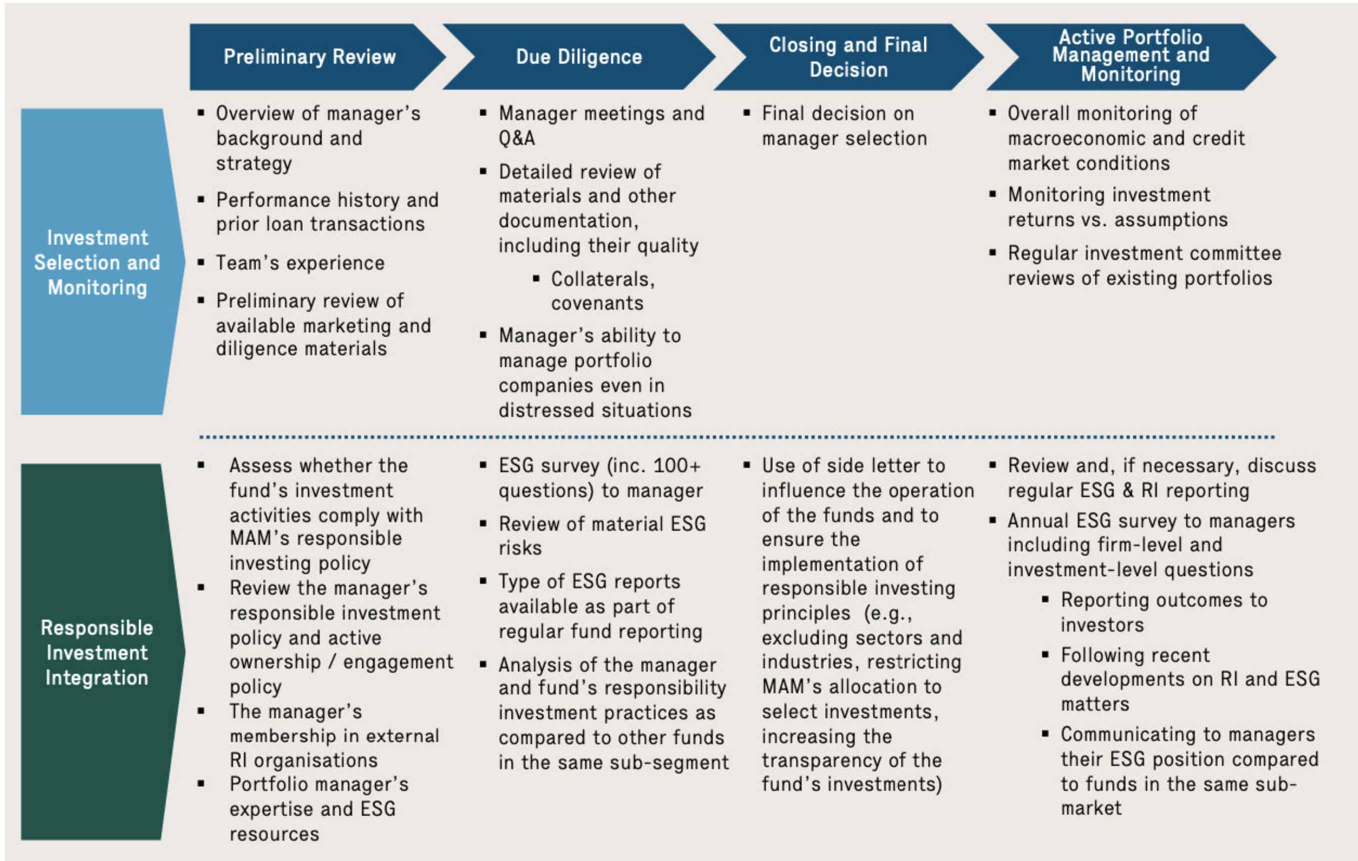
The beneficial result of strategy diversification affects our approach to ESG analysis. We evaluate ESG programs and policies with a number of other factors in mind, including strategy or location, similar to how direct lending or opportunistic strategies each play a different role in our portfolio.

DIFFERENTIATED APPROACH TO ESG STAFFING

MAM believes that ESG implementation requires the support of the entire organization, including its investment, ESG and legal professionals. However, MAM takes a differentiated approach to ESG staffing, focusing on building a team with prior investment and operational expertise as opposed to recruiting ESG professionals who then need to learn about our investment strategies or the legal framework of alternative funds.

MAM's dedicated ESG team has previous and direct experience in private markets, legal matters, credit portfolio management and reporting, along with significant expertise in ESG policies and procedures.

Figure 1: Investment Process



Source: Mandatum Asset Management.

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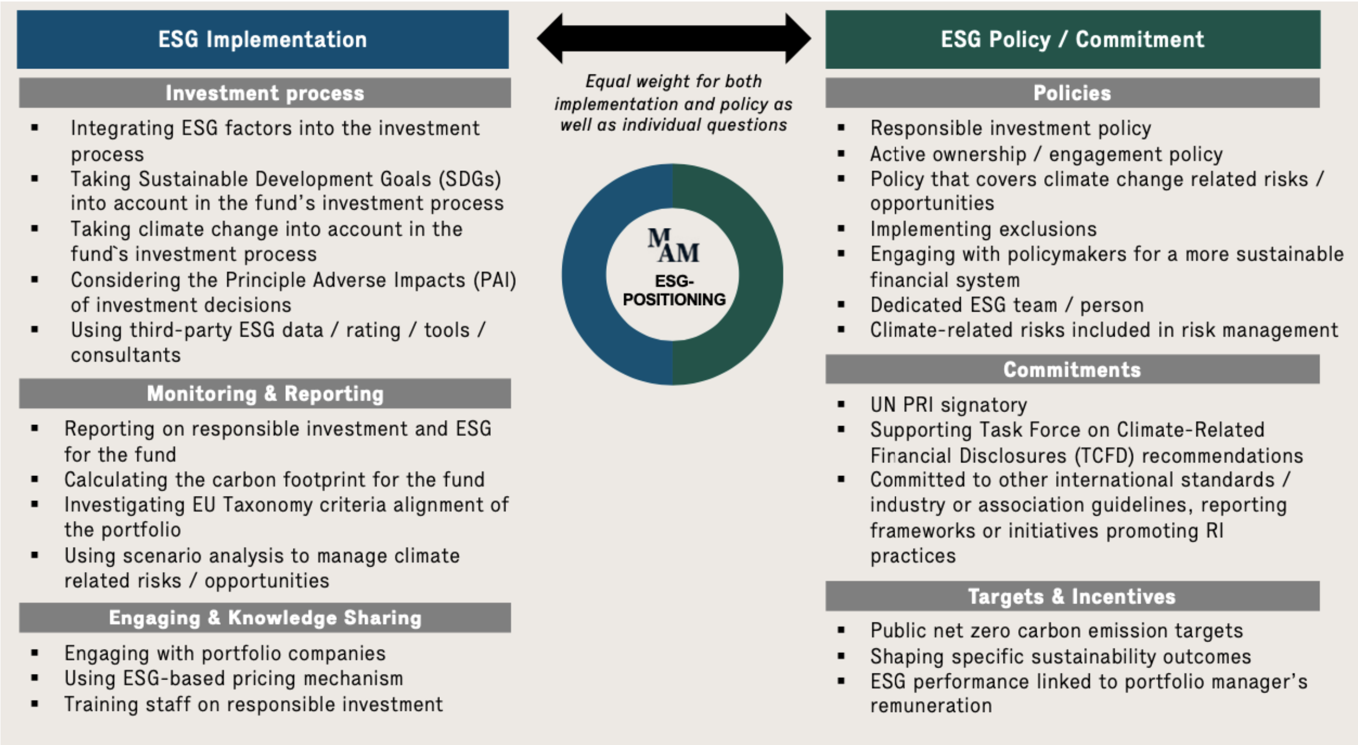
Figure 2: ESG Implementation



Source: Mandatum Asset Management.

Although the starting point for ESG implementation is with the portfolio management team, we believe that this approach allows our ESG team to truly evaluate the sustainability factors of a potential investment in the context of the full portfolio's strategy and risk-return targets.

For the private debt program, the ESG team actively works with portfolio managers to review each target fund from an ESG standpoint. With their added investment experience and perspective, the ESG team can provide their analysis of a target manager and fund's ESG program as compared to other managers within a subsegment and with an understanding of how the target fund also affects the program's portfolio construction.

In addition to the ESG team, the portfolio management team looks at each deal from an ESG angle, beginning from the first meeting with the target manager and fund. The portfolio managers work closely with the ESG team throughout the due diligence process to create an informed decision on each potential investment based on financial and sustainability factors. Finally, the legal team is also critical to the legal review and negotiation of each target investment to ensure the implementation of responsible investing principles.

RIGOROUS INVESTMENT PROCESS AND MONITORING

An ESG analysis is fully incorporated into the due diligence process and the continued monitoring of our managers and their funds, as demonstrated in Figure 1. In a fund of funds program like our private debt program, MAM believes the due diligence process and legal negotiations are the most important times to influence ESG matters. The ESG team leads the sustainability-related diligence and monitoring while working closely with the portfolio managers, who lead the investment diligence and monitoring.

Preliminary Review

During an introductory meeting with a manager, the team will review the target manager's responsible investing policy, membership to RI organisations and its ESG team and resources. MAM will also analyse whether the fund's investment activities comply with our responsible investing policy. Based on the preliminary review of the manager's investment experience and track record along with its ESG policies and practices, MAM will either pass on the opportunity or move into due diligence.

Due Diligence and Proprietary Survey

A key part of MAM's ESG due diligence is its proprietary 100+ question survey. Each target manager is required to answer the survey during the due diligence process, as well as annually over the course of the manager's partnership with MAM.

As demonstrated in Figure 2, the survey consists of firm-specific and portfolio-specific questions, which relate to policies and principles, governance, risk management, ESG integration and engagement, along with ESG reporting and resources. Based on survey responses, the managers and funds are classified in a chart (see Figure 3) and compared to other managers and funds within their subsegment. The survey responses and chart allow MAM to review any potential relevant ESG risks and issues and discuss these in further detail with the manager prior to making an investment decision. A copy of the chart is also included in the materials for the Investment Committee to demonstrate how each target manager and fund compares to the program's existing investments.

The analysis from the survey serves as one tool to evaluate managers and funds' ESG practices during due diligence. In addition, the ESG team, alongside the portfolio management team, meets with each target manager to discuss the results from the ESG survey in more detail. At this stage, we can also promote the ESG matters that we consider important to the firm and the private debt program.

Legal Review and Closing

Once both the investment and ESG diligence is complete, a final decision will be made whether MAM will invest in the target fund. During legal negotiations, the portfolio management and ESG teams leverage MAM's legal team and external advisors to influence and ensure the implementation of responsible investing principles, including the exclusion of select industries or increasing transparency into underlying fund investments.

Active Monitoring

Responses to the ESG survey during due diligence allow for active monitoring of the managers' management of sustainability and development of various ESG matters during the partnership. As referenced, all current managers receive the same questionnaire to answer on an annual basis, and meetings are also held with each manager to conduct a deep dive of their ESG integration and development. In the future, the ESG development of each manager and fund will be compared to other funds within each subsegment. Additionally, investments are monitored by reviewing regular ESG reporting, if available, and managers are strongly encouraged to report on ESG for the fund on a regular basis.

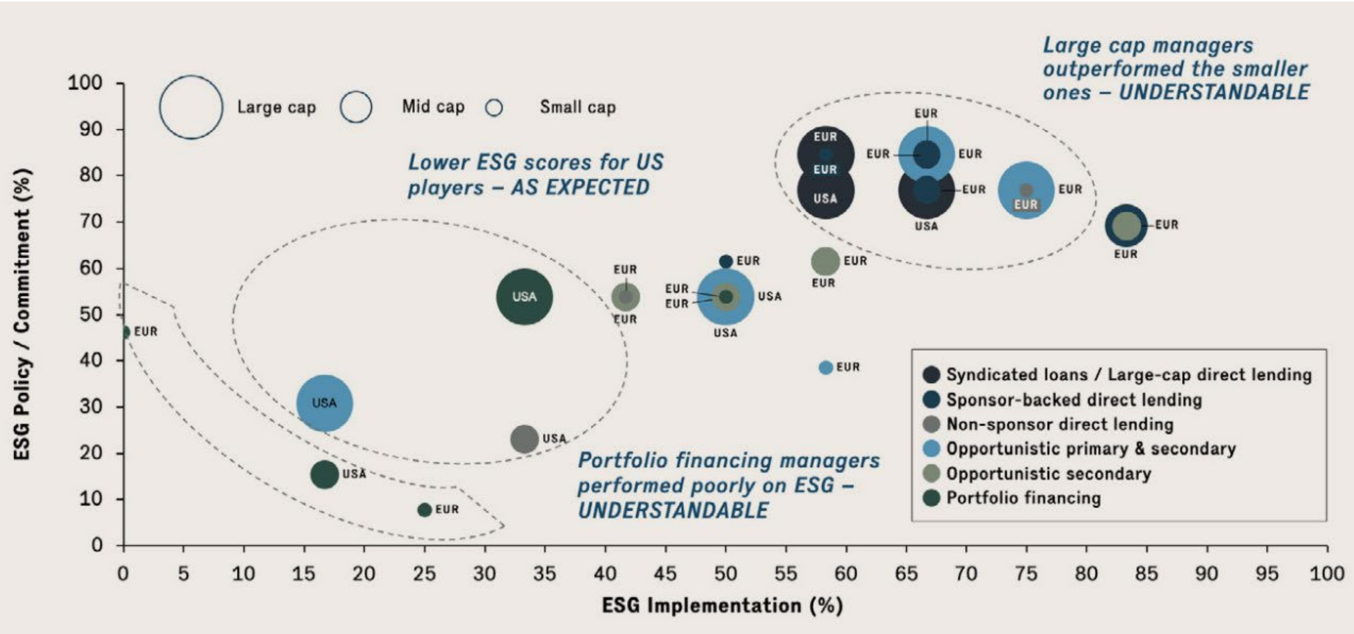
PROPRIETARY ESG FRAMEWORK INFORMS INVESTMENT DECISIONS

As discussed, the survey results are a critical part of the due diligence process and ongoing monitoring of active managers. However, the survey results have also shown a number of interesting conclusions regarding the ESG position of our 22 active managers, as shown in Figure 3, that influence our investment selection. Particularly, we see that there are different levels of ESG implementation and commitment based on strategy and geography.

Portfolio Financing Managers

Portfolio financing managers generally have lower ESG scores given the number and types of investments made. On the whole, portfolio financing managers tend to lend to a large number of underlying companies, including small, family-owned businesses, making it hard to manage and review each company's ESG policy. However, it is important to understand the types of underlying companies that

Figure 3: Managers' ESG position heavily dependent on strategy and geography



Source: Mandatum Asset Management.

portfolio financing supports. For example, loans by portfolio financing managers to small, family-owned businesses aid local economies, especially during the COVID-19 pandemic, and you cannot expect the same level of reporting from an SME as compared to a large cap PE-owned company.

Small vs. Large Cap Managers

Our large cap managers outperform the smaller managers in the portfolio. On one hand, these managers usually have more resources to develop and build out ESG programs, principles and resources as compared to their smaller counterparts. Additionally, many of the large cap managers we track are focused on private equity and invest in more ESG-focused industries, like healthcare. Similarly, the underlying companies of the small and large cap managers have different levels of ESG implementation. Specifically, small cap companies tend to have more nascent ESG programs and fewer ESG resources as compared to their larger cap counterparts.

United States vs. Europe

As expected, European managers have better ESG scores as compared to their US peers. Historically, implementation and regulation related to ESG has been much more prominent in Europe, leading to more developed and larger ESG resources and capabilities. In the United States, ESG implementation has only recently become a focus for managers, although we are seeing good progress and initiatives, albeit overdue, from these managers.

Primary vs. Secondary Managers

We have also seen a difference in ESG scores between our primary and secondary managers. Overall, our primary managers have scored better given their ability to influence ESG matters during investment and legal diligence. On the other hand, when buying an existing loan on the secondary market, many of the ESG terms in the loan documentation had already been agreed to a number of years ago, which may now be outdated, and challenging to amend or correct.

Influencing Investment Selection

We believe that a target manager and fund's ESG score from our survey should not ultimately be the only tool to determine whether the investment is attractive based on its sustainability factors. Instead, as seen in Figure 3, we should review the manager and fund's ESG capabilities in the context of its subsegment and investment strategy. Given their investment background and experience, our ESG professionals are able to complete a comprehensive review of a target fund that accounts for these factors, in addition to the ESG score from the survey.

For example, a portfolio financing manager's low ESG score could impact declining an investment opportunity. However, comparing the ESG score to other similar managers within the sub-segment provides additional detail on the manager's ESG position. Additionally, diving deeper into the fund's intended strategy and understanding that it may improve the local economy through its loans to local small, family-owned businesses offers a completely different ESG perspective of the investment.

CONCLUSION

MAM takes a dynamic approach to the ESG review and monitoring of our private debt program's managers and funds. Based on our diversified approach to portfolio construction, we take a wholistic view on the ESG position of our target funds based on its ESG scoring and investment strategy. With our proprietary survey as a base, we have a framework to compare and analyse the ESG program and capabilities of our managers within a subsegment of the private debt market. However, our ability to take a more informed view of our managers' ESG capabilities is dependent on our ESG professionals, who also have prior private markets and portfolio management experience. We believe that these dedicated professionals are a key differentiator and, alongside our portfolio managers, can help to build a diversified private debt program that reflects both financial and sustainability factors.

From left to right: Mattias Lindfors, Timo Vertala and Christoffer Sundberg, portfolio management team – HCP Bricks.

HCP Bricks: ‘Value-Add’ Gate to Core Real Estate

By Eugeniu Guzun – HedgeNordic

Over more than a decade, real estate investments have transitioned from simply an “alternative” asset class to a material recipient of total allocations. Core real estate assets – that is, safer higher-quality, long-lease assets – are considered the safest and closest investment alternative to bonds in terms of risk and potential returns, and can build the foundation of an institutional investor’s real estate portfolio.

This quality is generally priced in core real estate assets, which can mean expensive valuations and lower returns than other options. But that is no reason to avoid the “core” segment of the real estate market altogether. Transitional “manage-to-core” situations that can turn undervalued rough diamonds into core real estate represent some of the most attractive risk-reward opportunities in real estate. The caveat, however, is that this type of value-add strategy requires significant market expertise.

To launch a fund that employs a “manage-to-core” real estate strategy, Finnish asset manager Helsinki Capital Partners believes to have found this expertise in a real estate advisory firm Cobbleyard Real Estate. Cobbleyard’s founder Christoffer Sundberg and his team now joined forces with Tommi Kemppainen’s team to launch HCP Bricks – a Finnish open-ended alternative investment fund that will focus on real estate opportunities in the largest cities in Finland and in Stockholm.

“We are combining my team’s experience in direct real estate investing and management with the HCP team’s background and skillset in investing and fund management under the same umbrella,” says Sundberg about the HCP-Cobbleyard collaboration. “There is a good match between HCP’s top-down analysis skills and our hands-on entrepreneurial approach to real estate investing.”

THE OBJECTIVES

The HCP Bricks fund born out of the HCP-Cobbleyard partnership is designed to meet investors’ desire and need for commercial real estate. “With HCP Bricks, we want to bring the institutional-grade commercial property asset class to smaller investors such as tier-2 institutional investors, family offices and high-net-worth individuals,” explains Sundberg, who manages HCP Bricks alongside Mattias Lindfors and Timo Vertala. “Our objective is to offer a vehicle that can suit anyone looking to add an alternative investment to their portfolio, an investment that is not fluctuating as much as traditional asset classes and that can provide stable income and stable value both in the short and long run,” adds Lindfors.

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"The other main objective is to create value through the repositioning of run-down real estate using smart real estate management, which involves improving the ESG impact as well as the commercial characteristics and risk profile of a property," says Sundberg. "But the skillset one needs to manage the properties in this asset class is different from what one needs to manage other properties," he continues. "There is also a different network that is needed to source investments."

FLEXIBLE AND EVERGREEN

Due to its Finnish AIF structure, HCP Bricks has a very flexible investment mandate that enables to fund to invest in a wide range of properties to capture the opportunities with the highest value-creation potential and a stable long-term cash flow stream. "There is a fairly wide range of properties that we can invest in. We are not specifically targeting one property type," Lindfors points out. "Our broad mandate allows us to find and invest in the most attractive opportunities available in the market."

"With the world constantly changing and evolving, the ability to be tactical between the different property types is very important in our goal to structure an evergreen fund," emphasizes the fund manager. Following a specific niche or a specific strategy in a constantly-evolving market environment can put one on the back foot, according to Lindfors. "We want to be able to follow the trends, target the right sectors and get the timing right," he adds. "We want to be ahead of the curve."

The flexibility inherent in the AIF structure also enables HCP Bricks to apply conviction when choosing the location of properties. "The location is crucial in commercial real estate investing," says Lindfors. "Our mandate allows us to be brave and apply our unconventional vision by investing in areas that may not be very sought after today but perhaps very attractive tomorrow and the years ahead," he elaborates. Location risk can represent a lucrative source of attractive returns for HCP Bricks.

The team running HCP Bricks will strive to maintain a portfolio of five to ten different commercial real estate properties. "Diversification is important, but we will not be over diversified," says Lindfors. "When

> "We are combining my team's experience in direct real estate investing and management with the HCP team's background and skillset in investing and fund management under the same umbrella."
>
> Christoffer Sundberg

funding grows, there might be more properties in the portfolio. But we will more likely look into investing in bigger assets and into investing in larger markets with higher investment volumes such as Stockholm," he explains.

The HCP-Cobbleyard team behind HCP Bricks is simultaneusly chanelling its efforts and time on both asset raising and doing the first acquisition. "Buying the first property is very important for the ongoing fundraising process," emphasizes Lindfors. "Investors need to understand what they are buying into," he adds. "In the long run, we will have multiple assets in the portfolio, but from the start, we want to have a flagship asset and a first story that depicts what type of assets we want to buy."

THE CORE: IN-HOUSE EFFORTS

Transitional "value-add" situations in commercial real estate can represent value-rich, attractive risk-reward opportunities for investors. Significant market expertise and experience are required to unlock value in such situations. The already complex – and increasingly complex – marketplace for commercial real estate is pressuring managers to rely on outsourcing to third parties to improve efficiencies, reduce costs and access specialized competence. However, Cobbleyard Real Estate's founder, Christoffer Sundberg, opposes the idea of outsourcing management and value-add functions to only focus on property selection.

"Many managers only perform the investment function and outsource big parts of the real estate management to third parties," says Sundberg. "When outsourcing operations, the quality is not there and the speed is not there. With us doing most in-house, our quality will be very high and we will do our operations quicker," he adds. "Because we are in the business of repositioning and renovating commercial real estate properties, timing and speed are very important because we are measured in terms of internal rates of return."

"Since creating value is our core business, we want to produce all important managerial operations in-house because this allows us to manage the real estate more efficiently," argues Sundberg. Drawing from the expertise and experience of the Cobbleyard

> "With the world constantly changing and evolving, the ability to be tactical between the different property types is very important in our goal to structure an evergreen fund."
>
> Mattias Lindfors

Real Estate team consisting of engineers, project managers, commercial managers, among others, HCP Bricks has a platform that can unlock value in value-rich opportunities. "The key to success for our strategy is the collaboration between HCP and Cobbleyard," says Lindfors. "They come in with the fund management experience and we have the actual property and real estate knowledge, where we have the know-how of all the small components in the process of creating value through real estate development."

HCP Bricks will employ a 'middle-ground' value-add strategy "where we are focused a lot on value add and on doing active development of our assets, but at the same time, avoiding the development of properties from scratch," according to Lindfors. "Becase of risk management reasons, we want to have assets that already generate some cash flows that limit the risk associated with the investment," he continues. "But we also want to have upside potential by perhaps leasing up vacant space or developing or renovate space for more suitable activities and finding more value and return for the fund through property development."

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The Domicile Choice Shan't Raise Eyebrows

By Eugeniu Guzun – HedgeNordic

> "The answer to the question of 'who are your investors?' is the main criteria that influences how one structures a fund and determines the choice of the domicile."

As alternative asset classes are becoming less 'alternative' for investors, more and more private markets-focused managers are coming to the alternatives scene. Choosing the right domicile – as much as choosing the right team, strategy, partners, etc. – can be vital for the success of an emerging manager. In theory, private market managers have a wide range of domiciles to choose from around the world. In practice, emerging managers are impelled towards certain jurisdictions by a host of considerations such as the nature of their target investors and their preferences, among others.

"The answer to the question of 'who are your investors?' is the main criteria that influences how one structures a fund and determines the choice of the domicile," explains Kerstin Lindgren, Director of Client Coverage in the Nordics at RBC Investor & Treasury Services. "Who do you want to raise capital from?" is one of the first questions a manager should answer, according to Lindgren. The answer to this question should offer a better understanding of the target investors and their requirements, concerns, needs, and preferences that stem from their geographical location, type of organization, their investment goals, and other factors.

Kerstin Lindgren, Director of Client Coverage in the Nordics – RBC Investor & Treasury Services.

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"The best situation for fund managers going out to speak to potential investors is when the fund's structure and domicile are not a topic of conversation. Ideally, you want to pick a structure that your investors have already invested into before."

The pursued strategy and targeted asset class also bear importance in the choice of domicile. "What the manager wants to invest into, of course, is another driver of domicile choice," says Lindgren of RBC Investor & Treasury Services, an asset servicing organization supporting managers with administrational, banking, depositary services and many other functions that managers need for their funds to work. "When managers have an idea of the strategy they want to pursue and of the investor segment that may be interested in allocating to that strategy, there is a set of factors that will drive the decision for what domicile and setup to choose."

Legal flexibility, range of structures, expertise and competition among service providers, taxation framework are just some of the key factors to keep in mind when looking for fund domiciles. "Which toolbox can you find, what legal structures are there, which service providers can you find, what type of experience and expertise can you get, how does the taxation framework look like, what is the regulation around, how safe do the investors feel," are several of the many questions managers need to answer when deciding on where to host the fund, according to Lindgren.

Most importantly, however, "after analyzing all decision drivers and factors, managers should choose the domicile that will cater best to their strategy and their target investors," according to Lindgren. Evaluating all factors such as tax implications, costs, time to market, distribution channels, reputation, and ability to implement strategies is indeed important. Nonetheless, soft factors such as investors' personal experience and familiarity with a certain jurisdiction also tend to influence a manager's choice of fund domicile.

"The best situation for fund managers going out to speak to potential investors is when the fund's structure and domicile are not a topic of conversation," considers Lindgren. "Ideally, you want to pick a structure that your investors have already invested into before," she elaborates. "You may have a very new and interesting investment strategy that requires something different, and can justify a slightly different structure. But you typically want to pick a structure that investors are familiar with, where you have well-known service providers that raise no eyebrows."

MAJOR TRENDS

The Alternative Investment Fund Managers Directive (AIFMD) introduced in 2013 was one of the most significant changes to the regulatory framework around investment vehicles, including those focused on private markets. This directive led to the creation of the AIFMD marketing passporting that enables barrier-free access to all funds registered and domiciled in the European Union across the entire EU region. "The private capital space had been largely unregulated before the introduction of the AIFMD," says Kerstin Lindgren. "There wasn't a drive for regulation that came from the fund industry itself," she points out. "These days managers are, to a large extent, looking to launch funds that are in the scope of the AIFMD."

"Thanks to the AIFMD passport that comes with this increasingly well-known regulatory framework, managers no longer look to stay out of the scope of the AIFMD," Lindgren discusses one of the major trends related to the choice of domicile in the European fund industry. Another major trend is the democratization of private markets, according to Lindgren, referring to a development that is enabling smaller, non-professional investors broader access to investment opportunities in the often-inaccessible private market space.

"The popularization of what we call private capital is an important trend that we observe," says Lindgren. "Although there are still challenges to overcome, this democratization process enables broader access to illiquid alternatives and makes such an interesting group of asset classes more accessible for a wider range of investor types," she elaborates. High-net-worth individuals and private individuals, who may not traditionally have had the opportunity to invest in the asset class, are increasingly gaining access to investments that had previously been restricted to institutional investors and only the most affluent individuals and family offices. "We see more and more managers coming with offerings relying on fund structures with lower investment thresholds in an attempt to reach out to smaller family offices, private banks and investors."

THE GO-TO DOMICILES

Although Luxembourg has been a "go-to" domicile for real estate funds and private equity funds for decades, the Luxembourg Partnerships, the simple partnership (société en commandite simple, or SCS) and the special limited partnership (société en commandite spéciale, or SCSp), introduced in 2013 made the Grand Duchy an even more popular domicile choice. "Luxembourg put in place the limited partnership law in 2016 and that was really what was missing before," considers Lindgren. "The go-to structures for private capital managers before had been the UK and the Channel Islands." The Luxembourg Partnerships filled a gap in the Luxembourg domicile space.

Luxembourg Partnerships setup as RAIFs have become very popular private fund vehicles since their introduction in 2016 due to their flexibility – to invest in all types of asset classes – and agility – in going to market without prior approval by the CSSF. "The RAIF has been a very competitive vehicle, which combined with the fact that Luxembourg is such a well-known domicile brand all over the world, has increasingly made Luxembourg a go-to place for private capital managers," according to Lindgren. But there is a new Irish structure – Irish Limited Partnership (ILP) – that is also attracting some interest.

"Ireland is also a well-known domicile that is very well respected, and has a very strong industry," argues Lindgren. "The limited partnership, however, had been missing for a longer period," she emphasizes. "A differentiator that remains between the domiciles is the RAIF legislation, which has no equivalent in Ireland. Aside from that, the difference between Luxembourg and Ireland is more a matter of Ireland simply being a smaller domicile, a little bit less well-known depending on which investor segment you are looking at," according to Lindgren. "US and UK investors may be more familiar with the Irish domicile because of its common law system, not to mention the English speaking culture." European and Asian investors, meanwhile, may be more comfortable with Luxembourg because of their familiarity with this domicile.

"Even in the Nordic region, the preference for Luxembourg or Ireland differs a little bit across countries," says RBC's Director of Client Coverage in the Nordics. "We see, for instance, that Norwegian investors have a tendency to lean towards Irish structures, while Swedish, Danish and Finnish investors are going more towards Luxembourg," elaborates Lindgren. "These tendencies stem more from preference and experience rather than technical aspects and differences."

"The popularization of what we call private capital is an important trend that we observe. Although there are still challenges to overcome, this democratization process enables broader access to illiquid alternatives."

WHEN TO LEAVE THE DOMESTIC SETUP BEHIND

For emerging private capital managers, choosing the right domicile and structure is a crucial exercise that requires looking well into the future. With a fundamental consideration in the choice of fund domicile representing the nature of target investors, there is little surprise in the fact that some Nordic managers opt for setting up their funds locally. Lindgren sees two main reasons for setting up a fund in the home domicile: reputation and simplicity. "One of the drivers to keep a fund at home has been the reputation of some offshore domiciles that are associated, rightly or wrongly, with the perception of tax avoidance," says Lindgren.

The other reason is simplicity. "Some managers choose a local structure they are more familiar with because they may feel they don't have the expertise to assess how a Luxembourg or Irish structure would benefit them, how it will affect the cost structure of the fund and how it should be set up," considers Lindgren. "As long as you have only local investors or international investors who, for various reasons, have already done the due diligence on local investment vehicles, and if you are not looking for investors elsewhere, you could choose your local structure and domicile," she argues.

But if managers want to reach out to foreign investors or think they might want to do that in the future, then often managers should choose Luxembourg or Ireland as a domicile from the get-go. "It is important to note that these structures are fully accessible to local as well as international investors, so it is a choice that poses fewer limitations for capital raising," says Lindgren. "If you want a structure where you only focus your time and efforts on your strategy by outsourcing the administration and all of those bits and pieces around, there is a good reason to go to Ireland or Luxembourg because there is such a big service provider selection."

Gilles Lafleuriel, Head of Sweden – Obligo.

Obligo's Approach to Future-Proof Infrastructure

By Eugeniu Guzun – HedgeNordic

With infrastructure investment sitting at the heart of many governments' post-Covid economic recovery plans and a worldwide need for infrastructure investments, a much-needed flood of investor capital should not struggle to find opportunities to invest. The resilient and defensive nature of infrastructure assets – due to quasi-monopoly, regulated and long-term contracted cash flows – make this asset class an attractive allocation for institutional investors, particularly where there is an ESG focus.

"There is definitely a lot of capital piling up ready to be allocated to infrastructure as more investors are interested in getting a feel for the asset class," says Gilles Lafleuriel, the infrastructure-focused Head of Sweden at asset manager Obligo. "Infrastructure is a fairly mature asset class now with a track record of a couple of decades behind its back," he adds. "Not many infra managers have failed in their pursuit of delivering returns to their investors, which has comforted the interest from investors."

Both infrastructure and real estate investments usually fall under the umbrella of investments known as "real assets," tangible assets one can watch and touch. Yet, infrastructure investments share certain attributes that make them unique from a portfolio allocation context. According to Lafleuriel, "private equity infrastructure investments sit very well alongside real estate investments in a portfolio because they are touching different business models and are exposed to different risks." Lafleuriel argues that infrastructure and real estate investments "are not working in the same way, especially when it comes to how cash flows are contracted and how remuneration works." For that reason, "the inclusion of infrastructure into a portfolio brings diversification also within the real assets bucket."

"Infrastructure assets include assets that are essential to the society and, for investors, they are delivering stable cash flows over time because they are either operating in a monopolistic environment or involve cash flow streams that are regulated or long-term contracted," explains Lafleuriel, the former head of real assets and alternatives at Nordea Asset Management. "We have a rather pure definition of infrastructure, which for us, involve tangible assets that are essential to societies and are delivering stable cash flows over time," he continues. "The more essential the asset is to the community the better. It needs to provide an essential service that will help the communities and society as a whole. That is the characteristic on top of our agenda when we invest."

"We have a rather pure definition of infrastructure, which for us, involve tangible assets that are essential to societies and are delivering stable cash flows over time."

FOUR VERTICALS OF INFRASTRUCTURE PROJECTS

Although infrastructure construction projects can span a variety of industries ranging from power, transport, residential, and renewable energy to oil and gas pipelines, terminals and others, Oslo- and Stockholm-based Obligo has positioned itself as a trusted local partner tying international capital to Nordic sustainable infrastructure projects. "We are focused on sustainable infrastructure investments and everything that can contribute to climate change mitigation," emphasizes Lafleuriel. Obligo has, therefore, identified four main verticals for its infrastructure investments.

"One of them is power generation," starts Lafleuriel. "And because we focus on sustainable infrastructure and projects that contribute to climate change mitigation, we are obviously mostly focusing on renewable energy, such as wind, solar or hydro power," he elaborates. Infrastructure projects in this vertical can also span to include power plants that generate electricity or heating from other renewable sources. "The second vertical is electricity networks," continues Lafleuriel.

"When developing new ways of producing power, we also need to grow the electricity network accordingly, both at the distribution and transmission levels," he explains. Any investments focused on increasing energy generation from cleaner sources need to be accompanied by an increase in transmission and distribution networks. "The third vertical is the electrification of the transport sector," says Lafleuriel. "That goes all the way from the electrification of traditional road vehicles to the electrification of trains and boats," he elaborates. "This transition from internal combustion engine vehicles to electric motors is not going to happen overnight, but we are seeing pockets of opportunities in each sector and we want to be part of this transition."

The last vertical Obligo focuses on involves digital infrastructure. "We are living in a world that is more connected than ever and people are using more and more digital infrastructure to get information, to manage it and to communicate with each other," says Lafleuriel. "We believe there are ways to do these digital infrastructure investments sustainably and we are willing to invest in this sector as well."

> "Not many managers [within infrastructure] failed in their pursuit of delivering returns to their investors, which has drawn a lot of interest from investors."

Renewable energy space features the strongest pipeline of transactions across the infrastructure universe in the Nordics at the moment, according to Lafleuriel. "We see most deal flow in the renewable energy area, which is a sign of strong demand for those types of assets," he explains. "As of today, at least, we also see fewer transactions within the electrification of the transportation sector, but we believe that will change over the next couple of years, specifically within the area of power charging networks, for example."

GREENFIELD VERSUS BROWNFIELD PROJECTS

Infrastructure investments can take many forms and have many classifications, with one distinction differentiating between "greenfield" and "brownfield" assets. While the latter is just the older brother of the former, a greenfield asset holds a degree of development and/or construction risk that the brownfield does not face, simply because it is operational, according to Gilles Lafleuriel of Obligo. "When investing in a brownfield asset, we are not shooting for the stars," says Lafleuriel. The expected returns from these investments tend to end up in the mid to high single digits. "That is typically low when compared to traditional private equity, but on the other hand, we buy into much more predictable cash flows that are protected in various ways either via contracts or regulations."

To target higher returns in the infrastructure space, some investors may opt for investing in so-called greenfield projects. "More sophisticated and experienced investors might be willing to invest a bit earlier on in the process, either in the development phase or construction phase, which involves accepting a higher level of risk and a wider set of risks," explains Lafleuriel. "When investing earlier in the development of an asset, one can achieve higher returns on investments," he elaborates. Obligo is launching a new infrastructure fund that will make investments into a mix of greenfield and brownfield assets. "But those assets are the same in nature. We do not go off-road by investing in greenfield assets. That simply involves buying into projects at an earlier stage, involving more risks expected to deliver better results if allocated and managed appropriately."

The fund format still remains the most desirable way of accessing this asset class, according to Lafleuriel. "Doing an infrastructure investment as a direct investor involves a lot of work, requires a lot of commitment not only to transact, execute and manage deals and projects, but to also source and build the right connections and network to uncover deal opportunities."

> "We are focused on sustainable infrastructure investments and everything that can contribute to climate change mitigation."

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Christoph Junge, Head of Alternatives – Velliv.

The Holy Grail of Diversification

By Eugeniu Guzun – HedgeNordic

With inflation becoming omnipresent and geopolitical uncertainty rising due to the war in Ukraine, market participants witnessed a conundrum of consequences in the first quarter of 2022. The first quarter's market environment characterised by rising interest rates – hence falling bond prices – and falling equity markets has – yet again – shown the fragility of the traditional balanced portfolio of 60/40 stocks and bonds. The objective of the bond component to act as a stabilizer to the equity allocation has not been fulfilled, again.

"The historical relationship between bonds and equities that so many portfolios rely on, namely a negative correlation between those two during times of crisis, failed," says Christoph Junge, Head of Alternatives at Danish pension provider Velliv. "This, by the way, is not something new and has happened before," he continues. "When looking at historical data, one could even argue that the negative correlation between bonds and equities during the last 20 years was the exception, not the rule."

With the role of bonds as portfolio ballast frequently coming under pressure, alternative investments are increasingly becoming more mainstream as institutional investors seek ways to diversify their portfolios. "So which options does this leave investors to build robust portfolios?," asks Junge. "More and more are turning towards alternative investments in the hope of the holy grail of portfolio diversification."

Velliv, one of the largest pension funds in Denmark, allocated DKK 22 billion to alternative investments at the end of 2021, up from DKK 18 billion at the end of 2020. The alternative basket, which accounts for about a tenth of Velliv's assets under management, comprises investments in private equity, illiquid credit, real assets such as infrastructure and timber, as well as liquid alternatives. "Private equity and illiquid credit are the largest allocations in our alternative investments portfolio, followed by real assets (infrastructure and timber) and liquid alts," Junge tells HedgeNordic.

THE MULTI-FACETED ROLES

Although the use of alternative investments as a "risk diversifier" alternative to bonds has been increasing, alternatives play multi-faceted roles in a multi-asset portfolio. "The alternative investment universe is very heterogenous, so the various strategies or sub asset classes fulfil all their own purpose," highlights Junge. "For us, private equity is all about higher returns than on public equity. The same for illiquid credit strategies."

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The illiquidity premium is seen as a key component in the long-term return investors can receive from private equity, private credit or other unlisted investments. However, Junge goes on to emphasize that investments in the unlisted corners of financial markets benefit more from earning a complexity risk premium rather than the illiquidity premium. "Not that I am a firm believer in an illiquidity premium, but there is more a complexity premium in these investments," says Junge. "Where skills meet opaque and inefficient markets, magic happens."

Describing the role of the other alternatives in Velliv's portfolio, Junge says that "infrastructure has – for us – the role of delivering stable returns and some kind of inflation hedge." Hedge funds and other liquid alternative investments, meanwhile, act as portfolio diversifiers. "Some alternative investments provided much needed relief and diversification in the first quarter of 2022, and especially CTAs had a huge comeback with crisis alpha when it was the most needed," according to Velliv's Head of Alternatives.

In the current market environment dominated by unabating inflationary pressures, gepolitical tensions, and financial market uncertainty, "the defensive and inflation protection characteristics offered by some alternative asset classes are most attractive to investors," according to Junge. However, the most wanted characteristics alternatives can offer are "very much dependent on the market regime, the asset class, and last but not least, the individual investors' goals."

ON-RAMPS FOR ALTERNATIVES

In the past, institutional investors had to build their own infrastructure and teams to be able to access alternative asset classes. Co-investment opportunities have served as more unique, lower-cost ways to access the alternative investments space. "In alternative investments, we are only going the indirect way and have also teamed up with partners to make co-investments in private equity," he emphasizes. "It would be too resource-intensive to run it in-house at the moment."

"The advantages of fund investments are better diversification, access to high quality teams and, of course, access to co-investment deal flow," considers Junge. The disadvantages of fund investments, however, are the associated costs and the J-curve. "Co-investments are much cheaper, even when externally managed, but increase the concentration risk when the company is both in the primary fund and the co-invest vehicle," continues Junge. "In addition, co-investments typically allow for quicker ramp up and less J-curve."

> "More and more are turning towards alternative investments in the hope of the holy grail of portfolio diversification."

RISING BOND YIELDS – INFLECTION POINT FOR ALTS?

As bond yields have started climbing with expectations of them rising even higher in the coming months, some institutional investors started seeing investment grade bonds attractive again – thereby skimming off some investor interest in alternatives. "My expectation is that investors who have embraced alternatives won't stop just because rates are higher now," considers Junge. "They have built up the resources and knowledge and as alternatives hopefully still offer a premium over risk free rates (or risky but liquid rates for that matter) and have other interesting portfolio characteristics, there are still reasons to invest in alternatives," he elaborates. "But maybe there will be fewer new entrants to the market?!"

On the question of which alternative asset classes are best positioned for the current market environment, Junge says "it really depends on how the future unfolds." According to Velliv's Head of Alternatives, "if we just see a rise in nominal yields, but flat or falling real yields, those asset classes that profit from inflation could benefit, like certain parts of the infrastructure space or parts of the credit space that are of floating rate nature." He goes on to emphasize that "credit could suffer if rates rise too much, leading to an increase in defaults."

"If we, on the other hand, see a substantial rise in real yields, there is not much shelter from any asset class that is long-only," considers Junge. "Like in the listed markets, certain areas of the alternative asset classes have reached frothy valuation levels," he adds. "A substantial increase in real yields would most likely lead to losses on many of the alternative and traditional asset classes. In this scenario, I would only expect certain types of hedge funds to be able to perform."

> "The alternative investment universe is very heterogenous, so the various strategies or sub asset classes fulfil all their own purpose."

By Eugeniu Guzun – HedgeNordic

Trees: a Natural Inflation Hedge

From left to right: Jyri Hietala, fund manager – United Bankers and Kari Kangas, fund manager – United Bankers.

"Historically, wood prices have been a good inflation hedge."

Jyri Hietala

Inflation rates may not be the same everywhere, but rapidly rising inflation appears to have become a more global phenomenon and problem. Both institutional and smaller investors are increasingly looking for inflation-protected investments to stay ahead of inflation and hedge against the erosion of portfolio value over time. A strong candidate to serve that inflation-protection role is forestry.

"In the current environment, inflation hedge is the one attribute investors need to look for when building up a portfolio," confirms Jyri Hietala, a forestry-focused fund manager at Finnish asset manager United Bankers. "Historically, wood prices have been a good inflation hedge," emphasizes Hietala. The inflation-adjusted price of wood has been stable for the past ten years, especially in Finland, according to the Helsinki-based portfolio manager. Perhaps more than many other commodities, timber has historically moved in tandem with the overall price level of the economy over the long-term.

INFLATION HEDGE

The inflation-hedging properties of forestry investments stem from the many uses of wood in the real economy, with wood used for fuel, building materials, furniture, paper, tool and more. "Derived demand for wood is dependent on the demand for its uses and the end products," explains Kari Kangas of United Bankers. Higher demand – and thereby prices – for end products simultaneusly leads to higher demand for wood and higher wood prices, which makes timber a good hedge against the rising prices of goods and services. In addition to the price of timber, as a commodity, being closely related to changes in global demand, there has been another driver of higher wood prices this year.

"Logistics-driven and supply-side inflation due to the war in Ukraine has also driven wood prices higher," according to Kangas. "Prices for roundwood are rising at the moment, perhaps not due to inflation only, but also because of the situation in Ukraine and what has happened to Russia's export market of wood and end products," elaborates Hietala. "The war and the associated consequences have changed the whole market, resulting in a scarcity of raw materials and end products, which, of course, led to increasing prices."

"Forest properties have also appreciated in value even more than the rate of inflation, with inflation running at a little over one percent per annum and the price of forest properties rising at an average of over three percent," according to Hietala. "The current situation is quite different to what we have experienced in the past, because inflation is very high and rising very rapidly at the moment," acknowledges the portfolio manager. "Even though inflation is very high, we expect the prices of roundwood and forest properties to increase more or less at the same rate as inflation," considers Hietala.

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"Prices for roundwood are rising at the moment, perhaps not due to inflation only, but also because of the situation in Ukraine and what has happened to Russia's export market of wood and end products."

Jyri Hietala

DIVERSIFICATION

In addition to fulfilling the role of inflation protection, an allocation to forestry and timberland also provides diversification. "If we talk about portfolio theory, an allocatiion to forestry can be used to improve the diversification and risk-return profile of any portfolio," says Kangas. "An allocation to forestry or timberland takes a portfolio to the efficient frontier," the set of optimal portfolios offering the highest expected return for a defined level of risk. "Diversification is an important aspect of forestry investing," corraborates Hietala, particularly in the current volatile market environment. These diversification properties stem from "the unique ingredients of forestry yield that are not correlated to any other asset classes or risk drivers," according to Hietala.

One unique ingredient involves the biological growth of trees, which represents an integral driver of a forestry investment's returns and the asset value of forestry assets. The return on forestry investments consists of two components: a direct cash flow return generated by the net earnings from forestry activities and an asset value growth that is determined by supply and demand for forestry assets, changes in the growing stock and its composition, among others. Therefore, the biological growth of trees affects both the direct cash flow return and asset value growth.

"The value growth does not only depend on the price increase of the land, but also from the biological growth," explains Kangas. In Finland, the biological growth of trees has been around four percent on average over time. "Since we are active and professional managers in this space, we have to do a little bit better," says the fund manager. "For example, UB Timberland Fund has enjoyed an annual total return of about 5.1 percent on average, of which a large share is comprised of the value appreciation of property holdings." As Hietala explains, "most of the value growth comes both from the standing – and growing – stock, but also from the increased value of the timberland." The assortment of trees also determines the value of forestry assets, according to Kangas. "There are different roundwood assortments, some more valuable than others." Forestry assets, therefore, do not only increase in value due to volume growth but also due to moving into higher-priced wood-product categories.

In addition to the value growth, forestry investments also offer an annual net revenue realized return. "The main component of this revenue stream comes from selling roundwood," explains Hietala. "That is the revenue-generation stream, but you also have costs associated with silvicultural and other activities that usually account for 10 to 15 percent of the revenue," explains the fund manager. The portfolio-level cash flows can be smoothed or optmised through investor-directed management and harvest plan, resulting in a stable, secure and sustainable cash flow from forestry investments.

THE ESG DEBATE AROUND FORESTRY INVESTMENTS

The European Commission's new EU forest strategy for 2030, which is part of the EU's European Green Deal, has led to ongoing discussions and concerns around the topic of how forests should be managed and what their wood can be used for. "Sustainability is a multi-dimensional issue in forest management," acknowledges Hietala. "With the EU Green Deal and the Fit-for-55 package, there are some positives," says Hietala, as forests can act as carbon sinks – anything that absorbs more carbon than they release – and wood-based products are seen as renewable and climate-friendly raw material that substitutes energy-intensive materials and fossil fuels. "At the same time, under EU Taxonomy, for example, we expect there will be new regulation introduced to actual forest management practices focusing on protecting biodiversity," according to Hietala.

"It is still too early to say what the actual criteria will be for forest management," says Hietala. The clear-cutting technique where all trees in an area are felled may face restrictions, according to the fund manager. "There can, for example, be some kind of limitation either in terms of maximum areas that can be clear-cut or in terms of strictly protecting a percentage of the forest," elaborates Hietala. As a large forest owner, United Bankers is well positioned to navigate future regulations due to their ability to identify areas to protect, for instance.

Moreover, sustainable forest management has always been an integral part of the timberland funds managed by United Bankers. "We aim for the highest, meaning that all of our timberland funds will be classified as sustainable investments as defined in the EU Taxonomy," adds Hietala. Despite uncertainty regarding soon-to-be-implemented regulation, sustainable forestry management can offer great opportunities for green, ethical, socially responsible investing, as well as opportunities for accessing stable, inflation-protected return streams.

"The value growth does not only depend on the price increase of the land, but also from the biological growth."

Kari Kangas

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By Filipe Albuquerque – NordSip

The Case for Impact through Private Equity and Private Debt

Although sustainable investing is increasingly a part of mainstream investor's tools, a low yield environment means continues to drive the appetite for sustainable investments in riskier markets. Although generally associated with higher returns, private markets remain a frontier sustainable investors find difficult to conquer due to the lower disclosure requirements for unlisted companies, their smaller scale and the limited resources at their disposal to respond to sustainable concerns.

As a result, NordSIP took some interest in two recently-published notes by impact asset manager BlueOrchard, part of Schroders group, discussing the roles of private equity and private debt in fostering the transition to a more sustainable economy.

FOSTERING FINANCIAL INCLUSION IN EMERGING MARKETS VIA PRIVATE EQUITY

In a recent whitepaper, BlueOrchard argues that private equity investments offer in companies tackling financial inclusion in emerging markets (EMs) have been a relatively successful strategy for the impact investor.

"1.7 billion adults remain unbanked, women continue to suffer disproportionately from financial exclusion, and individuals and businesses alike require funding to reignite their economic activities in the aftermath of the Covid-19 crisis," the report explains.

According to the report, the case for private equity in Ems is particularly interesting for investors looking to gain exposure to "businesses with regulatory capital requirements where equity provides the basis for debt funding." Thus, the private equity investment works as the foundation upon which businesses may then leverage themselves to finance growth. Another appeal of private debt is that it provides access "to cash-generating businesses that typically cannot be accessed through debt markets, such as insurers or fast-growing technology companies, typically funded via equity." According to the data provided by BlueOrchard, exposure to financial inclusion in EMs has traditionally outperformed the rest of the market.

The impact asset manager argues that its own experience has been even more successful. "The firms in BlueOrchard's portfolio have fared even better than their emerging markets peers. By tending to the underserved segments of the population

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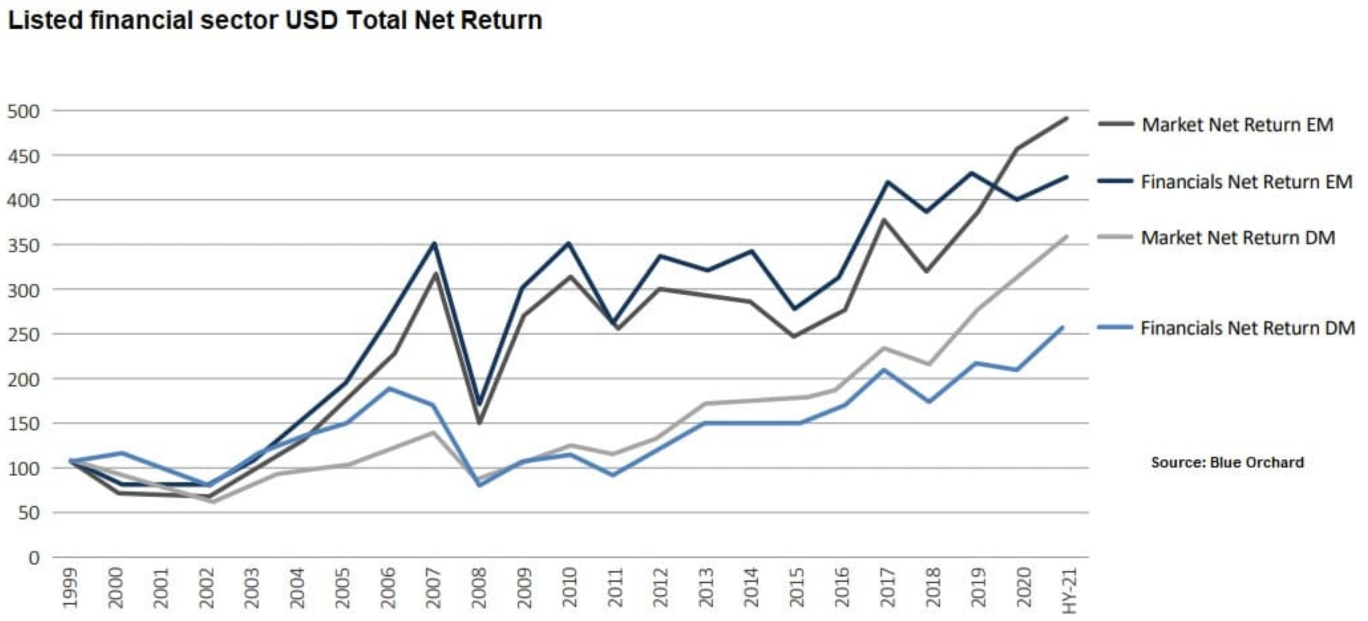

"1.7 billion adults remain unbanked, women continue to suffer disproportionately from financial exclusion, and individuals and businesses alike require funding to reignite their economic activities."

and economy, they have grown their assets more than fivefold on average over the last decade," the whitepaper continues.

Blue orchard also argues that a focus on private markets is best. "The analysis of 180 banks and non-bank financial companies in the BlueOrchard client portfolio suggests that the largely non-listed universe of companies focusing on financial inclusion is growing even more strongly than their listed financial sector peers in emerging markets," the report adds.

The report was authored by Felix Hermes, Head of Private Equity & Sustainable Assets at BlueOrchard, and Ernesto Costa, Head of BlueOrchard's Private Equity Investment activities.

PRIVATE DEBT: A PREFERABLE ROUTE TO RENEWABLE INFRASTRUCTURE

In a market commentary article, Ashwin West, Head of Sustainable Infrastructure Investments at BlueOrchard, argues that private debt is the best channel for investments in renewable infrastructure at the moment.

"Emerging market infrastructure debt offers a material premium over the developed markets, but with a similar or marginally greater risk profile."

"The falling cost of renewable energy is cause for celebration and much needed optimism in the fight against climate change. However, as project costs have fallen and governments have adjusted their approach to project procurement, competition has risen. This is putting returns under pressure for private equity investors in infrastructure projects. Indeed, the average return in emerging and frontier market renewable energy private equity investments has been falling steadily for about a decade. But the same is not true for the credit portion of infrastructure project finance," West says.

The cost of installing the infrastructure and producing power declined over the last decade. In South Africa, for example, renewable energy represents 16% of the country's energy capacity, up from 4.9% ten years ago. These improvements have found their way to the pocket of consumers, the unit cost per kilowatt-hour of renewable energy ("tariff") has fallen by approximately 37% on average (and as much as 70% for solar PV).

According to West, market conditions appear to be better in debt markets "Emerging market infrastructure debt offers a material premium over the developed markets, but with a similar or marginally greater risk profile," he says.

"The additional 200-400 basis point spread achievable in the emerging markets, whilst taking similar or marginally higher risk than similar investments in the development markets, supports this strategy," West concludes.

Lars Granat Jensen, CMO – RareWine Invest.

By Eugeniu Guzun – HedgeNordic

Wine – The Illiquid Liquid Alternative

“If we compare to traditional assets, wine is somewhere in between government bonds and the stock market, though closer to bonds than stocks in terms of risk.”

Lars Granat Jensen

Some investors may view alternative investments as assets that can diversify a portfolio. But some are more exotic and esoteric investments within the alternatives space than others. Think classic cars, fine art, bottles of whisky, some of which we have already introduced. Fine wine is one such investment, an emerging alternative asset class that benefits from two features – healthy demand and limited supply – that make it an attractive investment for long-term-oriented investors.

“Stable returns and low risk are the main characteristics of wine investment,” explains Lars Granat Jensen of RareWine Invest, a Danish firm offering individuals a platform for investing in wine. Fine wine’s attractive investment characteristics stem from attractive supply-demand dynamics due to its inverse supply curve. “The market is mainly driven by simple factors such as supply and demand,” says Jensen.

Three underlying factors are driving the fine wine market’s supply-demand dynamics, according to Anders Tang, the founder and CEO of another Danish company – Jero – providing services across the whole investment journey of wine. “First, there is scarcity of supply due to limited production,” starts Tang. Only specific vineyards in certain wine-growing regions have the qualities and recognition to produce top-quality wines. “The best vineyards in the world are at full production, so you have a limited supply,” says Tang.

“Production cannot be increased,” Jensen corroborates Tang’s observation. “Actually, climate change could mean even lower production of the best wines in the world in a longer-term,” argues Jensen. Another factor affecting the supply-demand dynamics is the consumption of wine, with supply actually decreasing as more of the wine is opened and drunk. “Over time, consumption will lower supply and prices will rise,” says Jensen. As time passes, there are fewer and fewer bottles in the fine wine market without demand falling, according to Tang of Jero.

The third underlying “supply-demand”-affecting factor is increasing demand. “Growing world population and the rise of ultra-high-net-worth individuals will increase demand for the best wines in the world,” says Jensen. The number of ultra-high-net-worth individuals is expected to increase by about 30 percent over the next five years, according to The Wealth Report by Frank Knight.

“More and more people are getting wealthy, with countries like India and China seeing more wealthy people every day,” confirms Tang of Jero. “As a result, the demand for fine wine either for consumption or for investment is increasing at a rapid pace,” he continues. “Rising demand, stable to declining production, ongoing consumption provide optimal conditions for making supply and demand dynamics be the primary influence on the price development

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Anders Tang, CEO – Jero.

of wine," summarizes Tang. "This combination of factors makes wine a really attractive asset for long-term investment." Jensen agrees, emphasizing that "wine investment is a long term investment."

INVESTMENT CHARACTERISTICS

Investible fine wines offer low correlation with traditional asset classes, attractive returns over the longer term and bond-like volatility. "If we compare to traditional assets, wine is somewhere in between government bonds and the stock market, though closer to bonds than stocks in terms of risk," argues Lars Granat Jensen from RareWine Invest, an associated company of RareWine which has traded professionally in rare and fine wines globally for more than a decade.

"Basically one can say that the returns are better than bonds and the risk is lower than stocks," summarizes Jensen. "Certainly Champagne and Burgundy have been the best performing wine areas during the last 15 years, but if we look a the total market for fine and rare wine, one should expect approximately 8 percent return per year." In the period 2005-2020, the broadest wine index on the wine exchange Liv-Ex had a higher Sharpe ratio than both gold and stocks. The Liv-ex Fine Wine 100 Index delivered an annual return of 8.4 percent with a volatility of 5.1 percent to reach a Sharpe ratio of 1.53, over the 0.57 Sharpe ratio for gold and 0.61 for the S&P 500. "If the story repeats itself, then it suggests that adding wine to a diversified investment portfolio can optimize the portfolio's risk-adjusted return," says Tang.

"Wine has historically been shown to have a low correlation with the financial markets, which makes wine as an investment asset particularly suitable for diversifying and reducing portfolio risk," explains Anders Tang. "Wine investments generally exhibit low correlation with financial markets as wine price formation is not determined by the factors driving broader markets," he elaborates.

"The demand for wine goes beyond the immediate benefits as an investment asset, it is also driven by passionate consumers," according to Tang. "This does not mean that wine investment is without risk of loss of value," he acknowledges, adding that "it is very likely that wine price formation will continue to be determined by internal factors and behave differently from stocks, bonds, etc., which fluctuate more based on general market sentiment and political intervention."

> "Rising demand, stable to declining production, ongoing consumption provide optimal conditions for making supply and demand dynamics be the primary influence on the price development of wine."
>
> Anders Tang

WINE AS AN INFLATION HEDGE

In an environment of high and rising inflation, an allocation to fine wine can also fulfill the role of inflation protection, according to both Lars Granat Jensen and Anders Tang. "Rising production cost, inflation and more sustainable production methods will make production more expensive in the near future," says RareWine Invest's Jensen. "In addition to the development of the general supply and demand, the value of exclusive wine in the future is determined by the cost of production and the consumer's ability and willingness to pay a higher price in the future," adds Tang.

"The production of exclusive wine requires a high degree of manual labor, which is why the general wage development will have a natural impact on wine prices," elaborates the CEO of Jero. "If prices for future vintages increase due to higher production costs, one can expect previously released vintages to observe a price increase as well despite being produced under different conditions."

MAIN RISKS ASSOCIATED WITH WINE INVESTING

More exotic investments such as fine wine are characterized by lower liquidity than traditional financial markets or even other alternatives such as real estate. While this represents a significant downside for some investors, reduced liquidity can also insulate this type of investment from panic selling. "There is bigger liquidity risk compared to equities or other publicly traded securities," says Tang. Although the sale processes are different in many ways, the timeline of selling a bottle of wine resembles an apartment or house sale, according to Tang. "If you want to sell today, you will not get the price you want. But if you have a little patience, you will get your price."

Lars Granat Jensen, meanwhile, argues that "it is not difficult to sell the best wines in the world, it is difficult to obtain them." The success in wine investing, according to Jensen, hinges on "selecting the right wines for your portfolio." Expertise, storage, fraud, insurance, and other aspects make wine a difficult to access asset class. Yet, RareWine Invest, Jero and perhaps other players provide a full range of services that can serve as an off-ramp investment program for wine investors.

"You do not need to be a wine expert to invest in wine. We handle the process from A to Z," says Jensen of RareWine Invest. "We help investors select investment grade wine and build a portfolio with a certain risk diversification including well know wine areas such as Burgundy, Bordeaux, Champagne, Piedmont, Tuscany, Napa Vally and more," he elaborates. "Besides building the portfolio, we also take care of logistics, insurance and storage at our own warehouse facility, Nordic Freeport, which is a bonded warehouse for wine and spirits located in the Denmark. Being a bonded warehouse means that the wine portfolio is stored without VAT and excise duties."

Anders Tang's Jero is on a mission to democratize the fine wine investment market by building a platform that enables wine reselling to private investors and wine lovers without the need of professional merchants. In addition, Jero is "delivering services throughout the investment process by seeking attractive investment opportunities (focus on smaller top-quality wine producers that are often lower priced and can deliver good returns), as well as taking care of import, insurance, storage, reporting and divestiture," according to Tang. While there is a different set of risks associated with wine investing such as lower liquidity as well as storage or insurance costs, many investors will likely turn to wine investing for returns, low correlation, enjoyment and social currency.

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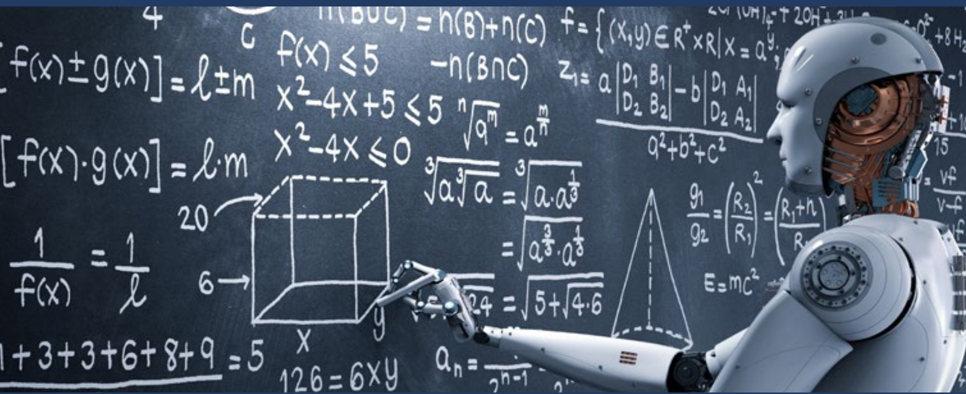

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