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PERSPECTIVES

PRIVATE ASSETS: THE BRIDGE OVER A CLIFF TO A DIFFERENT WORLD

Private assets have undoubtedly been among the winning asset classes since the Global Financial Crisis (GFC). The appeal of higher returns against a low yield backdrop, the promise of a safe haven against the volatility of public markets, compatibility with accounting-friendly diversification and ESG mainstreaming helped fuel a sustained fundraising trend. If anything, history has shown the resilience of private assets and their ability to bounce back from a crisis.

Will things be different this time? In stark contrast to the GFC, the real economy has suffered a sharp blow. While the appeal of private assets as a whole is likely to survive the crisis, the asset class is bound to face a reckoning, out of which not all capabilities will emerge unscathed. Who will come out on top of this new world order?

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Infrastructure

Without a doubt, infrastructure is bound to emerge as the big winner of this crisis, crowned for its unrivalled resilience to economic shocks. Short-term profitability issues, prevalent among private asset managers, will be toned down for infrastructure managers by the long lifecycles of assets. In the longer run, massive government stimuli will fuel growth, focusing on sectors in which the crisis has revealed the need for transformational investments: renewable energy, utilities, vertical infrastructure, digital infrastructure.

As the dust settles, one of the key lessons learned from the crisis will unarguably be the core importance of resiliency - i.e. the ability to resist macroeconomic risks – in devising sustainable and compelling investment strategies. This concept will prove particularly relevant for infrastructure strategies and may well come to provide a more relevant segmentation and supersede the increasingly unreliable core/ value-add dichotomy.

Real estate

The same rings true in real estate, albeit with a greater sense of urgency. The short-term return issues caused by rent payment delays granted to tenants have revealed the risks of an asset class that had come to be considered as a suitable replacement for fixed income products in investors' portfolios.

The Covid-19 crisis has highlighted and accelerated the trends set to transform the real estate investing landscape. Changing consumer behavior and work practice, translating into a likely decline in the demand for office space and the rise of online consumption will reshuffle opportunities and force asset managers to rethink their approach. In this new world, generic strategies, such as commercial real estate, may no longer make the cut. Enhanced product segmentation will take center stage, showcasing the high performing segments prized as nuggets of resiliency: logistics, datacenters, health and social real estate.

Private equity

In private equity, the picture may appear bleak as most funds will likely be impacted by the global economic shock. Although the deal machine still appears to be running, it is largely fueled by large volumes of dry powder and the power of inertia. More PIPE transactions are also likely as indicated by Q1 deal log.

While seasoned LPs are unlikely to time the market, fundraising will take longer for most managers. LP co-investments will also be more difficult to execute. Finally, heightened secondary market activity is to be expected as forced sellers scramble for liquidity, hit by portfolio valuation uncertainty and frozen exit routes.

Over the mid-run, a new line of differentiation will crystallize. Once again, resilience will be the name of the game. The ability to identify the sectors and business models that can weather economic shocks; to operate in a virtual environment at full efficiency; to adapt to changes in global trade patterns, travel and logistics will spell the difference between winners and losers. Those private equity firms with strong resources in operational excellence and in-depth ESG analysis credentials will press their advantage by supporting and transforming their portfolio companies through the post-CoVid-19 world.

In the longer run, nascent endeavors to transform investors' approach to the asset class (long-term capital, evergreen funds) may lay the groundwork for a renewed and more resilient framework for private equity investing offering enhanced alignment with LP expectations.

Private debt

Private debt is likely to suffer the toughest blow from the crisis (direct corporate lending, including unitranche strategies). Across the board credit repricing has already led investors to arbitrage away from the asset class towards public markets, that have become more attractive on a relative value basis. Issues that were already raising eyebrows pre-crisis – weak covenants, over-concentrated portfolios, copious rounds of leverage – will likely concentrate investor focus. Against this backdrop, opportunities are fast arising for asset managers nimble enough to seize the moment and able to marshal the right skillsets and resources to target distressed opportunities or special situations.

In the mid-run, the private debt market is betting on the ongoing bank disintermediation trend to act as the rising tide that will lift all boats. This is a plausible scenario but by no means a done deal. Traditional lenders may find themselves in a strong position to hold their ground, bolstered by replenished amounts of capital, vocal public authority support and a revival of capital market access mechanisms (securitisation). Private debt managers may well find the crisis to have a deeper effect on their business than they had initially reckoned and will need to demonstrate their value-add in times of turmoil.

In brief, while private asset classes experience mixed fortunes throughout this crisis, major common trends are likely to redefine success for private asset managers going forward:

- The focus on resilience in sourcing and investment appraisal;
- The integration of sustainability analysis (ESG risks) at the heart of investment strategies and processes;
- The need to revise offer segmentation in line with renewed LP segmentation (incl. investment horizon, impact focus, co-investment opportunities, performance and remuneration KPIs).

INDEFI is an independent strategic advisor for the investment management business in Europe. Our positioning at the cross-roads of asset managers and investors across Europe gives us a unique vantage point on the impact of the Covid-19 pandemic on the asset management industry.