Resilient and Robust: An Industry Adapting to Change

Alter Domus' Bruno Bagnouls on how alternatives are evolving in the face of political storms, new technology and shifting investor demands

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We live in interesting times. We are moving into a presidential election year in the US, British Prime Minister Boris Johnson is pushing for a general election in the UK before the end of the year as he seeks to get his Brexit proposal through parliament, and throughout Europe the political landscape is changing as the established parties see their longstanding majorities diminished by parties from the right and left wings of the political spectrum.

The alternative investment industry is not immune to these upheavals, and fund managers are eyeing the coming months with a due sense of caution. Over and above these political developments, fund managers and indeed investors are coming to the conclusion that we have now reached the top of a credit cycle. This, in turn, is fuelling interest in special situations and opportunistic debt. A recent Preqin survey identified the competition for assets as the key risk for fund managers at present. The general consensus is that there is simply more money than deals out there right now, so while vanilla direct lending is still a mainstay, a dog-eat-dog mentality has grown up to grab a deal when it arises – and this quick, aggressive attitude is not one that fund managers are used to, nor feel comfortable about.

This current environment is further complicated by the stricter controls on transparency in the industry. While fund managers are keen to highlight that their practices and procedures are consistent with regulations, the assets and investors behind them remain confidential: disclosing too much information could be seen to be giving an unnecessary advantage to competitors. While there may have been few evolutionary changes of late in this area, transparency is most certainly a key topic and one that will continue to weigh on the industry in the near future.

As with all financial sectors, environmental, social and governance (ESG) issues are becoming more and more important in the industry, and a groundswell towards responsible investment is increasingly evident. Nevertheless, it is clear that this change is still lagging behind other industries, and a clear strategy of how and where it can be best implemented remains to be defined. The coming years will be very interesting for ESG in alternative investments, as it represents a very fertile landscape for change and there is a strong impetus to ensure that measures are implemented in a timely fashion. Watch this space!

So where are investors going with their money? There is a great deal of demand for co-investment, for example, and fundraising sponsors tout many opportunities. The relatively low success rate of club deals, coupled with their dense governance and time involved, has prompted sponsors to favour more passive co-investors in their search for large deals. Plus LPs appreciate the diversification and good returns these vehicles offer. The old way of working, whereby sponsors would do deals and then bring in co-investors to help dispense with some of the risk and syndicate the parts still occurs, but generally sponsors bring in LPs earlier nowadays, prior to the deal closing. This improves their chances of influencing the structure of the investment. There is no shortage of money available to invest, and investors are keen to diversify and find a solution that works well for them.

Co-investment is not a magic bullet, of course. LPs are reliant upon their sponsor to do due diligence and structuring and to find a good opportunity. They also need them to get the right price and manage that investment through to a good exit and a satisfactory return. While the co-investor can customize their portfolio, they can still end up very exposed to one manager.

As for the sponsor, you are including more and more parties in your endeavor, which means more people to answer to if things go awry. To combat this, and to make the whole process that much more smooth, many sponsors are standardizing their co-investment documentation as much as possible. That way they can avoid facing the same issues over and over again when parties are brought into a deal.

Multi-platform asset managers have long championed synergies between private equity and real estate, and technology has helped drive this forward. The two asset classes are unquestionably related. Proptech companies can optimize efficiency in the building, sales or lettings process. Connectivity-focused businesses can make properties more valuable with the addition of better internet, energy efficiency or smart office design.

There's also the matter of returns. Tech deals frequently secure higher valuations, with global companies in this sector trading at 22x EBITDA as of November 2018, according to S&P Global Intelligence. Depending on the strategy, real estate funds have different return profiles to conventional private equity. Core funds will target IRRs of around 5%, while opportunity funds will look for 20% and 2x investors' money.

Questions remain over investor appetite for such vehicles. Limited partners typically have separate allocations to real estate and private equity because the risk profiles are different. But as real estate and technology become increasingly interconnected, distinguishing between the two strategies may become more of a challenge.

What is sure is that the alternative investment industry has proven time and time again that it is one of the most resilient, robust investment industries, and it continues to attract large volumes of funding year on year. The portfolio diversification, inflation-hedging opportunities and high rewards that alternative investments offer, combined with the greater regulation and transparency now in place, means this financial sector is one whose reputation is improving where others are suffering. There will most certainly be more regulation going forward, and more calls for greater transparency, but while these will challenge us and oblige us to adapt and change, it will also ensure that our industry continues to receive the respect that it deserves from our colleagues in other areas of finance, and maintains its high regard among those outside of the investment industry.

Alter Domus

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