



SMOOTHING THE PATH: MANAGING THE RISKS IN PRIVATE ASSET INVESTING

- Pedro Arias, Amundi

A quiet revolution is happening in Europe. It is no longer just banks and governments that are providing funding for the real economy: insurance companies and pension schemes are also playing their part.

The transformation might be silent but it is powerful. Investment in real and alternative assets – which include private equity, real estate, infrastructure and private debt – reached another all-time high of €7.00tn in 2017. And new capital raised hit a record of €673bn in the same year.

The popularity of these investments among pension schemes and insurance companies is well understood: the unconventional monetary policies developed in response to the Global Financial Crisis had a significant impact on all asset classes.

Long-term low bond yields and expensive yet volatile equities made investors look to other assets for better sources of return. Real assets are appealing to long-term investors for three reasons: they allow such investors to capture an illiquidity premium, enhance income through a source of predictable returns and create diversification, as they have low correlation to traditional asset classes.

Stricter regulation of banks is also driving the demand for alternative sources of finance for the real economy. This disintermediation of banking is a rapidly growing trend. It is estimated that the move away from bank financing represents between 75% and 80% of funding volumes in the US market and about 20% to 25% of all funding in Europe, where growth is faster.

ENCOURAGEMENT FROM EUROPEAN POLICYMAKERS

It is less well appreciated that European regulators are also playing an important role to encourage investors to invest directly in real economy.

For example, the legal framework makes it easier for insurance companies to buy these assets. The Solvency II directive requires these investors to consider the risk-adjusted return relative to the capital cost of an investment. This is known as the solvency capital ratio (SCR). Under this metric, the regulator has made a secured real estate debt yielding 2% more attractive than a high-yield portfolio yielding 6%. In addition, the SCR of a private debt portfolio is equivalent to BBB – irrespective of its specific credit rating. And the SCR of an infrastructure fund can be reduced to 30% from 49% in certain eligibility circumstances.

The European regulator is now encouraging wealth managers and high-net-worth individuals to invest in this asset class. European long-term investment funds (ELTIF) were created to increase the pool of capital available, in particular, to infrastructure projects as well as small and medium-sized enterprises. These funds must invest in alternative long-term assets and should hold around 70% in those assets. The remainder of the fund can be invested in listed securities to provide a liquidity buffer which aims at managing the asset-to-liability ratio of the portfolio.

While the ELTIF regime was established to provide access for institutional investors to a long-term investment product, it can also be marketed to retail investors. In particular, these funds can be included in pension products.

ASSET MANAGERS MUST EDUCATE THEIR CLIENTS

Although the European regulator is taking the steps necessary to encourage both institutional and retail investors into these asset classes, this is unfamiliar terrain. Investors are reliant on fund managers not only to provide access to these asset classes but also to educate them.

It is important for investors to understand that alternatives have different risk metrics

to traditional asset classes. It is impossible to achieve the same level of diversification in a private equity portfolio that has 15 investments as an MSCI World tracker covering 1,600 shares!

The risks associated with private markets and real assets are broader than those associated with equities and bonds. Political and sector-specific risks are more important considerations. In addition, as these investments are illiquid, it is much harder to accurately measure

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performance of the assets. The opacity of many investments and the lack of robust statistical and historical data make the task even more difficult.

Take private equity. It can often take four to five years to source the right deals and once deployed, it is another eight to 10 years to create the target value so it is often more than a decade before the return is realized – assuming the right exit strategy is in place.

LEGITIMATE CONCERNS OVER FEE STRUCTURE

Locking capital up for 12-15 years is a tough liquidity constraint. Investors' concerns about the fee structure in this scenario are understandable: if they are too high, they could erode the potential return. Investors need to know if they are paying fees on the capital they have committed or on the capital which has been invested. Is it fair for investors to pay fees on capital that is languishing in a bank account, waiting to be deployed?

Amundi believes it is better for fees to be paid on invested capital. This trend is

gaining popularity and we think it should become standard practice in private and real assets.

Charging fees on invested capital might encourage a faster deployment of capital. This might also improve the rates of return on investments as managers will be incentivized to shorten the ramp-up period and therefore the J Curve effect is alleviated.

But charging on invested rather than committed capital would not necessarily improve an organization's ability to access good-quality deals at fair value. This is a key concern frequently voiced by institutional investors when considering investing in private markets. It would be reasonable for an investor to be concerned with such a high level of dry powder, which mounts ever higher. Over the last five years, the global level of dry powder kept reaching a new record high – last year it was €1.5tn. This could encourage funds to take less care when selecting their next project.

A NEW BREED OF ALTERNATIVE MANAGER IS NEEDED

Alternative asset managers have tended to pursue one of two business models. There are boutique firms with deep expertise in a specific market but lack financial clout. There is a danger these smaller players do not have sufficient financial strength to ensure they will survive for the full length of an investment project of one to two

decades. Or there are large global players with strong resources, which ensure they will still be around in a decade when the profit on the investment is realized. These organizations can also generate economies of scale by centralizing risk controls.

There can also be useful pooling of knowledge across different specializations such as real estate debt and property management which creates insights a specialist player cannot access.

Amundi believes successful real and private asset managers have to combine the best of both worlds: they need to be strong global players who can access the right deal flow, and understand the specific complexities of an individual asset class and of a local market. For example, the European market remains highly fragmented where local knowledge and contacts are vital. Long-term business and banking connections are needed to gain access to assets. Boutique specialist managers often lack these connections and struggle to find these potential deals.

Infrastructure illustrates the intricacies of an individual asset class. This is a highly complex and technical asset class. The due diligence required to assess the operational and investment risk takes both time and considerable resources.

Determining how to exit the investment is equally complex: some investments can be easily divested in a few months

while others benefit from special tax or regulatory conditions which require the investment to be held for years. Technical expertise is required to evaluate both industrial and maintenance risk.

It is, however, possible for large financial organizations to reduce the complexity of investing in these real assets and to increase access to a strong source of high-quality deal flow by working in partnership with industrial groups. Working in combination helps to mix the respective talents of the fund manager and the industrial partner. The manager can provide its financial knowledge while the partner understands how to, for example, manage a solar energy farm.

BALANCING TWO COMPETING CONCERNS

Regulators want to encourage investors to allocate capital to the real economy but they also want to ensure investors' lack of familiarity with these assets does not result in them taking unnecessary risk.

As regulators continue to encourage both institutional and retail investors to invest in the real economy of Europe, demand will increase for asset managers that understand the complexities of each asset class and that are able to access high-quality deal flow.

AMUNDI ASSET MANAGEMENT

Amundi is Europe's largest asset manager by assets under management and ranks in the top 10 globally¹. Following the integration of Pioneer Investments, it now manages over €1.45tn of assets² across six investment hubs based in 37 countries. In 2016, Amundi launched a platform dedicated to real and alternative assets to provide easier access to unlisted investments. Bringing together capabilities in real estate, private debt, private equity, and infrastructure (green energy), this platform has a headcount of 200 people for AUM of €41.6bn², and offers solutions through funds, club deals, and multi-management funds, including two innovative and ambitious partnerships with EDF and CEA.

PEDRO ARIAS – GLOBAL HEAD OF REAL & ALTERNATIVES ASSETS

Pedro joined Amundi in 2013 to manage the alternative assets business line. He was previously Deputy CEO in charge of international development and real estate at the Casino group, the French retail Group. He served as board member of Casino's major subsidiaries in Colombia, Argentina, Brazil, Uruguay, Thailand, Hong-Kong and Vietnam. Pedro started his career in a law firm before moving to corporate and investment banking in various leading institutions. Pedro was notably involved in mergers and acquisitions across Europe and Latin America and eventually in co-head of the restructuring practice at Rothschild & Cie for Europe. Pedro graduated from ESSEC business school and Paris-Descartes University (Law degree).

<http://real-assets.amundi.com>

¹Source IPE "Top 400 asset managers" published in June 2017 and based on AUM as of end December 2016.

²Figures as of 31 March 2018. Source: Amundi Asset Management