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Covid-19: Anticipated effects on alternative investments - a first assessment

The Bundesverband Alternative Investments e.V. (BAI- German Association for Alternative Investments) has always been concerned with all current aspects of the various asset classes allocated to alternative investments. At present, Covid-19 is, of course, the dominating topic, especially due to its effects on the health sector and with regard to expected economic consequences. The virus implies an enormous effort for all asset managers, service providers, advisors and institutional investors, not only with regard to a changed work structure, but especially with regard to reporting, risk management and rebalancing. The high price losses in equities and bonds in particular, together with generally broad sell-offs for risk and liquidity reasons in all asset classes, pose particular challenges for the implementation of strategic asset allocations and compliance with quotas etc. prescribed by the regulators, as "tail risk" and "black swans" are unfortunately no longer just hypothetical at present.

While the corona crisis is far from over, and is likely to become even more widespread globally, the following is an initial assessment of the possible effects on alternative investments. This assessment cannot be fully comprehensive at the present time, of course, especially since a differentiated view is only possible once a "bottom" has been reached in the current environment. The illustration is therefore limited to selective aspects. The statements reflect the opinion of BAI and are based on recent discussions with several association members and investors.

Private Equity

The enormously high "dry powder" stocks may be a stroke of luck in the current environment, as companies in particular have high financing requirements. Capital calls for portfolio investments are also increasing when funds call up liquidity, e.g. for overcommitments or FX hedging.

As far as new investments are concerned, it is to be expected that capital calls will slow down significantly for the time being. In the medium term, however, there may be higher calls again, as developments following earlier crises have shown that particularly the funds newly launched at that time (not only in private equity but also in other asset classes) deliver a very good performance.

Exits from existing investments will become more challenging, as IPOs in the current market environment and also sales to strategic or financial investors will be more difficult, at least in the short term, due to the general market uncertainties. It also remains to be seen to what extent new fundraising among institutional investors is feasible in the current market environment and whether sufficient liquidity is available among all investors to meet commitments already made.

Surplus returns are possible in the healthcare/medtech/biotech sectors, but also in the telecommunications and information technology sectors - due to the strong demand, e.g. with regard to home office workplaces.

Due to the usual lag in net asset value reporting, a full assessment of the impact of the crisis on private equity funds will only be possible from May 2020 onwards, i.e. later than, for example, for private debt investments.

Private Debt

A new set of opportunities is emerging for private debt funds, as banks in the current scenario are coming up against limits in terms of capital adequacy (despite intended special regulations). Currently, private debt is in high demand for syndicated loans in the secondary market, but also for syndicated loans whose placement is delayed. In addition, private debt could also be made available more quickly and pragmatically than liquid funds, e.g. through the KfW aid programmes. However, this is countered by the difficulty of assessing creditworthiness, as it is currently hardly possible to prepare reliable business plans.

At the same time, defaults on existing loans are foreseeable due to lack of liquidity on the part of borrowers. Unsecured lenders in particular will be affected, but secured lenders may also be exposed to a decline in the value of the collateral.

Infrastructure

Increased public infrastructure order to stimulate the economy would have positive effects. However, the current general decline in transport, which means lower toll revenues for roads and bridges, for example, is negative. Lower production will also have an impact on energy investments.

The implementation period for new projects is lengthening in all crisis regions due to disruptions in the supply chains, but also due to the shutdown by the authorities. This, in turn, leads to an increase in project costs, later completion of construction work and a drop in earnings.

In particular in regions where Covid-19 will not appear until later and where its effects are expected to be severe (e.g. Africa), but also in countries already affected, at least a temporary suspension of infrastructure projects planned or already under construction is foreseeable.

Overall, therefore, capital calls by asset managers from investors - at least for new projects - will slow down as well.

Real Estate

Expected effects on real estate are in the conflicting. On the one hand, there will continue to be demand for real estate as a result of the corona crisis, which will persist for some months to come, and not only in the private sector (“concrete gold”). On the other hand, there will be negative price effects due to an increased supply, among other reasons because construction loans can no longer be serviced as usual (see also the discussion of the legislation on rent deferral) or because property owners will have to sell their properties to generate liquidity. Retail and wholesale properties as well as shopping centres, catering/restaurant and hotel properties are affected particularly severely. With regard to the duration of realisation, the same applies as already mentioned for infrastructure.

Hedge Funds

Institutional investors deliberately included hedge funds in their portfolio diversification in order to be prepared for highly volatile extreme situations. Depending on the hedge fund strategy chosen, it can be assumed that these investments will now contribute to stabilising returns.

Analyses by Absolut|Alternative dated March 20, 2020 show that even hedge fund-like strategies (UCITS), so-called liquid alternatives, are able to be a stabilizing portfolio component in these turbulent times on the financial markets. Long/short volatility approaches have performed particularly well to date. Unlike long/short approaches, smart beta strategies have been less successful in the current environment. Long/short credit opportunity funds are also currently recording positive stabilisation effects.

Depending on the extent of the "event driven" strategy, performance losses cannot be ruled out, partly because M&A transactions hardly ever take place as planned in the short term. In the medium term, however, a recovery should take place here, as M&A transactions will increase again; to a lesser extent, as has been the case to date, with the primary goal of increasing growth, but rather for reasons of consolidation.

Commodities

Only oil and gold will be mentioned here as examples. With regard to commodities, the oil price development, which directly or indirectly affects all alternative asset classes, will be of particular importance in the coming months, on the one hand due to the decline in demand as a result of the crisis (especially on the part of industry), but also due to the price war between the OPEC states and Russia. The oil price development also has a serious impact on oil-producing developing and emerging countries and, accordingly, on alternative investments in these regions.

The further development of the price of gold and other precious metals will be influenced by inflation expectations, but also by the sustainability of general uncertainty as well as possibly further expanding liquidity requirements. The current decline in the price of gold already reflects high liquidity pressure.

Transport

Significant losses in air, sea and long-distance traffic, but also, of course, in rail transport are undeniable. As a result, investments in aircraft and other means of transport in particular have been extremely badly affected by the crisis. The secondary market is also affected in the sense of a resale of assets, as the demand for aircraft, for example, is drastically declining due to existential problems of airlines.

Digitalisation

Alternative investments in the field of digitalisation should profit from the crisis, partly due to changed workflows and structures, but also in view of the enormous cost pressure on personnel expenses, among other things. Numerous employers will now examine automation options even more intensively. Once the crisis has been overcome, new opportunities will arise for block chain technologies to leverage savings potential (e.g. further digitalisation of supply chains and logistics). Additional applications with distributed ledger technologies are also expected in fund sales in order to reduce redundancies for the asset managers, service providers and other parties involved.

Data transmission is also of particular importance. It is to be assumed, for example, that the expansion of 5G networks will now be demanded with even greater intensity.

In contrast to other asset classes, crypto assets lack extensive experience of price reactions in severe crises. Although the effect of Covid-19 on crypto assets is currently predominantly negative, a faster recovery than for other assets could be possible in the medium term.

ESG

The alignment of portfolios with ESG criteria across all asset classes has been a key issue for most investors and asset managers in recent months. It is to be hoped that this prioritisation can be maintained in the near future, as massive capacities are currently also required for fundamental issues in asset management. Nevertheless, in the medium term at the latest, "G "overnance issues will also be of particular importance, especially the assessment of crisis management. A further anticipated effect is the increased demand for renewable energies due to the relatively low correlation of this asset class to other classes, especially in the current environment.

Currencies

Increasing nationalisation tendencies can already be observed in the current crisis mode. As a consequence of this and in light of the anticipated intensification of trading conflicts, greater currency fluctuations are foreseeable with corresponding effects on all alternative foreign currency investments, provided that these are not accompanied by FX hedging, for example.

Particularly Africa, but many other developing and emerging countries also, will continue to be affected for a long time and severely by the corona crisis and its effects. Even for Asia, a renewed stronger outbreak cannot be ruled out. These developments, along with the US elections this year, will contribute to greater exchange rate volatility.

Against the background of the uncertainties outlined in this overview, broad portfolio diversification is essential. In addition, as is so often the case, "cash is king" is evident, as sufficient liquidity opens up attractive options despite all the market turbulence.

More importantly however, stay healthy - you, your family and colleagues! Let us all hope that the serious consequences of the Covid-19 crisis for both individuals and companies will not burden the world for too long.

Annette Olschinka-Rettig
Managing Director
Bundesverband Alternative Investments e.V.

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