Industry Overview
European Alternative Investing

Alternative Income Group

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Ninepoint Partners Industry Overview
European Alternative Investing
Alternative Income Group

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Executive Summary

As the global economy recovers from the COVID-19 pandemic, monetary and fiscal policy has pushed traditional asset class valuation and volume to unprecedented levels. To reduce portfolio concentration, improve diversification, and generate returns, investors will look to alternatives as an attractive option. In this environment, Europe is poised to become a global powerhouse, with real GDP growth and pending stimulus expected to outpace the rest of the advanced economies.

This white paper addresses the prospects for three of the most popular alternative asset classes in Europe: private equity, private debt, and real estate.

Private-equity investing is the number-one alternative market in Europe, with over 3,981 active fund managers.[1] In terms of ownership, investors tend to be large financial institutions such as pension plans and insurance companies. Recent developments in the market, however, have shown promising signs of a shift in manager perspective, and we anticipate that investment options for retail investors will increase from 2021 onwards.

Much like private equity, private debt has historically been the domain of institutional investors. There are ~640 private debt funds in the European market, most of which are targeted to the institutional market. The European private-debt industry continues to evolve, however. Managers are beginning to launch products with lower minimum investments, shorter holding periods and an open-ended structure to accommodate smaller investors. As funds grow in size and popularity, there will be a momentum effect as more individuals realize this alternative asset class may contribute both higher returns and diversification benefits.

With real estate, investors benefit from stable cash flow as well as capital appreciation. COVID-19 had a significant impact on performance in 2020, but there is optimism for 2021 and onwards. Dry powder also remains strong, with ~€60 billion available for deployment. Here, however, environmental considerations play a key role, with climate change seen as one of the key risk factors for real estate portfolios.

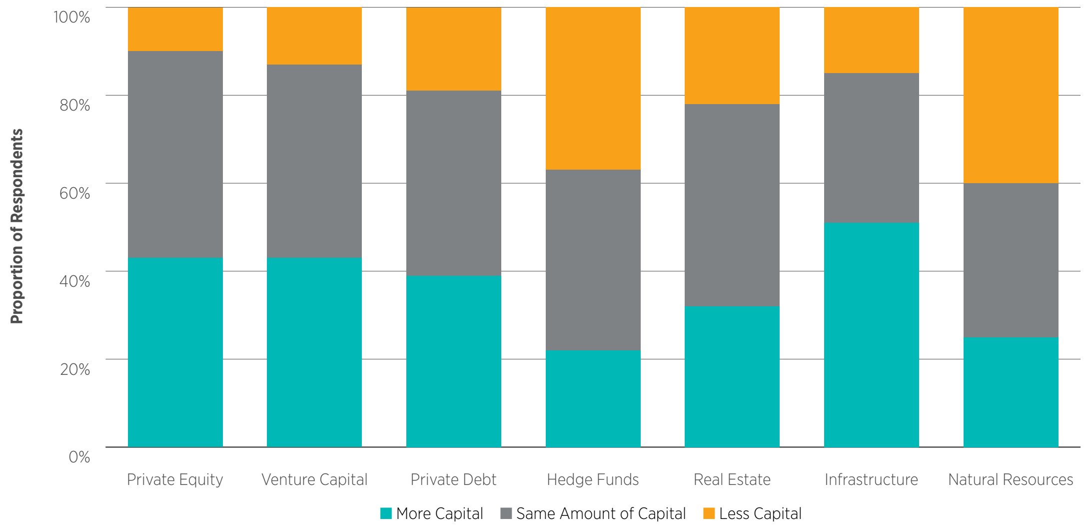
For years, alternative investments have been the sole domain of institutional investors. And now this form of investing is gaining momentum for smaller, retail investors. As these investors get more familiar with the alternative assets available to them, we expect fund managers to take notice. European managers seeking non-traditional sources of capital will be looking to expand their investor base, and Canadian investors should welcome this new opportunity.

Introduction

Over the next five years, a variety of themes will characterize the investment landscape in Europe. As the EU's €750 billion COVID-19 recovery fund is distributed and geopolitical tensions (Brexit and, to an extent, Chinese/American tensions) continue to affect market stability, there will be a need to generate returns via alternative assets. Alternative investments within the European region are projected to increase from $2.17 trillion to $2.83 trillion, representing a compound annual growth rate (CAGR) of 5.4% from 2020 to 2025.[2]

Subsectors within the alternatives space include private equity, private debt, real estate, infrastructure, hedge funds and venture capital. For the purposes of this white paper, we will delve into three popular asset classes in Europe: private equity, private debt, and real estate. Private equity is expected to remain the largest of the alternative asset classes, but private debt investments continue to gain significant traction.

Figure 1: Investors' Expected Capital Commitments to Each Asset Class in the Next 12 Months Compared with the Previous 12 Months



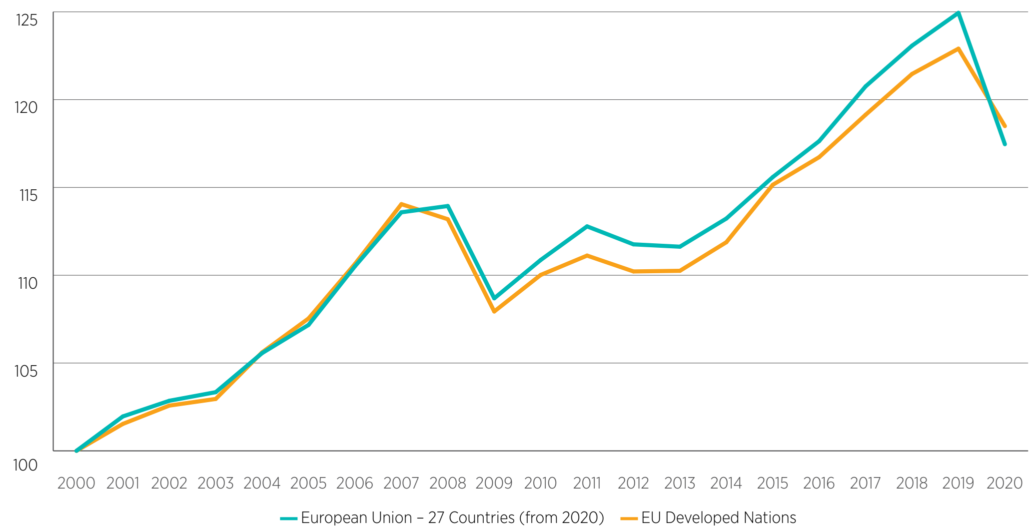
Source: Preqin Investor Survey, June 2021.

European Market Outlook

Global markets and GDP expectations were shaken by the COVID-19 pandemic in early 2020. Throughout the year, most investors saw a recovery in asset prices, and portfolios reached new highs. Markets were buoyed by enhanced stimulus and money printing by those governments with the means, along with regulatory reform in emerging markets.

Global GDP, however, did not have that same recovery, with the lasting effects of COVID-19 yet to be seen. The impact of the coronavirus on GDP was swift, with reported FTSE Developed European nation real GDP falling more than 3.5% between 2019 and 2020.[3] While this decline was less than initial estimates of -7.6% across Europe, the decline was one not seen since the global financial crisis of 2008.

Figure 2: Real GDP Per Capita, Indexed to 2000

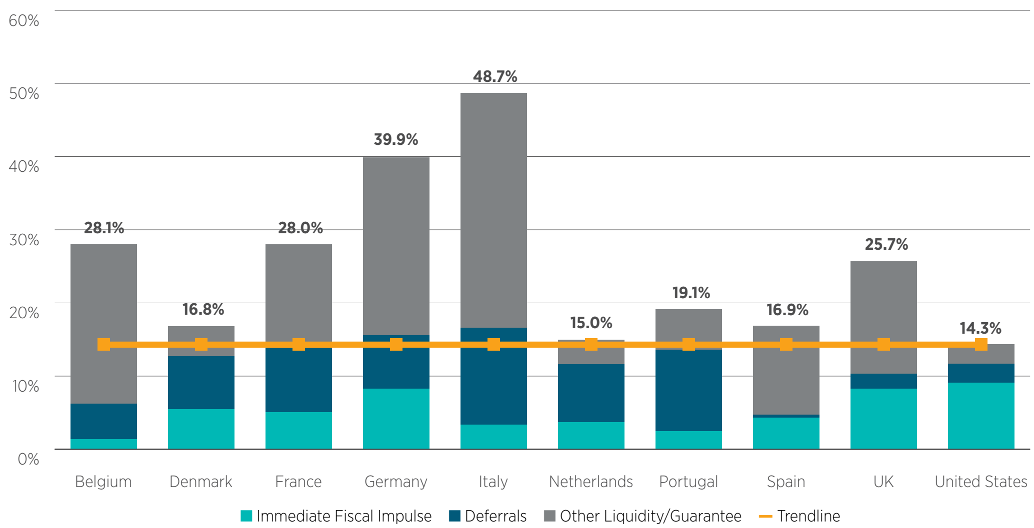


Source: Eurostat.

Europe, as a region, did not have the same level of immediate stimulus available to boost the local economy within the first year of the pandemic as the United States. Throughout 2020, US stimulus packages totaled 13.1% of GDP, versus the European Union's 4.3%.[4] Even prior to COVID-19, Europe was expecting a period of slower growth, and it was among the worst hit by the pandemic. International Monetary Fund (IMF) 2020 forecasts had Europe's GDP at -7.6%.[5] This significant decline in GDP and relatively small stimulus package made Europe a particularly difficult region to invest in in 2020.

For 2021 and beyond, however, the IMF's real GDP growth expectation for Europe paints a significantly brighter picture. A recovering real economy, delayed onset of mass stimulus, and depressed asset prices make Europe an attractive spot for investors. European stimulus is scheduled to be deployed over the next few years, making Europe an attractive arena for investment. Given the delay, the stimulus will be larger than that of other advanced economies. Real GDP is expected to grow by 5.0% in 2021, 3.3% in 2022, and 2.5% in 2023,[6] far outpacing the rest of the world's advanced economies. With interest rates expected to stay low, the growth in real GDP could be a significant driver of asset-price increases in the near term.

Figure 3: Discretionary 2020 fiscal measures adopted in response to Coronavirus by Nov. 2020, % of 2019 GDP



Source: Brugel Datasets: The fiscal response to the economic fallout from the coronavirus 2020.

Investment Landscape

Post pandemic investing appears to have significant upside in Europe, with an expanded interest in ESG investing, vast deployment of stimulus and a robust, diverse economy. European managers have a distinct home court advantage when investing in European businesses, and those with established relationships typically have first pick of acquisitions. Limited partnerships looking to gain exposure to Europe will likely face high competition for allocations to top-quartile funds.

European private investment funds are often structured much like their North American counterparts. The typical fund structure for a private investment is a fixed-term, closed-end vehicle with limited capacity. The common investor preference for long track records and top quartile performance leads to competition to get into highly sought-after funds. This is particularly the case for new entrants in the alternatives market, where general partners tend to favour investors with which they have had previous relationships. These trends act as barriers for new investors seeking access to Europe as a portfolio diversifier and are particularly hard on small investors with no established relationships with general partners.

Regulations are another important factor to consider. Many funds are advised out of locations with favourable offshore regulations, such as England, Ireland and Luxembourg. Regulations for direct lending/investing structures require fund vehicles to be EU-based. In light of Brexit, Luxembourg is the optimal location for funds. Its EU status provides accessibility to private markets within the EU. Luxembourg also offers strong credit enforcement support, straightforward processes and beneficial withholding tax structures for funds with special-purpose vehicles.[7]

Risks to Alternative Investing

When institutions began investing in alternatives, the goal was to reduce overall portfolio risk by diversifying sources of portfolio return. Over the past 70 years, a composite of endowment portfolios from 1950 to 2017 was able to achieve a return of 6.6% with a sharpe ratio of 0.54, compared to a generic 60% equity 40% bond portfolios return of 5.6% and sharpe ratio of 0.37[8]. The track record of investing with alternatives versus a generic 60% equity 40% bond portfolio confirms the thesis: adding alternatives can reduce portfolio volatility while maintaining rate of return. Notwithstanding the benefits of alternative investing, investors must remain cautious of the risks added to the portfolio when a new asset class is introduced. Alternatives, specifically those in the private markets discussed in this paper, have several common risk factors including a lack of liquidity and concentration risks.

Private investments have historically had a very limited secondary market, which can leave invested capital tied up for long periods of time once allocated to a particular fund. This lack of liquidity can limit an investor's options when reallocating their portfolio. Many Alternatives have extremely long time horizons for their investments, leaving investors' short term tactical changes to the more liquid portions of their portfolios. Smaller investors often do not have the luxury of a perpetual time horizon and must find liquidity more quickly. Alternative managers have acknowledged this challenge and have begun to structure open-ended pooled funds that offer more reasonable liquidity terms to investors looking for exposure to these asset classes. By pooling investors' capital, the fund is able to make allocations to private investments while maintaining a diversified portfolio that generates cash to fund redemptions over a normal course of business.

Concentration within an alternatives portfolio can also be an issue for smaller investors. Typical alternative funds have minimum investment requirements in the millions of dollars, which can leave investors with a lumpy, concentrated allocation to just a few funds. Investors often turn to a Fund of Funds or multi-strategy vehicle when building an allocation to alternatives. By investing in a seasoned vehicle alongside other investors, a portfolio can immediately diversify the allocation without over exposure to one particular underlying fund or asset.

Sustainable Investing in Europe

ESG-conscious investing continues to gain momentum and has become a cornerstone for many institutional investors. More than three-quarters of respondents in Preqin's June 2021 Investor Outlook Survey claimed to have had an increased focus on their organization's ESG involvement.[9] Europe as a region is ahead of the global curve when it comes to ESG investing, with over 45% of European mandates offering firm-level ESG selection criteria.[10] The costs associated with developing new ESG mandates could put European managers at a significant advantage if other regions are forced to adapt quickly. With the United States rejoining the Paris Climate Accord in 2021, managers must account for the ESG impact of their investments today to mitigate regulatory impacts tomorrow.

Private Equity

Private equity is separated into various subsectors, including leveraged buyouts, growth equity, venture capital and secondaries. The most common form is a leveraged buyout, in which funds will purchase cash-flow generating companies and incorporate rigid operational and capital structure changes. The funds will then sell the overhauled business to generate a return, targeting a benchmark of up to 20% annually over the typical investment tenure of five years.

Growth equity and venture capital funds tend to target early-stage businesses and provide them with capital to develop in their chosen market. Growth equity identifies companies in early stages of operation, generating revenue and looking to scale the business model. Venture capital looks to invest in companies that are still proving out concepts and have an attractive business model. These are often pre revenue and have a high rate of failure but offer extremely attractive returns to investors when they succeed. Growth and venture equity tend to have a longer time horizon than buyout funds, with an investment tenure of seven to 10 years.

Secondaries are funds that purchase limited partnerships in established private equity funds, after the initial close. These can be holdings in any form of close-end private-equity strategy and are usually sold to generate liquidity for a limited partner in need. Buying an existing partnership's interest in a fund that has entered the investment stage can limit the J-curve for an investor, allowing them to realize a return more quickly. Unfortunately, buying in the secondary market is difficult as the market is fragmented and relies on existing relationships to generate deal flow. While trading in secondaries has become more common, it is still a relatively small segment of the global private-equity market.

European Private Equity Market

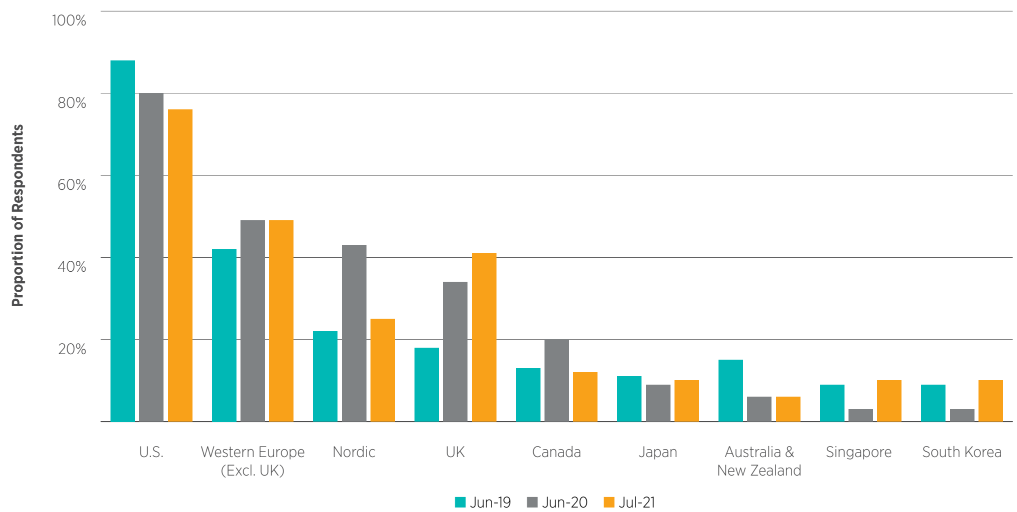
Private equity is the most popular alternative market in Europe, with over 3,981 active fund managers.[11] As the COVID-19 pandemic caused significant delays in deployment of capital and global liquidity dropped, there was an increase in limited-partnership focus for near-term returns. The typically favoured strategies, such as venture capital and leveraged buy-out transactions, faced a stagnant year with limited opportunities to transact. Global secondaries deal volume in the first half of 2020 dropped by 56.1% year over year,[12] which may have allowed some managers to purchase assets at extreme discounts to valuation. In contrast, the second quarter of 2020 created vast opportunities in the secondaries market as limited partnerships began looking to rebalance portfolios and offload long-duration assets. Historically, secondaries have outperformed all other private equity strategies in times of market stress.[13]

It is entirely reasonable to expect a substantial uptick in leveraged buyouts in the second half of 2021, as several global private equity firms already have large deals in the pipeline. The UK is particularly attractive to leveraged buyout funds, as it is home to large and established companies that suit investors who prefer regular distributions.[14] Further, ATP, Denmark's biggest pension fund, has allocated DKK 6 billion to a new long-term private equity strategy.[15]

With investors looking to get immediate exposure to active deals and accumulated dry powder hitting highs in 2020, many managers are on the hunt for new deals. The abundance of dry powder could cause an oversupply of capital and force the return imbalance to normalize in the future.

Market estimates indicate Europe is poised to lead the global economic recovery. By the end of 2020, total dry powder — committed but not called capital — from European firms was nearing $300 billion, per Preqin, double the amount from 2012. The year also saw the highest ever aggregate fundraising, but with record-high valuations, it's been difficult for firms to allocate, and the total number of funds has decreased to 2014 levels. Many market participants expect special-purpose acquisition companies to play an increasing role in the distribution of these funds during the coming years.[16]

Figure 4: Investor Views on Developed Markets Presenting the Best Opportunities in Private Equity, 2019-2021



Source: Preqin Investor Surveys, June 2019-2021.

Investing in European Private Equity

The European market has grown to be a global powerhouse. In terms of ownership, investors tend to be large financial institutions such as pension plans and insurance companies. Since 2015, there has been a rise in investment from non-traditional investors including high-net-worth investors and family offices. Smaller investors have caught on to the institutional investment model and have started to further diversify their alternative asset allocations in private equity.

As in North America, however, investment opportunities for small investors remain limited. European funds have high barriers to entry for small investors. The large investment minimums and long lock-in periods are prohibitive for smaller accounts and require a unique solution. Recent developments in the market have shown promising signs of a shift in manager perspective, and we anticipate that there will be investment options for retail investors to access the booming European market in 2021.

Key Market Participants

Firm	Headquarters	Total Capital Raised in the past 10 Years (€bn)	Estimated Dry Powder (€bn)
CVC	London, UK	59.5	36.2
Ardian	Paris, France	58.2	28.7
EQT	Stockholm, Sweden	26.2	3.8
Permira	London, UK	25.3	10.7
Cinven	London, UK	22.3	8.9
Advent International	Boston, USA	20.0	0.5
Apax Partners	London, UK	15.1	0.6
Carlyle Group	Washington, USA	14.0	6.4
BC Partners	London, UK	13.7	0.5
Partners Group	Zug, Switzerland	12.0	4.4
Bridgepoint	London, UK	11.0	4.8
Coller Capital	London, UK	11.0	2.9
LGT Capital Partners	Pfaffikon, Switzerland	10.3	5.3
Nordic Capital	St Helier, Jersey	10.3	2.7
Russian Direct Investment Fund	Moscow, Russia	9.6	1.6

Source: Preqin Markets in Focus: Alternative Assets in Europe, September 2020.

Private Debt

Private debt funds target different levels of the capital structure when selecting investments. These strategies can be categorized loosely into direct lending, mezzanine financing and distressed debt.

Direct lending is the most common strategy, in which creditors extend secured credit facilities to businesses in need of capital. These facilities include covenant packages that require the borrowers to maintain operational and financial discipline.

Mezzanine debt and second-lien debt, which do not offer the same structural protection as senior loans, are issued with a combined cash pay and payment-in-kind coupon.

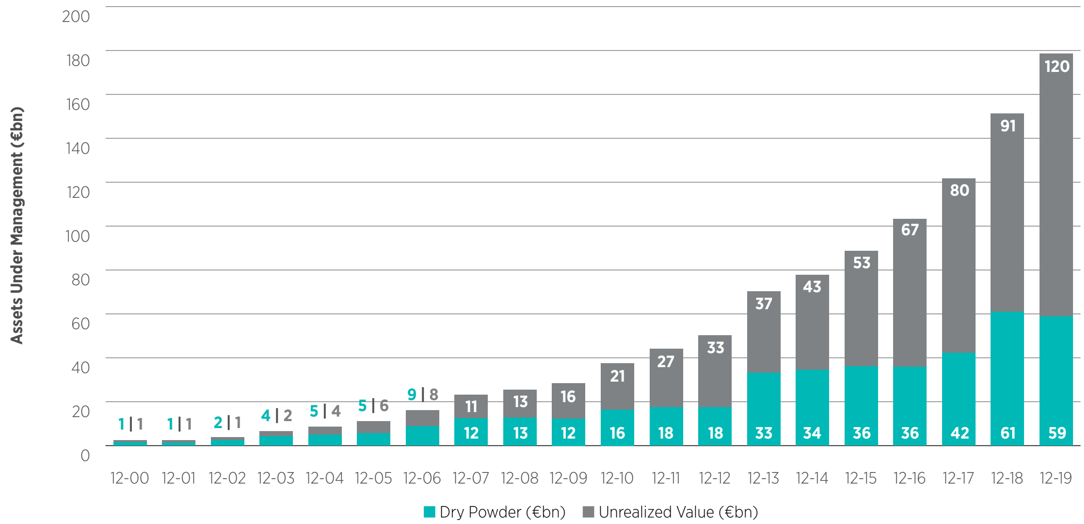
The last strategy, distressed debt, involves lending to borrowers who are near bankruptcy. This enables lenders to exert significant influence on the operational and financial strategy of the borrowers. Distressed debt strategies are typically used by specialized funds.

European Private Debt Market

Private debt as an asset class is gaining popularity around the globe, including Europe. The rise of European private credit has increased the liquidity options for companies. Private debt fundraising exhibited strong demand throughout 2020 as the asset class surpassed $42 billion, nearly on par with North America.[17] Fundraising was slightly lower in the first half of 2021 than it was in the first half of 2020 — $88.5 billion versus $93.2 billion, respectively. The *Private Debt Investor* fundraising report still considers this a healthy level, especially given the hindrances created by the pandemic.[18] With public equities displaying increased volatility and lower yields in public debt, there is increased interest for those willing to exchange liquidity constraints for diversification, lower volatility and recurring cash flows.

The European private-debt industry continues to evolve. Assets under management (AUM) more than doubled from December 2014 to December 2020, reaching a value of €223 billion.[19] European investors are realizing this alternative asset class will contribute to higher returns while providing diversification benefits. While the percentage of investors intending to allocate more capital to the private-debt sector is less than that of the previous year, the asset class remains strong. Treasury bonds now yield 1.22%, while the breakeven inflation rate sits at 2.36%, resulting in a negative yield of more than 1%. This will only drive more investors to transition to higher-yield private debt.[20]

Figure 5: Europe-Based Private Debt Assets under Management, 2000-2019



Source: Preqin Pro.

Investing in European Private Debt

Much like private equity, private debt has historically been accessed by the institutional market. There are ~640 private debt funds in the European market, most of which are targeted to large institutional investors. Retail investment solutions are more popular in North America, however, and these structures have begun to take hold globally. Managers are beginning to launch products with lower minimum investments, shorter holding periods and an open-ended structure to accommodate smaller investors. As liquid alternative funds continue to grow in size and popularity, there will be a momentum effect as more individuals also contribute. Private debt AUM is expected to grow at a CAGR of 17.3%, reaching $576 billion in 2025.[21]

Key Market Participants

Firm	Headquarters	Total Capital Raised in the past 10 Years (€bn)	Estimated Dry Powder (€bn)
IVG	London, UK	21.2	3.2
Ares Management	Los Angeles, US	16.2	2.9
Armont Asset Management	London, UK	12.0	4.6
Fortress Investment Group	New York, US	10.0	2.6
M&G Investments	London, UK	9.0	1.4
Hayfin Capital Management	London, UK	8.6	0.5
Alcentra	London, UK	8.4	3.5
KKR	New York, US	7.9	3.0
Park Square Capital	London, UK	7.2	1.7
Amundi Platform of Alternative and Real Assets	Paris, FRA	6.6	1.1
Permira Debt Managers	London, UK	6.2	3.2
Pemberton Capital Advisors	London, UK	6.1	0.9
GSO Capital Partners	New York, US	5.9	3.2

Source: Preqin Pro.

Real Estate

Real estate investment strategies provide fixed-income security-like characteristics by deploying capital into real assets. Investors benefit from stable cash inflow as well as capital appreciation. Strategies can be divided into core, value-add, and opportunistic investments.

Core real estate comprises established low-maintenance properties occupied by credit-verified tenants on long-term leases. The result is stable and consistent cash flows, optimal for conservative investors.

Value-add real estate is synonymous with properties that generate little to no cash flow at time of acquisition. The goal is to implement renovations, occupancy and management solutions in order to drive capital appreciation. Specialized knowledge is needed.

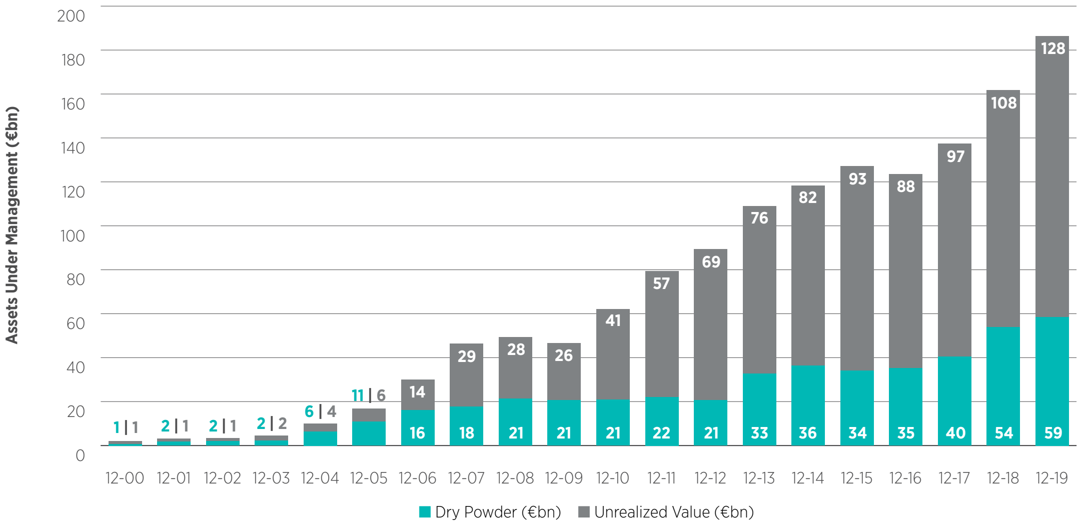
Opportunistic real estate investments take on the riskiest projects, which have not begun construction or require extensive renovation or rezoning. It involves land acquisition, ground-up developments and repositioning use of existing buildings.

European Real Estate Market

With fixed-income securities generating lacklustre yields, real estate is a popular investment asset class in Europe. Demand is likely to rise as investors look for both income and diversification arising from strong long-leased assets with covenants, indexed rents, stable cash flow and inflation protection.[22]

COVID-19 had a significant impact on performance in 2020, but there is optimism for 2021 and onwards. Dry powder also remains strong, with ~€60 billion available for deployment. Large deals are being transacted in sectors where flexibility and expertise may lead to unique value-creation opportunities.

Figure 6: Europe-Based Private Real Estate Assets under Management, 2000-2019



Source: Preqin Pro.

Investing in European Real Estate

As a long-term asset, real estate has been facing environmental scrutiny from investors. More than 70% of investors state that they expect climate change to create additional risk in real estate portfolios over the next five years. For their part, industry leaders have risen to the ESG challenge. As a result, 31% of investors surveyed expect to deploy more capital to the asset class over the coming 12 months, compared with 23% a year prior.[23]

Property type also plays a crucial role. The typical categories include office, retail, industrial and residential. Currently, there is demand uncertainty behind the two largest asset classes of real estate: office and retail. Given the COVID-19 pandemic, office real estate deals as a percentage of aggregate deal value have declined from ~46% to ~38% while residential deals have increased from 12% to 19%.[24] This coincides with the Emerging Trends Survey by PWC, which shows industry participants expect assets to be repurposed from office and retail to residential and mixed use.[25] The resiliency shown by residential properties throughout the pandemic has only made them more attractive to investors.[26] While office and retail investments constitute the majority of real estate transactions, there is an increasing focus on the industrial and logistics sub-sectors. These markets have been booming as the pandemic has driven businesses to ecommerce.

Given the capital requirements, the majority of real estate investors are dedicated institutions. Over $22 billion was raised by European private debt managers in the second quarter of 2021, more than five times that of Q1. Long-term interest rates in Europe are no longer negative for the first time since Q4 2020, which likely has been a factor in the increased capital raised by European fund managers.[27]

It is important to note that real estate assets do not solely target income. Funds can bolster returns by moving up the risk curve with development and refurbishments. Office real estate focused on core assets and a depressed interest rate environment will help minimize a decline in property values around 2-3% in offices and 10% in retail.[28]

Key Industry Participants

Firm	Headquarters	Total Capital Raised in the past 10 Years (€bn)	Estimated Dry Powder (€bn)
Blackstone Group	New York, US	25.8	9.2
Patrizia AG	Augsburg, GER	23.7	2.1
Lone Star Funds	Dallas, US	19.9	7.0
Amundi Platform of Alternative and Real Assets	Paris, FRA	12.7	1.0
AXA Investment Managers	Paris, FRA	11.5	1.4
PGIM Real Estate	Madison, US	7.0	0.7
Apollo Global Management	New York, US	6.3	1.2
AEW	Paris, FRA	6.0	0.8

Source: Preqin Markets in Focus: Alternative Assets in Europe September 2020.

So What's the Bottom Line?

With a 7.6% drop in GDP, 2020 was a challenging year for the global economy, and Europe faced one of the largest down years in history.[29] However, the future is much brighter. Real GDP growth and pending stimulus in Europe are expected to outpace the rest of the advanced economies in the next several years, which could lead to an investment-friendly environment.

As the global economy recovers from the COVID-19 pandemic, monetary and fiscal policy have bolstered traditional asset class valuation and volumes to unprecedented levels. For investors with a suitable risk profile, alternatives can be an attractive option to reduce portfolio concentration, improve diversification, and generate returns. In this environment, Europe appears to be an attractive landscape for new investment.

For years, alternative investments have been the sole domain of institutional investors. And now this form of investing is gaining momentum for smaller, retail investors. As these investors get more familiar with the alternative assets available to them, we expect fund managers to take notice and open their doors to the wealth of new capital. European managers seeking non-traditional sources of capital will be looking to expand their investor base, and Canadian investors should be poised to take advantage of this new opportunity. ■

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FOOTNOTES

[1] Source: Preqin.
[2] Source: Preqin: The Future of Alternatives in 2025, November 2020.
[3] Source: Eurostat.
[4] Source: https://www.statista.com/statistics/1107572/covid-19-value-g20-stimulus-packages-share-gdp/.
[5] Source: International Monetary Fund October 2020 World Economic Outlook.
[6] Source: Eurostat.
[7] Source: Baker McKenzie: Guide to Private Credit in Europe.
[8] Source: Chambers, Dimson, Kalle "Seventy fix years of investing for future generations" Financial Analysts Journal 2020, SLC Management.
[9] Source: Preqin Investment Outlook Alternative Assets H2 2021.
[10] Source: European Fund and Asset Management Association, November 2020.
[11] Source: Preqin.
[12] Source: Setter Capital H1 2020 Review.
[13] Source: Preqin Blog 22 September 2020, Cameron Joyce, CFA.
[14] Source: Preqin Blog 9 September 2021, Cameron Joyce, CFA.
[15] Source: Preqin LP Snapshot, Laura Messchendorp.
[16] Source: S&P Global Market Intelligence, Nina Flitman.
[17] Source: PDI Full Year Fundraising Report 2020.
[18] Source: PDI, John Bakie.
[19] Source: Investments Insights Blue Paper.
[20] Source: Preqin Investment Outlook Alternative Assets H2 2021.
[21] Source: Preqin: The Future of Alternatives in 2025, November 2020.
[22] Source: Preqin Markets in Focus: Alternative Assets in Europe 2021.
[23] Source: Emerging Trends Europe Survey 2020, PWC.
[24] Source: Preqin Markets in Focus: Alternative Assets in Europe September 2020.
[25] Source: Emerging Trends Europe Survey 2020, PWC.
[26] Source: Aberdeen Standard Investments: European Property Market Outlook Q3 2021.
[27] Source: Preqin Investment Outlook Alternative Assets H2 2021.
[28] Source: Preqin Markets in Focus: Alternative Assets in Europe September 2020.
[29] Source: International Monetary Fund October 2020 World Economic Outlook.

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