REPRESENTING ALTERNATIVE INVESTMENTS

What‘s more to expect in 2023?

A GPs perspective among BAI members

© Bundesverband Alternative Investments e.V. (BAI)

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Foreword

The last years have been challenging for investors. The global pandemic was just subsiding when war broke out in the East. And hence all the negative consequences for the European society and economy resulting in a new stress test for the investment industry: Persistent high inflation rates, rising key interest rates, energy crisis, shortage of goods, and the omnipresent competition for professionals are not the best breeding ground for investments. 2023 can still bring the long-awaited recovery for the markets or continue their stress test. Much depends on whether a recession breaks out in the USA and Europe, and how pronounced it will be. Thus, asset managers among the BAI members were asked for their opinions on the crises in 2022 and beyond and what impact they will have on their alternative investments. For the institutional investor perspective, please review our Investor Survey and accompanying reading on interest rate turn-around and inflation.[*]

Part one: Macroeconomics

Inflation and rising interest rates

After hitting a record high of 10.6% in October 2022, Euro area annual inflation is expected to be 8.5 % in February 2023, and thus only slightly lower than in January 2023 (8.6 %), Eurostat estimates. There are three main reasons for this decline. First are the falling energy prices, implying that the costs of companies and departments are going down. Therefore, there is no price pressure from the company side to raise prices. The second reason the inflation rate declined is that the wages increased much less than inflation did. This will depress demand throughout the eurozone and will have a negative influence on inflation as well[**]. Third, because the development of the inflation rate depends on the dynamics in the previous year‘s month, it is possible to see a falling inflation rate even though inflationary pressure has remained constant from one month to the next. This decline in inflation would be the so-called base effect.

However, most macro outlooks expect inflation to be well above target rates in 2023. Eurosystem staff now see average inflation for 2022 at 8.4% before decreasing to 6.3% in 2023 and projected to average 3.4% in 2024[***]. The European Central Bank (ECB) holds the position that the key interest rates are their primary tool for setting the monetary policy stance. The ECB is forced to keep their key interest rates at least at the current level and is even expecting to raise them significantly further. “Interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to our two per cent medium-term target.” (Conclusion ECB press conference December 15, 2022) Forecasters expect the ECB’s key main refinancing operations (MRO) interest rate to increase to 3.5% in the second quarter of 2023, before easing slightly in 2024 and in 2025 to below 3%[****].

* BAI-Publikationen

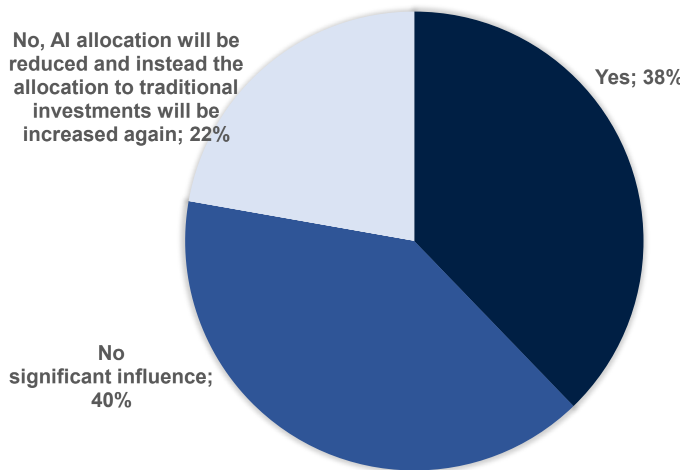
**https://www.euronews.com/my-europe/2023/01/06/inflation-in-the-eurozone-falls-back-to-single-digits-as-downward-trend-continues. Zsolt Darvas, senior fellow at Bruegel, Brussels-based economic think tank.

*** ECB press conference December 15, 2022

**** ECB Survey.

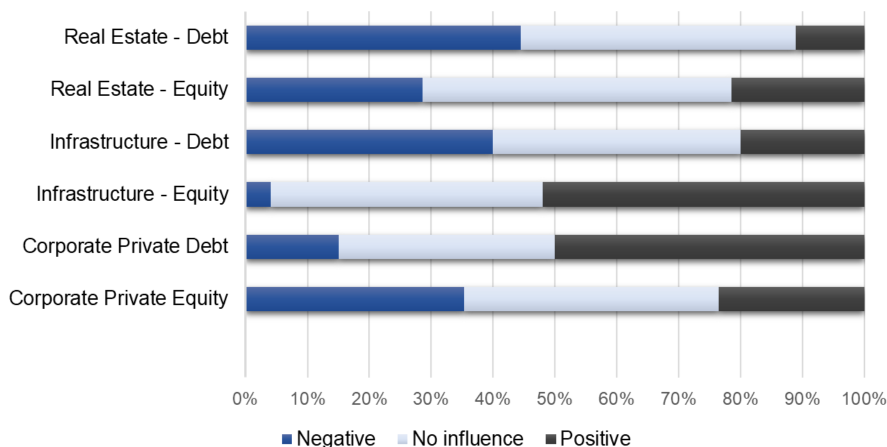
Rising interest rates and high inflation impact institutional investors' strategic asset allocation (SAA), which we show in detail in previous publications*. In the BAI Survey 2022, not only LPs but also GPs were asked about the influence of such high persistent inflation (>3%) as well as rising interest rates and an economic downturn on the expected performance and risk-adjusted attractiveness within the overall portfolio for various alternative asset classes. The effects described are seen by 38 % to cause a shift in SAA towards alternative investments, 40 % see no significant influence, and 22 % take a contrary view. Meaning, that alternative investment allocation will be reduced in favor of traditional investments**.

Influence of high interest rates on the SAA in favor of AI



Effects vary depending on the respective alternative asset class. Representative data from our BAI Investor Survey 2022 and BAI Member Survey 2022 show that investors and asset managers see Commodities as the alternative asset class benefiting most from the current environment. They are technically interconnected to inflation. Also, in the current volatile environment with high downside risks but the constantly existing possibility of dynamic market recoveries, alternatives to long-only strategies offer good opportunities. Therefore, Hedge Funds and Liquid Alternatives are widely regarded as possible major profiteers of the interest rate turnaround and inflation***.

Impact of high inflation (>3%) on relative attractiveness



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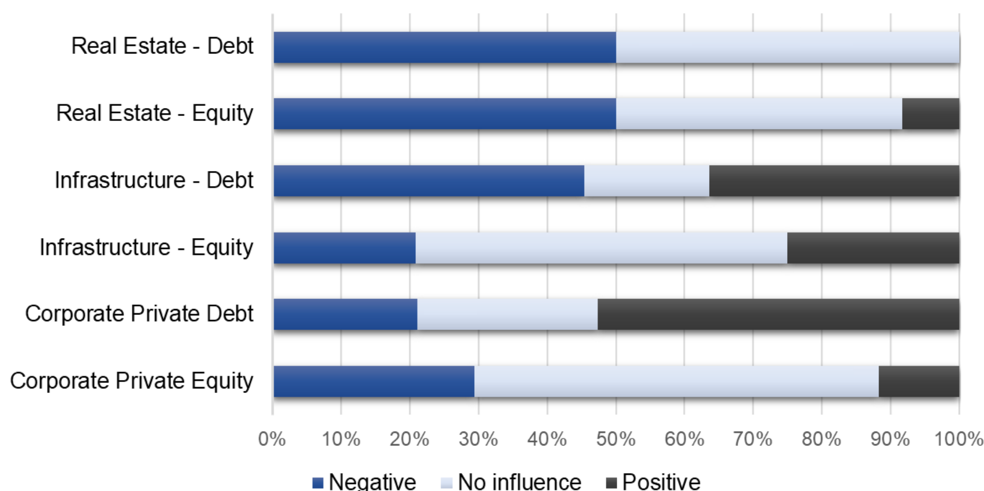
* BAI-Publikationen

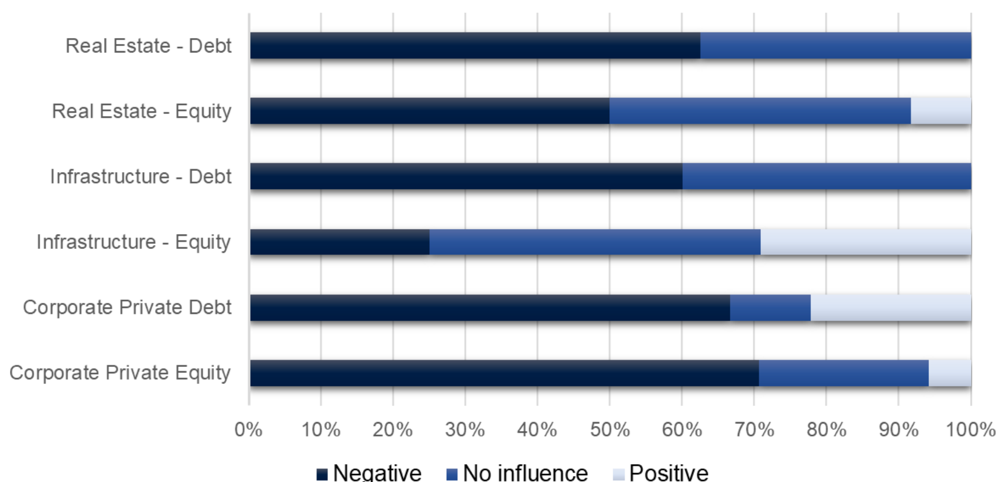
** For a detailed analysis, also regarding differences between GPs and LPs, compare our publications "Interest rate turnaround and inflation: Implications for Alternative Investments in asset allocation"and "Interest rate turnaround and inflation Alternative Investments remain robust - despite competition from rising bond yields".

*** BAI: Interest rate turnaround and inflation: Hedge Funds, Liquid Alternatives, and Commodities could be profiteers - investors expect geographical shifts in asset allocation.

The infrastructure sector remained resilient in 2022, withstanding market turbulence, with private markets outperforming public markets. No wonder, that infrastructure is seen as a relative winner for many GPs in a highly inflationary environment. The asset class confirms its reputation for resilience in an inflationary environment, which is consistent with the data of third parties analysis*. For detailed studies of the impact of inflation and interest rate on the strategic importance and performance of individual asset classes and AI in general, see our ongoing series of publications "Interest rate turnaround and inflation – impact on AI."



Private Debt may be needed in an overall portfolio context even more going forward with a view to rising interest rates and high inflation, keeping in mind that the correlation between equity and bonds was nearly always positive in periods of inflation exceeding the 3% threshold we have set. Whether current increased bond yields lead to a displacement of Private Debt by traditional bonds is a question of investors' perspective and the need for real interest rates versus nominal interest rates. Private Debt as a floating rate instrument with stable cash yield and short duration is particularly attractive to investors in times of rising interest rates, and many of our member companies share this opinion. Furthermore, due to the inverse yield curve for bonds, bonds are not necessarily in direct competition with Corporate Private Debt, but rather have a complementary function. For example, the inverse yield curve means that investors accept and pay for significantly higher interest rate risks with longer durations. This means there is a clear obstacle to significantly higher bond allocations, even when focusing on nominal values.



* UBS: 2023 Infrastructure Outlook.

As at present, a severe stagflationary scenario, in which economic stagnation and inflation go hand in hand, does not seem completely unlikely either. The asset managers surveyed give a clearer picture of the expected impact of possible stagflation. The influence of stagflation is seen as negative for private equity as well as for private debt investments. This is mainly due to negative GDP growth. Inflation and rising interest rates alone do not yet have a negative impact on Private Debt. Still, if negative economic growth is added to this, corporate profits fall, as can be seen in declining EBITDA, so many borrowers could get into difficulties. It is interesting and worth mentioning that the opinions of the interviewed asset managers and investors diverge. In previously mentioned publications, such as the BAI Investor Survey, we show that institutional investors are more optimistic about Private Debt as an asset class even in a stagflationary scenario. So are Infrastructure investments that continue to be viewed rather positively for the reasons discussed earlier.

Geopolitical crises

As mentioned in the foreword, the global economy has been through many crises over the past two years, and it seems to reached its peak in 2022 with the unthinkable taking place: War in Europe. As an export nation, Germany is particularly strongly interconnected internationally, which makes its economy especially vulnerable to geopolitical disruptions.

One of the most significant impacts of the war on Europe was the skyrocketing cost of energy and its consequences for the economy. However, a deep European downturn is not expected. 80% of the Russian gas imports have already been cut, and the overall gas consumption was reduced by 20% to 25%. All this without insurmountable headwinds for industrial activity. The U.S. is avoiding recession altogether[*]. Nevertheless, the latest SVB crisis in the U.S. as well as Credit Suisse's reach for the lifeline of the Swiss National Bank, show how fragile and sensitive the current framework appears, both in the capital markets and in the real economy.

BaFin warned only recently, regarding the war in Ukraine, that the financial stability or the integrity of the financial markets in Germany could be affected in a variety of ways: by subsidiaries in the respective regions or because processes and data have been outsourced to third parties, especially in the field of IT. There may also be contagion effects: For example, affected companies or economic sectors may suffer losses through credit exposures or capital investments. BaFin advises not to rely too heavily on past patterns and experience in risk management but to also think in terms of extreme scenarios. The key is still to achieve solid diversification[**].

But what does this mean for the global AI Allocation of BAI member companies? The impact of those geopolitical crises on the global AI allocation by regions is somewhat mixed for our member companies. This is particularly true for the USA. Most see no significant negative influence on any region but China. Europe and the USA should benefit the most as many GPs want to step up their investments in these regions. However, a clear trend cannot be discerned.

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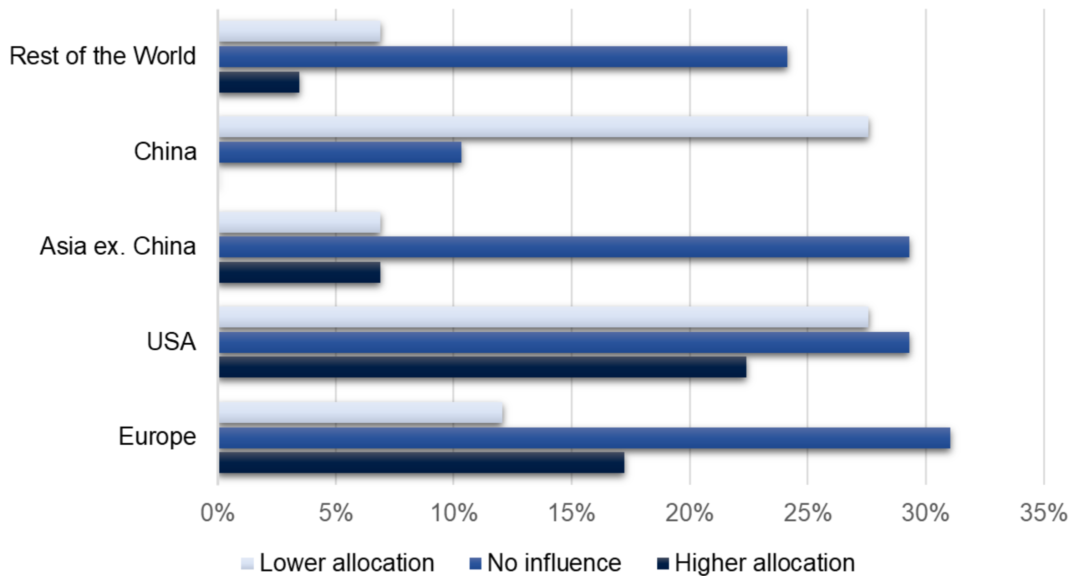
* Goldman Sachs: Macro Outlook 2023: This Cycle Is Different.

** BaFin: Risiken im Fokus der BaFin 2023.



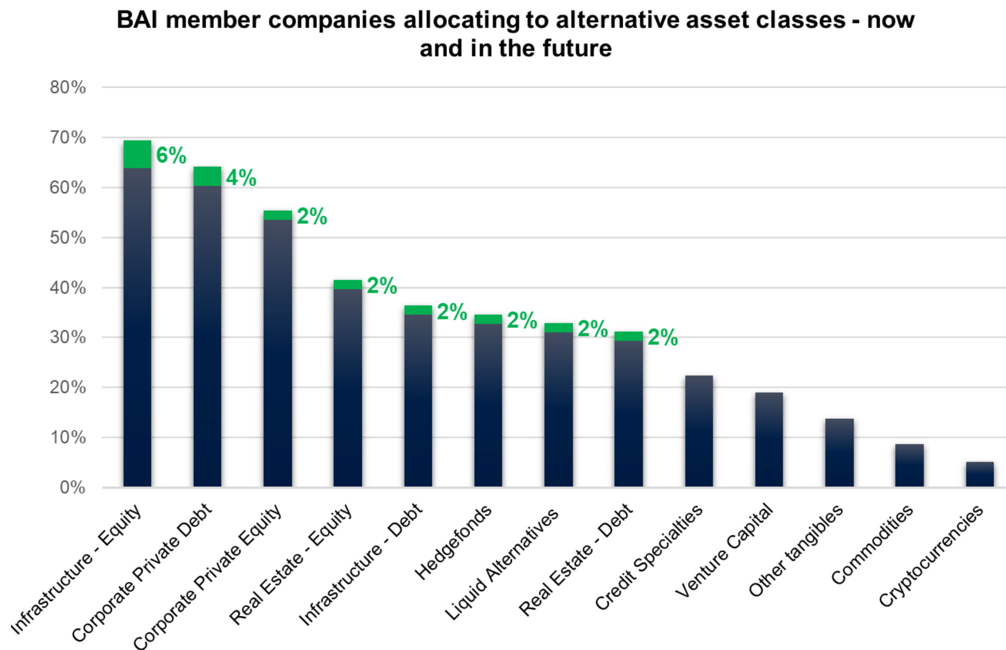
All in all, the world has become more complex due to the numerous crises' hotspots. Accordingly, we are experiencing an intensified global risk situation compared to the last decade, which must be considered when it comes to new investments. The symbolic doomsday clock shows at 90 seconds to midnight - and thus closer to a global catastrophe than ever before. Global diversification is being adjusted accordingly. Projects in China, for example, are being viewed with much greater caution than a few years ago.

For a detailed analysis of potential reasons for expected shifts in geographic asset allocations for AI, from institutional investors' perspective, compare the BAI publication "Interest rate turnaround and inflation: Hedge Funds, Liquid Alternatives, and Commodities could be profiteers – investors expect geographical shifts in asset allocation."*

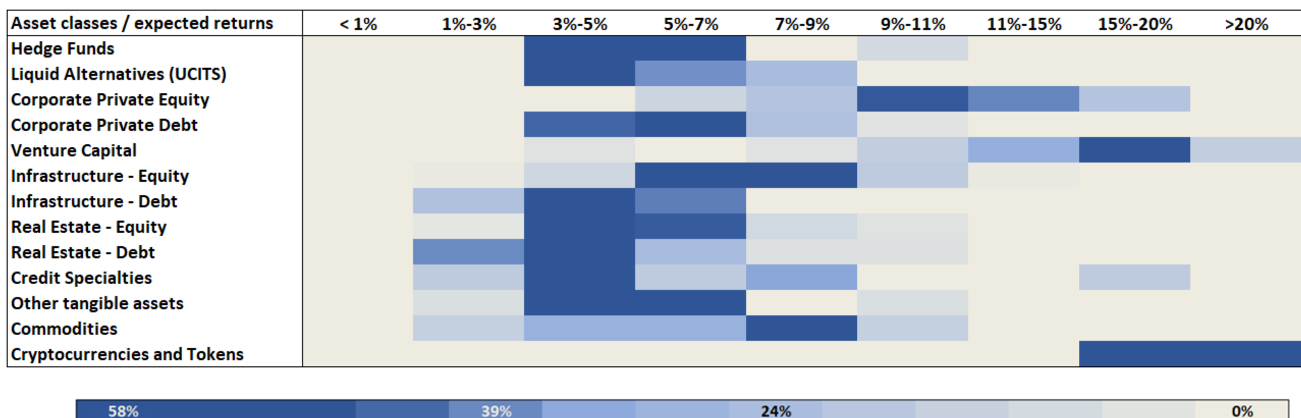
* BAI publication "Interest rate turnaround and inflation: Hedge Funds, Liquid Alternatives, and Commodities could be profiteers – investors expect geographical shifts in asset allocation".

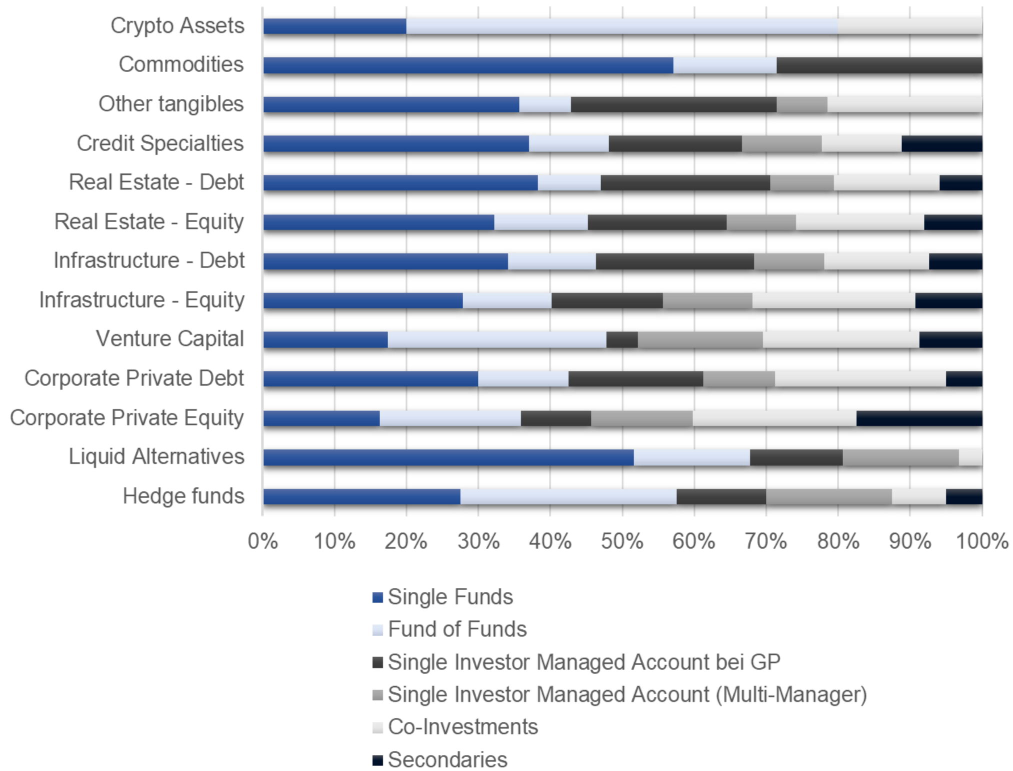
Part two: Alternative asset classes

In the following chapter, individual asset classes and their outlook for 2023 are discussed in more detail. The considerations from the previous chapter transfer evidently to the plans of BAI member companies, reflected in the planned entries into new asset classes in the upcoming months.



It should not surprise anyone that Infrastructure (Equity), Private Equity, and Private Debt are the most prominent among GPs, and given the current market conditions and demand from German institutional investors, most GPs that are not yet active in these asset classes are preparing to enter those markets.





Private Equity

The BAI Investor Survey has already shown that private equity is one of the most widely used asset classes among institutional investors to generate adequate returns in the portfolio. Around 71% of the participants are invested here. Looking only at GPs, Private Equity investments are actively managed by 53% of BAI's member companies. It is noteworthy that even though Corporate Private Equity and Debt are facing more challenging times from the current inflationary, fiscal, and monetary circumstances, most investors plan to increase their exposure to the historically performant asset classes[*].

As a result, a large proportion of investors are approaching their long-term strategic goals for private equity allocation. Little room for maneuvering now exists for those who have not yet done so. Especially considering the denominator effect in the public markets[**].

For GPs, fundraising has remained a key challenge throughout the years. The Private Equity (mid-market) fund managers' perception of the current fundraising environment has dropped to a recent year's record low. What's more, fewer managers perceive finding co-investors as easy. With most fund managers expecting the fundraising environment, finding co-investors, exit opportunities, and the access to finance of their portfolio companies to further worsen in 2023, there is a risk that we are yet to see the worst part of the crisis.

It should be noted that a higher proportion of fundraising is inevitably reserved for re-stocking with existing managers as fund distributions are recycled, leaving less room for new managers and increasing the concentration of capital with the largest managers in the industry[***].

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*BAI Investor Survey.

**BAI: Interest rate turnaround and inflation.

*** Preqin Global Report 2023: Private Equity.

For smaller managers this could be survival-threatening.

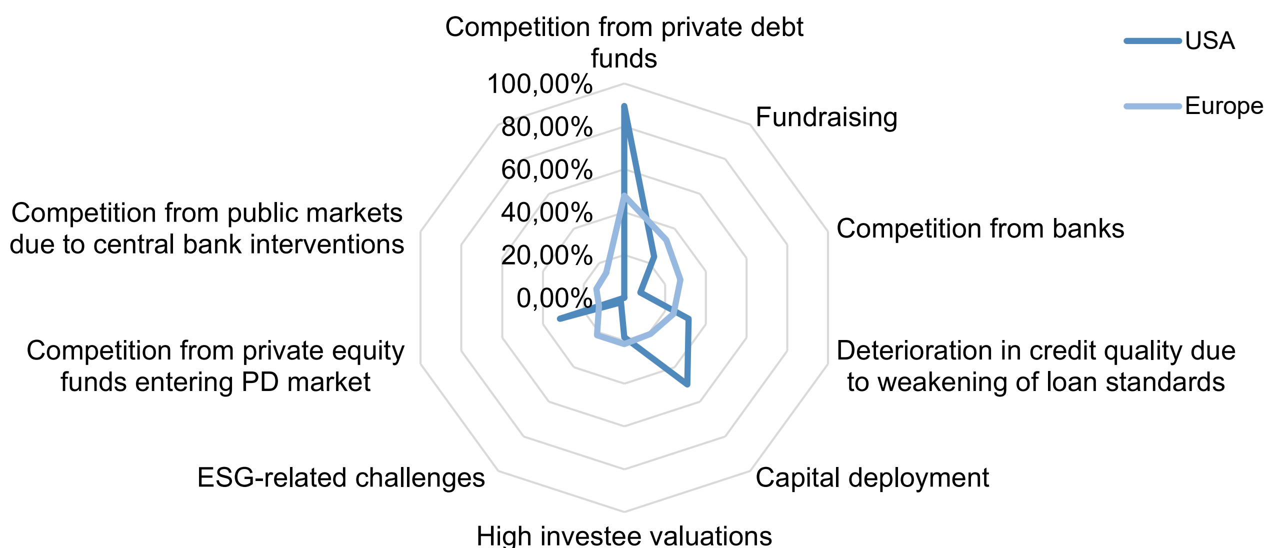
A look at the VC markets is also not to be ignored. Last year hit the Venture Capital Market hard. This asset class is especially exposed to the current market turmoil. Listed companies that have venture-like qualities saw declines up to 80-90%. The post-IPO performance of former venture-backed companies with the exit of their special purpose acquisition company was hit severely*. But the fundamental drivers of investor interest in the Venture Capital Market are still intact. 2023 may prove an attractive vintage over the longer term. We will monitor this closely and ask German investors about their plans and expectations. The current BAI Investor Survey revealed that about 27% of LPs are invested in Venture Capital, actively managed by 19% of the GPs among BAI members.

Corporate Private Debt

On the one hand, Debt Funds are playing an increasingly important role for European SMEs as they provide financing to companies that banks would not otherwise provide. By now, roughly half of Debt Funds' portfolio companies would not have been able to get bank financing**. Moreover, the BAI Investor Survey found that Private Debt is still on track to catch up to Private Equity in investor demand. On the other hand, both asset classes had a challenging year in 2022 compared to previous years due to the numerous crises***.

Looking ahead to 2023, interest rates and credit spreads are expected to remain key factors. Especially direct loans have the advantage of being from a high proportion of floating interest rates, which makes them more attractive compared to traditional fixed income securities. Investors and managers are aware that there are macroeconomic challenges, with inflation, interest rates, and geopolitical unrest of particular concern. Nevertheless, investor sentiment toward Private Debt is positive. Special situations were highlighted by investors as a good investment opportunity****.

Biggest Challenges in the Private Debt industry being expected in the future***



* Preqin Global Report 2023: Venture Capital.

** Block et al. (2023): A Survey of Private Debt Funds.

***https://www.cliffwaterdirectlendingindex.com/.

****Preqin Global Report 2023: Private Debt.

***** Block et al. (2023): A Survey of Private Debt Funds.

The BAI Investor Survey shows that around 56% of German institutional investors are invested in Private Debt, and about 60% of our association member companies actively manage this asset class. And here, too, an increase is expected in 2023 as numerous members indicate they will dive into the asset class – more than in any other asset class. Private Debt AUM could grow to $2.3tn in 2027, although at a slightly slower pace with fundraising and performance than in recent years*.

According to a recent academic study, the mean unlevered target IRRs in Europe and the U.S. have been comparable recently at, respectively, 8.70% and 8.16%**. The Cliffwater Direct Lending Index (measuring the unlevered gross of fees performance of U.S. middle market corporate loans) shows an average return of 9.32% since its inception (2004)***. Against the backdrop of diverse strategies with different risk-return profiles, our member companies continue to be optimistic (compare figure above). Comparable results were obtained in the above-mentioned study: Debt Fund managers both in U.S. and Europe are very confident about near- and long-term continued growth of the Private Debt Industry****. The average expected net return of German institutional investors (LPs) is as to be expected slightly lower (5.9%). A decrease compared to the previous year*****.

Hedge Funds and Liquid Alternatives

Around 15% of the participants in the BAI Investor Survey are invested in Hedge Funds, with 30% GPs (BAI members) actively managing. The volatile state of the economic environment and the capital markets ensure that Hedge Funds are gaining importance. As already mentioned in the first part, stagflation is no longer a theoretical construct but a real danger.
Institutional investors keep their Hedge Fund exposure reasonably constant, for being the most robust alternative investment in times of stagflation******.

Hedge Funds perform well under market stress as they can benefit from dislocations. Central banks are now on a mission to bring inflation under control and will use all the available tools to do so, which will likely lead to more volatility and stress in capital markets. Hedge Funds can not only absorb this shock but also profit from emerging market gaps and inefficiencies in the market. Strategies designed to offer protection, smooth returns, or provide crises alpha saved many portfolios when natural hedges failed to shield investors. Investors who have trusted and maintained their allocations to Hedge Funds indeed benefited from the asset class and will continue to gain from the industry's ability to produce attractive risk-adjusted numbers*******.

The same advantage that applies to Hedge Funds in times of volatile markets also applies to Liquid Alternatives. Around 12% of the surveyed institutional investors in the BAI Investor Survey are invested in Liquid Alternatives. From the GP side, this asset class is actively managed by 31% of BAI members********.

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* 2022 Preqin Global Private Debt Report.

** Block et al. (2023): A Survey of Private Debt Funds.

*** https://www.cliffwaterdirectlendingindex.com/.

**** On a scale of 1 to 10, debt fund managers had medians of 8 and averages above 8.24. Block et al. (2023): A Survey of Private Debt Funds.

***** More detailed sub-asset class return expectations can be found in the BAI Investor Survey 2021.

******BAI Investor Survey.

******* Preqin Global Report 2023: Hedge Funds.

******** BAI Investor Survey.

Hedge Funds and Liquid Alternatives reduce the effects of severe equity drawdowns. They have once again impressively demonstrated this in the current markets characterized by several crises. Exposure to these assets during volatile market environments may help investors avoid emotional selling, maintain a long-term investment perspective, and participate in subsequent rebounds. And what's more, liquid alternatives may provide positive returns during rising rate environments. These products tend to have both low beta and correlation to investment grade fixed income, providing an alternative source of returns in rising rate environments, which have historically generated low returns for fixed income assets*.

Infrastructure Equity & Debt

Overall, our data from the BAI Investor Survey shows that Infrastructure, especially Infrastructure Equity, can be seen as a winner from interest rate turnaround and inflation.

Low demand elasticity and typical free floats are welcomed yield drivers in times of high volatility. Also, high barriers to market entry result in Infrastructure providers' high pricing power, and higher costs can be passed on. Therefore, Infrastructure Investments are well established in the portfolios of the LPs. BAI analyses show that 80% of German institutional investors have already made infrastructure investments, while a further 10% are currently planning to do so. Most of these are equity investments with a partial admixture of debt investments. Almost all these investors have renewable energy exposure. Wind and solar power, followed by hydropower, are the most common investments. Alternative technologies such as hydrogen, energy storage, geothermal energy, or carbon capture can also be found in some institutional portfolios, e.g., via renewable energy funds for diversification purposes.

This also explains why no other alternative asset class has more BAI member companies in its line of business, be it asset managers or consultants, or other service providers. Infrastructure Investments are managed by 64% of the GPs among BAI members. Due to its crucial role in mastering the energy transition of the economy as well as the ESG conformity from companies and investors' perspectives, the importance of Infrastructure Investments, regardless of equity or debt, increased significantly**.

As already explained in the foreword and in part one, Infrastructure investments have proven to be particularly crises-resistant. In addition, there is the direct influence of the Russian war against Ukraine. This is forcing Europe to reshape its energy Infrastructure, best possible with regard to CO2 neutrality. That is the main reason why Europe-focused fundraising may catch up with, and then overtake, North America. By now, 68% of the fundraising to Q3 2022 was by funds with North America as a primary regional focus, well above the long-term average of 42%***.

The German Fondsstandortgesetz and the EU ELTIF reforms are also contributing to the fact that we are see increased activity among our members in the form of a „democratization of the private markets". Especially in the Infrastructure sector, funds are being launched which are also targeting retail investors.

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* Goldman Sachs Asset Management: Liquid Alternatives: Why Now?

** BAI Investor Survey.

*** Preqin Global Report 2023: Infrastructure

Real Estate Equity & Debt

The BAI Survey revealed that about 78% of LPs are invested in Real Estate Equity and about 45% in Real Estate Debt. On the GP side, 40% of BAI members manage in one way or another Real Estate Equity and 29% Real Estate Debt investments.

Asian Pacific investors seem to target Europe with a substantial increase in preference for opportunistic strategies, perhaps looking to increase their European portfolios at a discount. When looking at Europe, on an equally weighted basis, almost all access routes into real estate are expected to see an increase in allocations, with the exception of listed Real Estate and derivatives. Non-listed Real Estate Debt takes the top spot, with a 62% net increase position[*].

Nevertheless, Real Estate as an asset class has been hit hard by the sharp rise in interest rates. With $101.9bn of aggregate capital raised, 2022's total to date only represents 48% of last year's total[**]. In general, rising rates are impacting activity, and gaps between the expectations of buyers and sellers are widening. This is hitting deal activity, as well as fundraising.

Lastly, a look at Germany, where, according to BaFin and Deutsche Bundesbank, the market for German residential real estate has been harboring systemic risks for several years. Prices here rose particularly sharply and became increasingly distanced from economic fundamentals. Moreover, the risks in the commercial real estate markets have increased further. Here, too, financing conditions have tightened noticeably due to the sharp rise in interest rates and construction costs. This reduces commercial Real Estate market demand, which correlates strongly with economic development. Also, the positive trend in office property prices appears to be at a standstill. All in all, significant valuation corrections and book losses could occur for some investors[***].

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* Inrev: European investors plan to decrease allocations to real estate.

** Preqin Global Report 2023: Real Estate.

*** BaFin (2023): BaFin: Risiken im Fokus der BaFin 2023.

Digital Assets

Investing in Crypto is still comparable to early-stage Venture Capital investments. Recently BAI highlighted the institutional adoption of Digital Assets in a brief paper*. The Crypto industry always presents an anomaly. The recent collapse of several major Crypto institutions has created uncertainty in the market, and the industry is now looking to government regulation more than ever. The key question on which everything is based: Can the Crypto industry recover from the recent shocks once again?

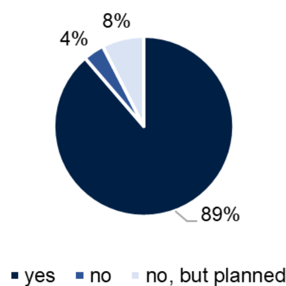
The events surrounding FTX put a big question mark on Crypto's long-term viability. And there seem to be good reasons for this. It is not yet clear what risk-mitigating mechanisms would be put in place to limit the transmission to traditional finance channels if mainstream financial institutions were significantly more entwined with crypto and exposed to its risks**.

Predicting the future always involves certain risks, but in the case of Cryptocurrencies, it is downright impossible. This segment has its own rules and laws, on which the macroeconomic challenges of the past year mentioned in the foreword and in part one seem to have little influence. FTX's failure also challenges cryptos disintermediating nature. Legislators and regulators need to establish and enforce effective laws and regulations to protect investor assets from misuse by Crypto platforms***.

Part Three: ESG

The BAI Investor Survey has already addressed this topic. Undoubtedly, next to inflation and interest rates, ESG is one of the most important ones in the industry. However, the Investor Survey predominantly addressed the views of LPs. The views of GPs will be examined in more detail here.

BAI members pursuing an ESG strategy



The BAI Survey revealed that about 89% of the surveyed GPs follow an ESG strategy, and only 4% are not planning to do so in the near future. There are many reasons to pursue an ESG strategy . But all the GPs interviewed agree that alleged media pressure does not influence on their strategic planning.

Instead, intrinsic interest and the expectations of the clients are the fundamental reasons for following an ESG strategy. This once again shows that institutional investors also have an essential role to play in the transformation of the economy. With their investment decisions, they have enormous influence and leverage they can exert on the investment flow of the GPs.

In mastering ESG conformity, the importance of Infrastructure Investments, regardless of debt or equity, increased significantly due to its crucial role in recent years. The GPs surveyed were asked about their investments in Sustainable Infrastructure, and the majority invested in wind power and photovoltaics.

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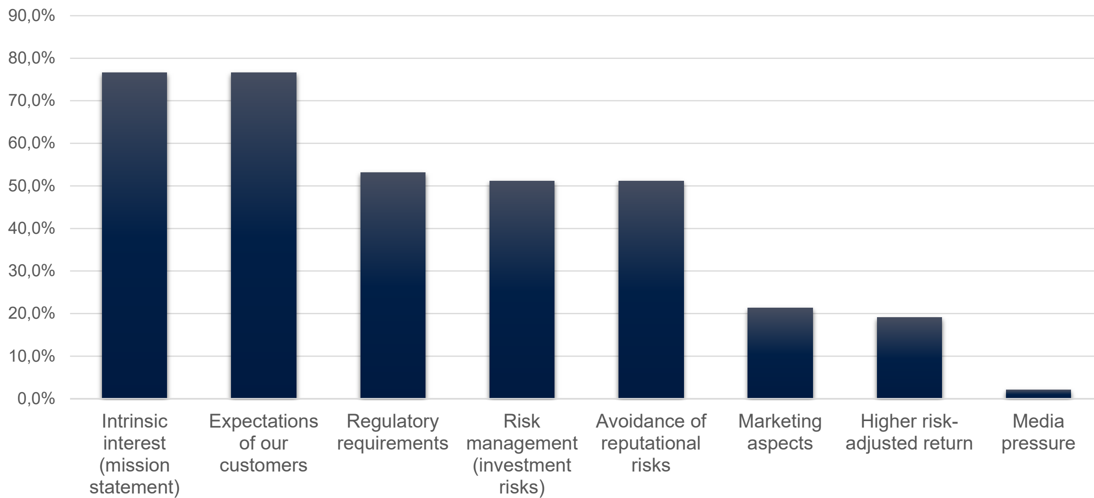
* BAI: Digital Assets: Is institutional adoption gathering momentum?

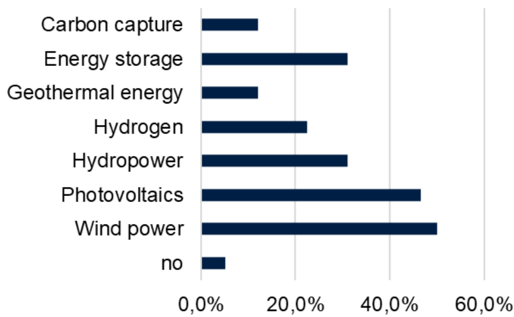
** CFA Institute (2023): Cryptoassets: Beyond the Hype.

*** Ebenda.

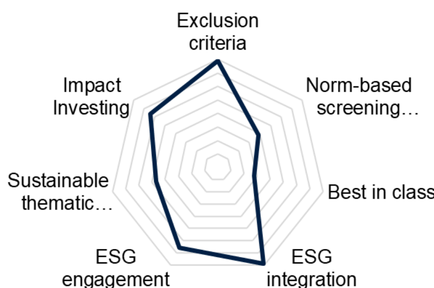
Geothermal energy plays a minor role in Germany, and to a large extent, in Europe, due to the geographical conditions. Interestingly, the situation is similar for carbon capture. However, this method has not yet been fully proven and is currently the subject of numerous research projects*.

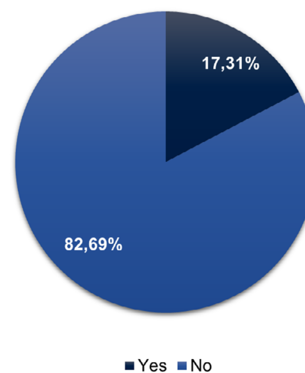


The BAI Investor Survey has shown that GPs and LPs pursue partly different and identical ESG strategies. Exclusion criteria, with 80% LPs and 79% GPs, is the strategy of choice for both.



ESG integration, on the other hand, is less popular among our surveyed LPs at 64% compared to GPs at 79%. The most significant difference, however, can be found in impact investing. While 64% of GPs pursue this strategy, only 35% of LPs do.** At this point, however, another problem could be illustrated that explains the striking gap: the need for a systematic definition and classification of various ESG and impact strategies. The reasons for pursuing an ESG strategy have already been highlighted. However, there is one crucial question that both GPs and LPs must consider: Does ESG-compliant investing mean sacrificing returns? Most GPs (83%) are united in their opinion: No.



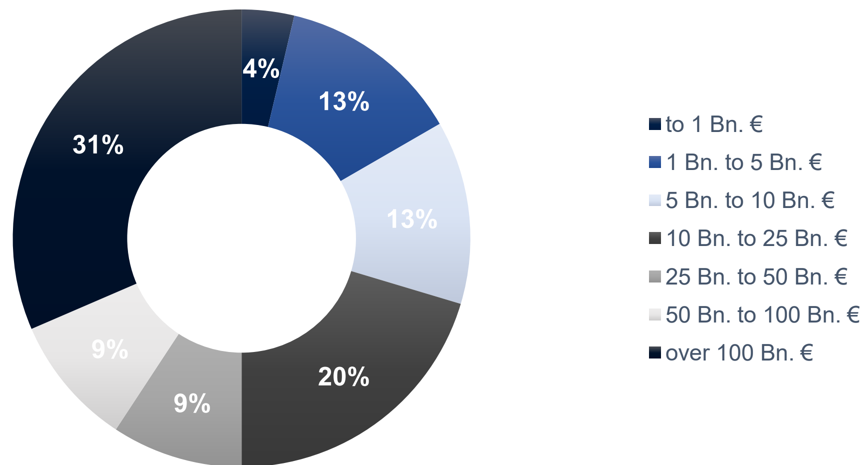


* Federal Environment Agency of Germany.

** BAI Investor Survey

Methodology

The data for this document was taken from the BAI Member Survey and partly from the BAI Investor Survey. In the BAI Member Survey, BAI members are asked annually about their current allocation, important investment topics, and their plans in the near future. The survey focuses on the asset managers among the BAI members. The amount of assets under management (AuM) varies significantly among the asset managers, from less than one billion to well above several hundred billion.



About us

Our goals

The Bundesverband Alternative Investments e.V. (BAI) is the asset class- and product-spanning representation of interest for Alternative Investments in Germany.

improving the level of public awareness for alternative strategies and asset classes.

creating internationally competitive and attractive (regulatory) conditions for the investment in Alternative Investments.

representing the interests of the industry to politics and regulators.

serving as a catalyst between professional German investors and recognized worldwide providers of Alternative Investments products and services.

supporting scientific research in the field of Alternative Investments.

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