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ACCESSING ILLIQUIDS: THE CHALLENGES OF PRIVATE MARKET INVESTING

1.3 ROUNDTABLE DEBATE

Accessing Illiquids: the challenges of private market investing

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Carlos Vilares: We will be discussing one of the most intractable challenges of private market investing; how to make private assets easier to access and to exit. If my conversations with clients and the content of most conferences these days - including this round table - is anything to go by, I don't need to convince many of you that there are many investors who have a desire to access private markets. Often, this is for the higher yields available, but can also be for the purposes of diversification.

Equally, private market assets aren't without their challenges. The first of these is the so-called J curve, where funds typically experience negative performance in the first months of their life given the fee load and the time it takes to create value in private markets. Secondly, cashflows are only received several years after putting capital to work. Thirdly, lower transparency, which could be both for the underlying issuers and assets that are being purchased, but also in terms of broad market data relative to public markets. Fourth, there is the decreased flexibility in terms of moulding a portfolio to your individual needs, as the typical way of accessing illiquid markets is through comingled closed ended fund vehicles.

The main challenge that we hear from our investors and the one that we want to focus on today is the challenge of locking up capital for the long term, often 7-10 years with no liquidity.

Sara Benwell: As an insurer who requires liquidity, is investing in illiquid assets difficult to justify? What role might illiquid assets play within your broader portfolio?

Natalia Soboleva: Illiquids play a very important role for us, and we do consider illiquids because of the high yield, as well as adding diversification to portfolios.

Of course, they do come at a price. That price is the volatility and risk, which should be considered and tackled separately.

Fuad Ahmed: Illiquid assets absolutely form a key part of our strategy within the policy holder business, including with profits and unit linked funds. What we are looking for is diversification, as well as solid returns. If we consider that a lot of companies are staying private for longer and if we are investing in equities over the longer-term, we need to be tapping into these opportunities.

Also, it links to our sustainability agenda. As a UK life insurer, a key part of this is investing in smaller and less developed companies within the UK and so this forms part of our venture and growth strategies within private equity.

> IF WE ARE INVESTING IN EQUITIES OVER THE LONGER-TERM, WE NEED TO BE TAPPING INTO THESE OPPORTUNITIES

Sara: Murtaza, can you talk about the underlying character of the assets that you manage generally and whether they necessitate a long lock up of capital.

Murtaza Merchant: MV credit is a private debt manager and have been doing this for 20 years. On the private debt side, when we talk about illiquids, it is now become a vast area. Within private debt you have various categories like direct lending, subordinated credit, direct loans, etc. Sometimes, when we talk to investors it is a confusing landscape just to identify which part of the private credit market we are active in.

We focus on the entire capital structure; we go from the broadly syndicated market down to the unitranche and direct lending market and some of the characteristics of these loans are more appropriate from the provision of liquidity perspective than others. For instance, loans that are in larger companies which have some trading in the secondary market could be called broadly syndicated loans. You can achieve some liquidity within the private market segment itself because you have participants within those loans where you can trade on the secondary market. We would never call them liquid loans but there is liquidity within these private assets.

The other feature of these loans is that most often, the legal maturity of these loans are typically 6-7 years. However, by their very nature most of these loans are refinanced and have an average life of 2-3 years. Given the private equity cycle, these are companies that are owned by sponsors and there is a natural turnover of these assets within a 2–3-year period. The average life and the legal maturity are two very different things, and this shortens the holding period of these loans.

Another characteristic of the private markets is the lower volatility inherent within them. From a valuation perspective, given the long-term hold to maturity nature of these loans, the valuation of these assets are quite stable and so there is much lower volatility in these assets.

Carlos: Flexstone invest across private markets including private equity, infrastructure, private credit, etc., and are investing in privately owned companies. This is primarily through closed ended funds, which is the traditional vehicle, these are typically 10-12-year funds in closed ended format with no redemptions. The first few years are the investment period, and the remainder of the life is the liquidation period, so the average break even cashflows coming in on years 6 and 7.

The key development is that there is a large and sophisticated secondary market that has developed over the last decade or more in private equity. There is around 90 billion per year in sales in closed secondary funds and there is a smaller but growing secondary market in infrastructure funds in private credit funds as well.

Long lock ups are no longer a necessity, so if you are going into a closed ended fund on day one, they are part of the structure. If you were to buy a fund later in its life, then you can take a different approach through the emergence of the secondary markets. Secondary markets are really starting to allow more liquid approaches to emerge.

> THERE IS A LARGE AND SOPHISTICATED SECONDARY MARKET THAT HAS DEVELOPED OVER THE LAST DECADE OR MORE IN PRIVATE EQUITY

Sara: Clearly anything can be sold in short order, but you might not receive the price that you want. When you say that it can be sold in a month, is this at a max spread/price hit from where it is marked?

Murtaza: The idea of combining liquid and illiquid credit is primarily designed so that the liquidity needs of the investor are met through the liquid part of the portfolio. There is a mechanism to do this whereby the liquid part of the portfolio is a primary driver, and over a period of time you re-balance the portfolio based on the ideal allocation between illiquid and liquid assets. When investors want liquidity there will be a price to pay for that liquidity and that is why it is very important not to put the illiquids in the front line of driving that liquidity requirement.

When we talk to investors, we ensure that these investors are long-term investors. This product is clearly not designed for investors who want to buy and sell into this strategy. For an investor with a reasonably long-term time horizon, there is the provision of sufficient liquidity for their needs over a short to medium period, but this is an investor who is going to invest through a cycle. This is a key factor and there is sufficient liquidity from the liquid part of the assets to meet any requirements for the investor and that is how it has been designed.

Carlos: For most investors coming into illiquid assets, it is not that they envisage exercising that liquidity in short order. If you are coming into it thinking that it is a 2–3-year allocation it is probably not the best thing to do.

Investors want that optionality, as they have a long-term mindset but want the comfort of some sort of liquidity option.

Fuad: We are in it for the long term, but equally, there are liquidity constraints that have to be managed. It is not a daily liquidity requirement where we are investing in private equity, but we do like to have that optionality and so co-investments and secondaries are very useful from our point of view. Both in terms of getting the exposure quickly, but also if we need to liquidate sooner than by the very nature of these investments, they should be slightly shorter dated anyway.

Fundamentally, we are accessing private markets because of the long-term nature of the lock up, the illiquidity premium and the excess return that we are hoping to generate.

An issue to be wary of as an investor, from a secondary market point of view, is whether opportunities exist consistently enough to ensure appropriate ramp

up of the portfolio. So, it is about being tactical and opportunistic in that regard.

Natalia: From a unit-linked perspective, the regulatory requirement in Switzerland means that there is daily valuation available (NAV) plus the possibility to step out at any time. Of course, we don't invest with the mindset of stepping out in 2-3 months, as this is a long-term investment where we usually match assets to liabilities, but it is an important feature which is imposed by our regulations. It is a compliance issue and a compliance consideration, which is an obstacle that has to be thought through.

100% confidence on these valuations all of the time. This does impose some additional requirements on us and some constraints as well.

Natalia: The skills and knowledge of your team also need to be considered. Especially for the due diligence procedures that you need to perform. Our regulators here have rather high standards of what should be in place in order to enter into and manage these investments, as well as the legal requirements and documentation.

> We need to make sure from an investment point of view that the net returns stack up

Sara: Aside from the issue of locking up capital, what other obstacles might prevent you from accessing illiquid assets?

Fuad: Beyond liquidity, fees are very important, and we and our policy holders have limited appetites for fees. There is also the issue of fee caps in certain funds. We need to make sure from an investment point of view that the net returns stack up, we are not just looking at the pre fee return, because then you would get a very favourable outcome. Also, we want to look at the totality of the fees being paid and whether they make sense.

On top of this, it is necessary to consider the scalability of the opportunities because of the constraints, we would never have too high an investment in this area but is it large enough to make it worthwhile? Will it actually make a meaningful difference in terms of the returns? And do we have the resources to oversee it, manage it, and ensure that we are not taking risks in this area?

The other area is around valuation requirements. Our financial reporting colleagues do have issues regarding the nature of the NAVs coming through, and for their quarterly reporting it is quite important to get that as accurate as possible. If we have a situation where there is a very large allocation to private equity assets, and potentially something happened in that quarter as we had last year with markets moving all over the place, it is very hard to sign off with 99 or

There is also the limitation on traditional size of how much you can invest, you can't over invest in this area so altogether it does make it more complicated than the conventional investment into more liquid markets.

Sara: When you are doing a cost benefit analysis and considering investing in private markets, what are the key issues that underpin the decision-making process?

Natalia: If you have the asset allocation and you believe that you can invest there and want to get the benefits, you need to try to overcome the legal costs that you usually have. In Switzerland, we have to prepare a concept for our regulator on alternative investments (private debt/ private equity) but from a broader standpoint, it is lucrative to get into this market from a return perspective.

Fuad: The key factors for us as per the SAA are related to the questions; does the risk adjusted return stack up? Does it make sense from that point of view? Transaction costs and ongoing charges are also important, as well as liquidity management. In with profit funds, we are looking over a 5–10-year horizon to make sure that over this time, we are within the right exposure range and not over allocating, because it is a closed book and funds are in run off.

The oversight factor is also important, as we want to make sure that we have the right resources and capabilities in house to oversee these investments.

> WE WANT TO MAKE SURE THAT WE HAVE THE RIGHT RESOURCES AND CAPABILITIES IN HOUSE TO OVERSEE THESE INVESTMENTS

The sustainability policy is also critical. It is a key part of this for us, within our venture and growth strategies.

Murtaza: Fundamentally, the ideas and challenges that my fellow panellists have highlighted are the inherent challenges for accessing illiquids. The idea of blending liquid and illiquid assets is to ensure that this can be presented in an open-ended structure, which is suitable for investors or that appeals more to investors to navigate their own constraints. Having an open-ended structure whereby you have the ability to access this liquidity through the liquid portion of the assets is key, and this is integral to blending the solution together.

Sara: Thank you all for sharing your thoughts on this topic.

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