Dear ladies and gentlemen, dear members,

Alternative Deal Structures on the Rise / Co-Investments and Secondaries

As you know, the BAI Investor Survey published in December delivered a number of exciting findings. Admittedly, it is hardly surprising that alternative investments have become mainstream for institutional investors. What is more exciting and very revealing is that due to the increasing expertise and experience in the world of alternative investments, the investors' perspective is now also very clearly directed towards new access channels and investment structures. These include, above all, secondaries and co-investments, especially in the private markets strategies of private equity, infrastructure and real estate, but increasingly also in the private debt segment.

Back in autumn, we dedicated a separate publication to the topic of co-investments, which we would like to refer to again at this point. It not only contains a very good overview of the different structuring variants (sidecar co-investments, direct co-investments, co-investments, etc.), but also provides great insights into the motivations and special features of these investments from the perspective of investors and asset managers.

The reasons for co-investments are manifold. The narrow market for target investments and considerable dry powder in many private equity funds are obvious. Not only can co-investments open the door to a new investment universe that meets the specific requirements and sector expertise of the investor and also does not contain any blind pool risk. Investors can also, above all, improve the risk-return profile in the portfolio, for example through lower management and performance fees. Through direct access to the company, investors can also exert more influence compared to traditional investment with the help of individual funds, which takes on a new significance, especially from an ESG perspective.

The concept of co-investments therefore also allows for great flexibility and thus brings advantages for asset managers as well as for investors. However, especially due to the parallel investment to a fund, there are a number of particularities to be taken into account, for example of a corporate law nature (including coordination agreements) or from a governance point of view. In addition, the co-investment is usually made at the same time as the fund and basically under the same conditions (pro rata purchase price) as the fund's investment.

Frank Dornseifer, BAI e.V.

For asset managers, co-investments offer various advantages. On the one hand, they can carry out transactions that they would otherwise not have been able to on their own due to restrictions - limits on transaction sizes, regional allocation limits and more. On the other hand, investors - especially large ones - can be offered an additional investment incentive. This significantly strengthens the relationship between investor and asset manager in the case of - successful - co-investments.

Co-investments are therefore a deal structure that offers a lot of potential, especially for experienced investors. In addition to diversification in the portfolio, there is also cost and capital efficiency, which, in part, can be associated with increased complexity and responsibility as a shareholder, so that the transaction process must be carefully planned and managed.

Given the tendency towards low market transparency in co-investments - in comparison with classic fund investments, for example - the investor's initiative is the main factor in setting up creative new investment structures together with an asset manager. Now that demand for equity investments is increasing, this trend is likely to extend to debt investments, especially corporate private debt.

In addition to co-investments, secondaries are also currently experiencing strong demand, a fact confirmed by the BAI Investor Survey. As many as 38% of the participants reported on such investments. There are many good reasons for this deal structure. Investors use the secondary market for alternative investments, especially to adjust or realign their portfolios. Buyers of secondaries thus enter the market for strategic reasons. Positions can be built up much more quickly through secondary market purchases, for example. Another advantage is that secondary investors invest in an already established fund. Investors who are investing in a new asset class for the first time can benefit from this in order to participate comprehensively in the different yield drivers in a timely manner and, above all, to build up a diversified portfolio over time by mixing different vintages.

In short: co-investments and secondaries are currently key topics for investors and asset managers. After our Investor Survey, this is reason enough to dedicate both a separate newsletter and the accompanying main topics in February and March to these issues.

BAI Webinar Special "Q&A with the BAI Office" / Virtual AIC 2021 / BAI General Meeting on 18 March

For the first time, there was an exclusive webinar for member companies only on 27 January, in which the BAI office reported on current and upcoming activities in the areas of law & regulation, market, events, publications, etc. The webinar was held in German. Almost 90 participants were given a comprehensive overview of projects and departments, and above all of opportunities to actively participate in the association's work and to organise webinars, etc. together with the BAI. In addition, there was ample opportunity to ask questions and - this too must be done once in a while - to thank the office for its good work.

We also used the webinar to inform the participants extensively about the status of planning for the AIC, not only with regard to the agenda, but also with regard to the tools and platforms for networking etc. So take a look at the conference homepage www.ai-conference.com, where you will now also find State Secretary Dr. Jörg Kukies from the Federal Ministry of Finance as another keynote speaker.

Before the AIC, this year's General Assembly will also take place on 18 March, once again virtually. Please make a note of the date - we look forward to your participation here as well.

2021 will be a Regulatory Bombshell Year

Uncomfortable truths must also be voiced! And this includes the fact that 2021 will be a regulatory bombshell year - including for the AI industry! But let's take it one step at a time.

On the one hand, a review process is pending for various European fundamental legal acts - for example, the AIFM Directive and the ELTIF Regulation, the toolbox for our alternative investments industry. While the concept has proven itself on the whole, there is room for improvement in certain areas, such as a simplification of reporting, an EU passport for small AIFMs, etc. It is important to carefully weigh up these issues. The Commission has put forward an extensive catalogue of issues for consultation and there is now a danger that this will lead to many exhausting discussions, which under certain circumstances could even lead to regress rather than progress. For this reason, we advocate a minimally invasive approach, and above all, national private placement regimes must be preserved, precisely because a third-country passport is currently a distant prospect. Even a moderate review can be seen as a success. That is our message to the EU Commission.

It is not only the managers, but also the investors who have set their sights on review. The Solvency and CRR reviews are already further along than the AIFMD review, for which we do not expect a first legislative proposal from the Commission until autumn. In the case of Solvency and CRR, the focus is on efficient access to alternative investments free of discrimination and, above all, without excessive bureaucracy in terms of transparency, reporting, etc. In this regard, we are still discussing the concrete design of the requirements with the EU Commission or EIOPA, for example for the so-called Long Term Equities (LTE), which for the first time have a risk-adequate capital adequacy of 22 percent. This is worth fighting for.

Moving on from familiar terrain, the legislative pipeline is filled with even more new initiatives that require our full attention. First and foremost, of course, is the Sustainable Finance Initiative with its 10 regulatory measures on taxonomy, disclosures, benchmarks, etc., as well as the Digital Finance Package with the MiCAR, Pilot Regime, DORA, etc., which will provide a technology boost to the entire financial industry and investors in particular.

To begin with, let's talk about ESG again. All products, all assets and the entire value chain from front to back office, sales, etc. are affected. Not only the scope and the level of detail of the taxonomy, which is not yet nearly complete, but also the foreseeable disclosure obligations vis-à-vis supervisors and investors are enough to make one dizzy. In addition, there is now the practical implementation - and here it becomes apparent that the devil - as always - is in the details. By now at the latest, all insiders are beginning to understand that sustainability requires effort! Particularly the real economy is waking up and complaining loudly about the auditing and reporting obligations that are coming their way. The discussion about the Supply Chain Act also shows that politicians have chosen the financial sector as the bearer of bad news, because indirectly, of course, the asset or company side is also under obligation. It will be a long time before things run smoothly here. On the other hand, there is not much time left. On 10 March, for example, the Disclosure Regulation will come into force and my feeling is that many companies are not yet properly prepared, nor can they be, because the implementation standards (RTS) that specify the individual disclosure obligations are not yet final. The next few months will be turbulent and it is a pity that politics in particular often fails to provide the sustainability in legislation that is now demanded from the financial sector when it comes to implementation. In order to support you in the implementation of the disclosure obligations, we have posted guides, briefings, Q&As, etc. on the topic of the Disclosure Regulation/SFDR on the BAI homepage in the section Regulation/Sustainable Finance under the corresponding keyword, which clarify important questions and provide recommendations for action.

Let us move on from sustainability to digitisation, the other mega-topic of the financial sector. What was the MiFID Directive at the beginning of the millennium is now the MiCA Regulation, which stands for Markets in Crypto Assets Regulation. Crypto assets are becoming part of the financial and investment universe. They are also partly included by MiFID, precisely where they are digital financial instruments. In addition, there are also the genuine new crypto-assets, which will receive an independent regulatory regime. In addition, regulations are needed for the new infrastructure that uses blockchain or distributed ledger technology in order to ensure a secure infrastructure and secure handling of the so-called ICT risks - i.e. information, communication and technology risks. This is the so-called pilot regime on the one hand and the Digital Operational Resilience Act - DORA for short - on the other.

In short: there is a lot to do - let's do it! All these examples illustrate the mammoth task currently facing the AI sector. I believe that 2021 will be a turning point, both in terms of sustainability and digitisation. The changes and challenges are enormous, which is why it is important to proceed cautiously with the review processes mentioned at the beginning and always keep an eye on the competitiveness of the German and European industry. Of course, this also requires much more than the federal government has just presented in the so-called Fund Location Act. And that, of course, is another topic that concerns us.

Focus on Co-Investments and Secondaries

As always, the main topic of the newsletter is also flanked by relevant extensive publications such as studies, fact sheets, etc. on the BAI homepage, to which I would like to expressly refer you at this point.

I wish you an informative read!

Frank Dornseifer