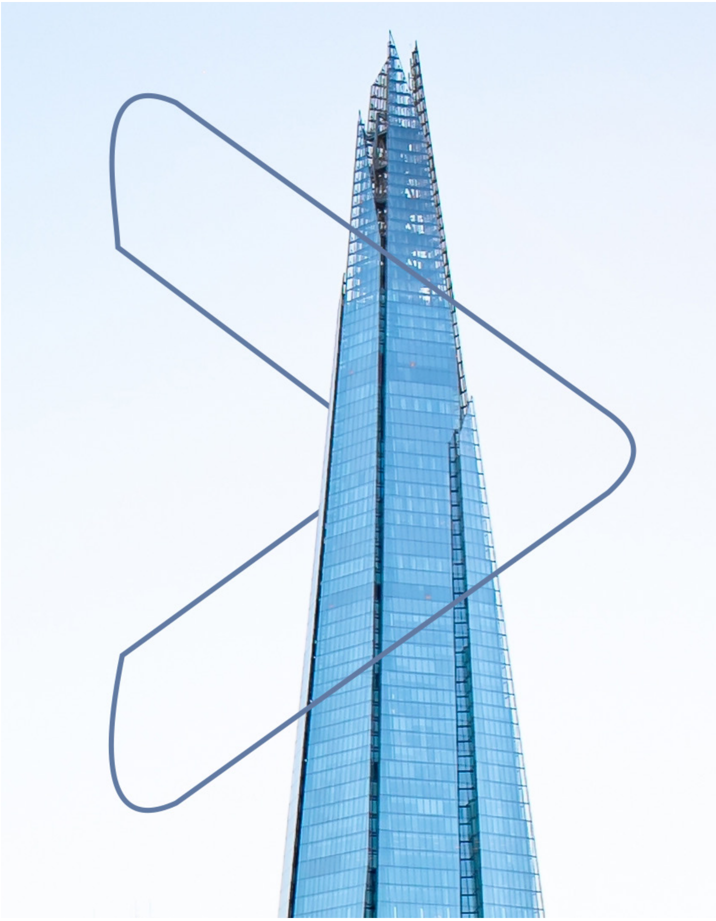
INSIGHTS



NOVEMBER 2024

VALIDUS

DURABLE RISK MANAGEMENT

HOW PRIVATE MARKETS ARE NAVIGATING NEW RISK LANDSCAPES

EXECUTIVE SUMMARY

The past two years have seen private markets firms adapt to and innovate through what has been a historically challenging period for the industry.

Managers have addressed fundraising challenges: by tapping into new regional markets and widening the net of investor types – with conversations around retail and private wealth channels picking up momentum. Flexible fund structures, such as open-ended or semi-liquid vehicles, have gained popularity to meet intensifying demands for liquidity. Asset classes such as credit and secondaries have experience unprecedented growth, enabling a semblance of deal flow in what has been an otherwise muted transaction landscape.

And there are many more shifts underway – each bringing with it a wide range of risks to consider, particularly when set against the backdrop of macro-economic shifts such as interest rate volatility, inflation, global geopolitical escalations and uncertainty around policy outcomes from the 2024 US election.

This report, produced in partnership by Private Equity Wire and Validus Risk Management, explores the wide range of risk considerations that the current macro-economic landscape poses for managers, including: the impact of interest rate fluctuations on buyout and credit portfolios respectively; the FX risk that emerges when diversifying LP bases by region; the comparative liquidity profiles of different fund structures; and the role being played by technology in mitigating the ever-evolving risk landscape.

In section one, senior market experts from Validus walk us through each of the above in detail – offering insight into effective hedging and risk management strategies for each. In section two, we hear from Joanna Shing, Treasurer at Oaktree Capital Management – on how her firm is addressing the current blend of risks facing its portfolio.

Also featured in this report is data gathered via Private Equity Wire's Q3 GP Survey, with 120+ fund managers giving us their insight into key risks and challenges currently on their radar.

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THE RISK LANDSCAPE

Bryan Cohen and Alain Smith of Validus dive deep into how interest rate and FX risks impact liquidity management for private capital funds and what makes an effective hedging programme.

In an ever-evolving macro risk landscape, the current blend of concerns is largely event-driven – from uncertainty around the US election to escalating geopolitical volatility, with some lingering effects of pandemic-related economic shifts.

“The outcome of the election not only has a direct bearing on policy, but also a knock-on effect on how the US is perceived as a dominant player in global financial markets,” says Bryan Cohen, Head of North American Client Coverage at Validus.

For private market fund managers, such a shift could represent currency volatility, in addition to inflation, interest rate changes, and a number of other influences that need to be factored into their risk modelling. Our survey revealed that recession, geopolitical volatility, and interest rate uncertainty were the three risks for managers when it comes to their portfolios, with nearly half (44%) expecting these to intensify over the next 6-12 months.

This is in addition to concerns around managing a backlog of assets on the books post-pandemic, which have been hard to exit due to high costs of debt, nervy investor sentiment, and a consequently hamstrung deal landscape. Firms need to assess what event risks and macro shifts will mean for funds and assets approaching end-of-life.

INTEREST RATE RISK

Cohen says: “Term interest rates have been volatile over the past year as markets digest data and monetary policy implications, with the yield curve consistently inverted through 2024. Specifically for private equity funds, infrastructure funds, and project finance players, this has prompted a re-evaluation of financing costs for deals – as new transactions get done and existing deals remain on the books for longer than expected. We’re seeing quite active, dynamic management and hedging of interest rate exposures as a result.”

Alain Smith, Validus’s Head of UK Client Engagement notes a similar trend, highlighting the strategic opportunities available for PE firms: “In the leveraged buyout space, managers who hedged assets during the previously ultra-low rate environment are now sitting on hedges that are far in-the-money. Considerations must be given to the expiry of such hedges in relation to any potential refinancings, and whether restructuring those hedges now and bringing forward the payout can be beneficial, for example, to improve the fund’s DPI or the underlying assets’ liquidity. For more recent deals that were hedged using caps or not hedged at all, there may be opportunities to hedge at better rates than originally factored into models. We’re seeing plenty of activity from an interest rate hedging perspective – both on new and existing deals.”

Credit spotlight

One asset class not mentioned above is private credit – the private markets segment that has ridden a wave of elevated interest rates to establish itself firmly in the global spotlight. Major global institutional investors have upped their allocations to private credit in recent years, pushing many PE houses to launch or reinforce their lending strategies.

When it comes to lending, the risk landscape has certain unique considerations. Cohen says: “For every other asset class, whether that’s buyout, infrastructure, or real estate, among others, interest rate considerations relate mainly to leverage on assets. Credit is the only one with direct rate exposure.

"This is more of a feature than a bug – especially as the asset class continues to evolve. Investors are often looking for a floating rate risk profile, while private credit as a product differentiates itself by offering more flexibility to borrowers than banks when it comes to the speed and conditions of lending, among other features. There is notable variety in the types of credit funds – from direct lenders to more hybrid, opportunistic lenders. The upshot is that credit funds can have complicated risk profiles, which may need to be managed at the back end."

This is further complicated if managers adjust their strategies in line with the interest rate environment. Smith says: "With rates on a downward trajectory, converting floating rate loans to fixed rates is an increasingly suitable solution – for borrowers and private credit funds alike. We're seeing more of these conversations emerge. That said, many of these funds have been marketed to LPs as floating rate vehicles – so managers will need to assess the viability of interest rate hedging, to lend at fixed rates and then swap into floating to match what has been promised to LPs."

As the world of credit grows more customised, Cohen notes that managers at the more sophisticated end of the spectrum are already building elaborate hedging strategies to allow even more flexible terms for borrowers while preserving the return profile investors are expecting.

FX RISK

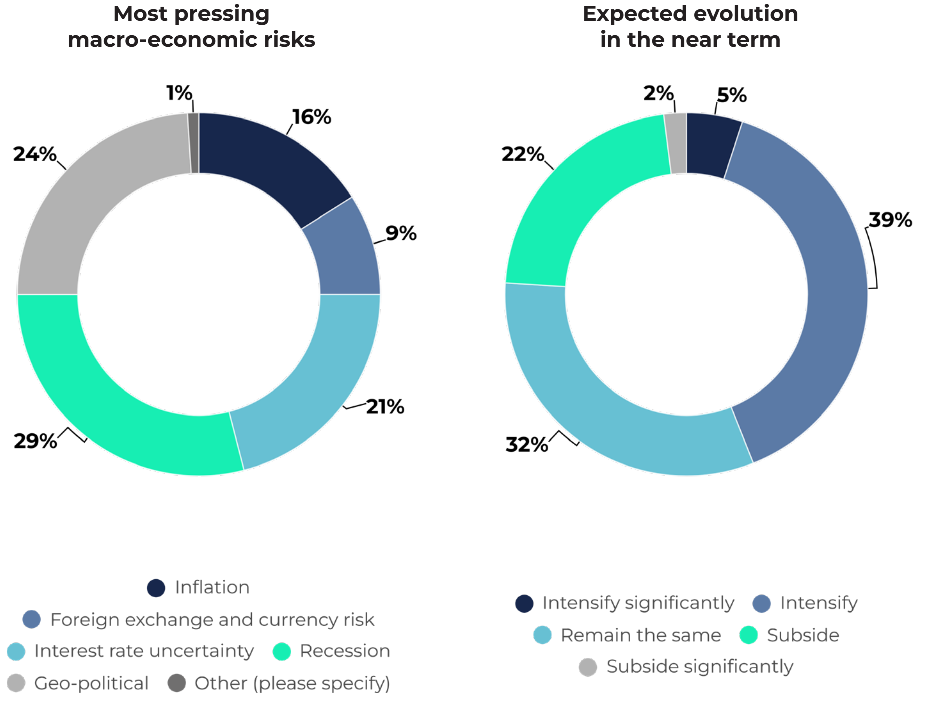
Fundraising has been notoriously challenging over the past few years. Indeed, 47% of our survey respondents said fundraising was the stage of the transaction lifecycle most threatened by the macro-economic risk landscape, followed by asset harvesting (20%) and fund/portfolio management (16%). Megafunds with firmly established track records, or highly specialised, alpha-generating strategies have been able to catch investor intention, but some mid-market managers have struggled.

A common strategy for many firms pressed for allocations has been to diversify their LP base – by type, as has been the case for 35% of our survey respondents, and by region, cited by 28%.

Smith says: "To accommodate diversification by region, many firms choose to establish multi-currency vehicles – a trend that we've certainly seen gaining pace throughout the course of 2024."

And while multi-currency vehicles help to mitigate fundraising challenges, by allowing LPs to invest and harvest in their own currencies, Cohen says they bring their own share of risks: "Managers are now offering to deliver returns in a currency that doesn't align with the underlying currency of their core fund. It's more risk than a traditional fund, with the entire non-functional vehicle exposed to FX risk. Luckily, there are established solutions to deal with this, usually by applying custom hedging programs to such vehicles."

Figure 1 The risk landscape



Source: Private Equity Wire GP Survey Q3 2024

Respondents were asked,
- 'Which of the following market forces poses the biggest risk to your portfolio? (Pick any two)'
- 'In the next 6-12 months, the above financial risks will:'

KEY FINDINGS

Diversification drive

Share of fund managers that have diversified their LP base:

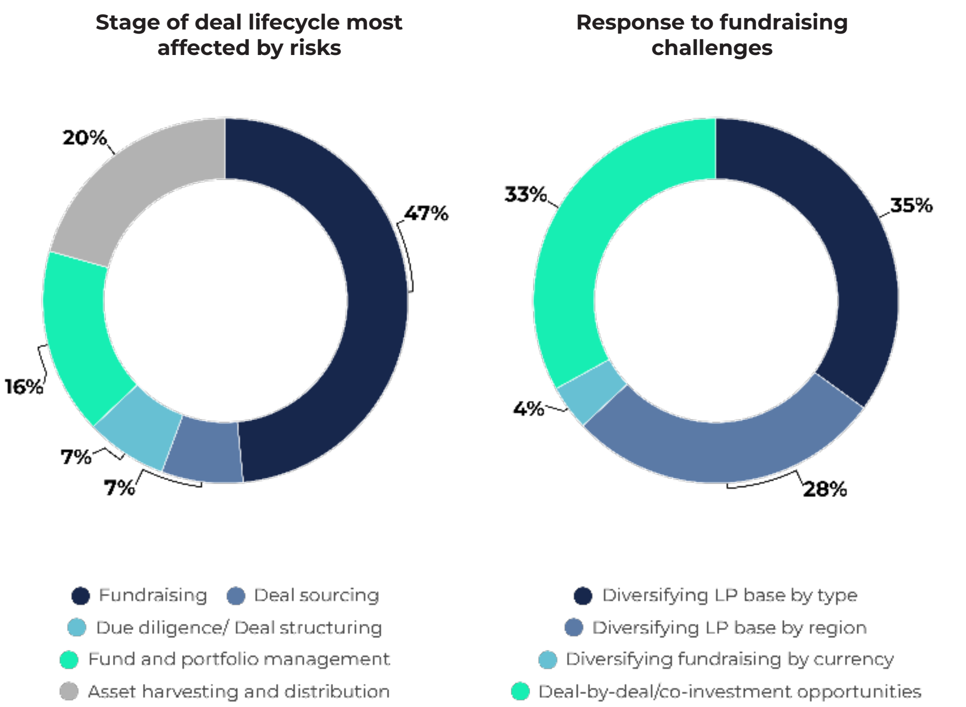
By type

35%

By region

28%

Figure 2 The fundraising landscape



Source: Private Equity Wire GP Survey Q3 2024

Respondents were asked,
- 'Which stage of the fund lifecycle is most affected by the above financial risks?'
- 'During the fundraising challenges of the last 18-24 months, which of the following strategies has your firm employed? (Select all that apply)'

For Smith, education and communication are crucial to manage LP participation in these fund structures. "Multi-currency sleeves drive economics for LPs – impacting how preferred returns and carry are calculated, as much of that is often done on a post-hedging, currency basis. For managers, the goal of hedging is to eliminate the variables – or the noise, per se – allowing them to focus on delivering to LPs."

"This varies from one asset class to the next – in a real asset fund, for instance, there may be uncertainty around holding periods and how the FX hedging impact ('carry') will look in the future, and as such hedging strategies must be adapted to work with a higher degree of unknown variables; while in a credit fund with more predictable cash flows, hedging may seem simpler. However, cost is a more important factor given lower return profiles in this asset class generally, and liquidity risk – which can create severe issues for a closed-ended fund, is often overlooked. The bottom line for managers is to adopt best practice, which can differ for a given investment strategy, fund structure, and LP considerations."

Allowing for multi-currency vehicles also increases the operational burden on the GP side – portfolio managers or investment officers that are used to accounting based on one currency, now have to factor in multiple denominations. "Firms need to have the internal capacity and infrastructure to manage these relationships, while external education for the LP community is also key," says Smith.

LIQUIDITY RISK

The asset logjam prevalent in private equity has put liquidity in sharp focus: for LPs, that demanded redemptions in the absence of deal activity; as well as GPs, who were being pressed for distributions and had to maintain liquidity across their portfolio.

According to Cohen, managers have three options when it comes to managing the liquidity risk associated with hedging programs. The first is to optimise their fund operations and risk management – closely monitoring cashflows and performance, and making tweaks to hedging programmes and counterparty terms where necessary. Much of this has been explored above.

The other two options at managers' disposal are: flexible fund structures such as semi-liquid or open-ended funds; or a suite of fund financing solutions.

Fund structures

Open-ended or semi-liquid fund structures are being widely explored in private markets – not only as a means to attract more LP capital on the promise of higher liquidity, but also to attract a wider variety of investor, particularly through private wealth channels.

The headline risk commonly associated with these funds is the duality of managing a book of illiquid assets, while allowing for regular redemptions and a flow of liquidity to and from the fund. According to Smith and Cohen, this is not the most informed view of these funds – and here, too, further education is of the essence.

Smith says: "It's true that managers need to have a stringent gating mechanism in place, and a clear plan of action if certain assets start underperforming – leading to mass redemptions and, consequently, a liquidity crunch."

Cohen contrasts this risk to the public markets, where shares can be sold at the drop of a hat when investors demand liquidity. But there is far more nuance to unpack in this space, with strict mechanisms and practices pushing GPs to act in the best interest of the fund.

Smith says: "In truth, many evergreen and open-ended funds actually have a superior liquidity profile than traditional, flagship funds in certain ways. LP commitments are taken up front, and gating mechanisms are set up to carefully manage LP withdrawals to prevent a 'run' on the fund.

"Many retail funds are pre-funded by investors and, particularly for larger managers, the assets being purchased through these open-ended structures are the same that go into closed-ended, flagship funds.

"Typically for traditional funds, the assets are initially bought using a subscription line, which is bridging the liquidity to the LP drawdown, whereas the retail strategy is pre-funded with cash up front. If something were to go materially wrong, with either the manager or the asset, the former has a much bigger liquidity risk than the latter – an interesting quirk that has come up as the market has evolved."

Fund financing

The third strategy for heading off liquidity risk is to approach lenders – to pay out investors amid longer holding periods through NAV financing, or to actively hedge and manage interest rate and FX risk.

According to Smith, fund finance liquidity was strained in the wake of the SVB and Credit Suisse market events last year, while dried up M&A activity saw lower returns for banks that were putting a substantial balance sheet out in the subscription line market. To make these up, banks have made a big push into the FX market as a source of ancillary revenue.

He says: "Managers have had to adapt in the past 12 to 18 months to have data on hand around how much FX wallet has been allocated to each bank and the value of these ancillary revenues, as banks have grown more demanding in that regard."

But fund financing remains a tremendous opportunity for managers, and Cohen suggests it runs hand-in-hand with fund-level risk management and hedging: "How you finance a business – whether a portfolio company, an infrastructure project, or a fund – is going to have an impact on its overall risk profile. The currency used for financing, and whether that differs from the underlying asset or fund, all has an impact. For example, a global company that has EBITDA in multiple currencies will create more risk by borrowing just dollars. With that in mind, a financing strategy should be wedded to a risk management strategy."

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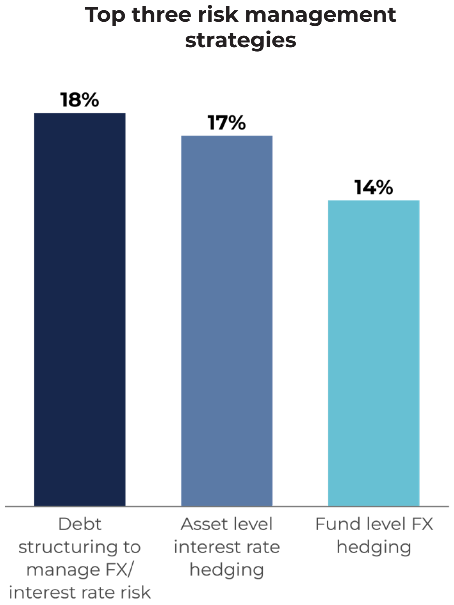
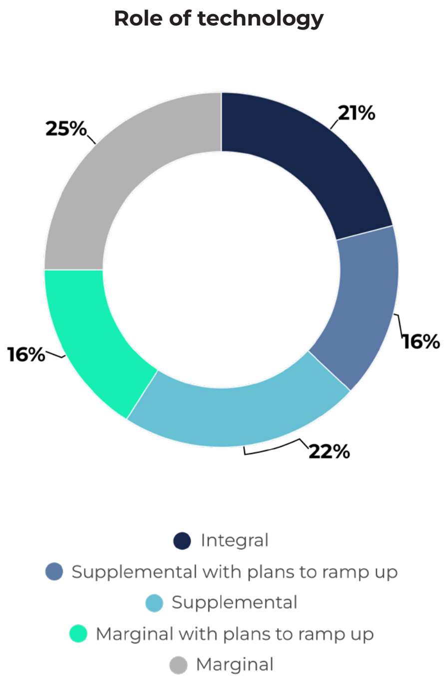
> **An effective hedging strategy will mean something different to everyone, and it boils down to balancing costs with risk management.**

Figure 3 Risk management strategies





Source: Private Equity Wire GP Survey Q3 2024

Respondents were asked,
- 'Which of the following risk management strategies does your firm employ? (Select all that apply)'
- 'What role does technology play in your firm's financial risk management strategies?'

EFFECTIVE MANAGEMENT

With a world of risks to consider, what constitutes an effective hedging and risk management strategy?

Cohen says: "An effective hedging strategy will mean something different to everyone, and it boils down to balancing risk/reward, by comparing the benefit (or even necessity) of risk reduction to the cost of doing so. The perfect hedging policy, which eliminates all risk exposure, can be expensive and create liquidity drains for the fund. Conversely, a liquidity-friendly, cost-light solution could prove ineffective from a risk standpoint. A hedging programme will therefore always have to be customised to be effective.

Tech support

One thing is clear, risk management for today's private markets firm is a minefield of operational complexity, and technology has tremendous value to add to the process. Per our survey, over a fifth (21%) of managers say tech plays an integral role in their risk management efforts, while 16% say it plays a supporting role with plans to ramp up.

Use cases vary significantly. Cohen breaks tech-based risk management into two themes: data management and exposure monitoring; and process management around the proper and secure execution of various investment strategies.

"The majority of our clients are farther along the adoption of the latter, process management tools. But there is significant variety by firm size and type – the larger the firm, the more sophisticated and complex their risk management needs are."

The one common feature of most efforts in this space, both Cohen and Smith report, is a focus on scalability. Smith says: "Most managers are of the view that day-to-day risks can be plugged and monitored with Excel and other tools. What they really want from us is the infrastructure to enable a consistent level of process management and risk monitoring as their firm AUM expands, fund structures grow more complex, and a host of new risks emerge as a result of global events.

THE MANAGER PERSPECTIVE

A rapid-fire Q&A with Joanna Shing, Treasurer, Oaktree Capital Management

JOANNA SHING

Treasurer
Oaktree Capital Management

What would you classify as the biggest risk affecting the PE landscape over the next two quarters?

From my seat as the Treasurer at Oaktree, it's an exciting time to be in alternative investments due to our market's growth and innovation. The growth introduces complexity and I think the biggest risk is ensuring we can continue to deliver high quality service to our clients and internal stakeholders. We have been focused on investing in technology to streamline our workflows and automate routine tasks to mitigate risk and increase operational leverage.

Describe the ways in which your firm has been hedging against interest rate and currency volatility

Oaktree has a dedicated team focused on hedging interest rate and currency risks for our funds. Because we do not base investment decisions on macro forecasts, our hedging objectives are to mitigate risk as efficiently as possible.

How has your firm managed liquidity at the fund level amid a challenging deal landscape and intensifying investor demands?

Oaktree maintains strong relationships with banks that partner with us on fund financing transactions. This has been crucial in managing liquidity for our funds this year.

Describe the ways in which you use technology across your risk management strategy

From a Treasury perspective, access to reliable and easily accessible information is key to managing risk effectively. We adopt a manage-by-exception approach and leverage technology to flag potential risks, allowing us to proactively address issues.

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KEY TAKEAWAYS

1. Interest rate hedging

For buyout strategies, interest rate fluctuations offer the opportunity to revisit hedging strategies and optimise strategies to manage interest cost volatility and visibility. Credit funds have direct rate exposure, requiring a more sophisticated hedging strategy – with opportunities around more complex financing solutions amid a declining rate environment, although this does bring complications from an LP standpoint.

2. FX hedging

Multi-currency sleeves and funds bring FX exposure for the master and feeder funds, and impact return calculations. An effective FX hedging policy is key, while communication and education for investors is critical – not only do LP economics change, but investing in multi-currency vehicles also increases the operational burden for managers.

3. Liquidity management

Open-ended and semi-liquid fund structures provide LPs with differentiated liquidity solutions, although require deeper analysis to better understand nuances of stringent gating mechanisms for investor withdrawals. Fund financing is a readily available pool of liquidity for managers, though lenders are demanding more information around FX wallet allocations. Managing liquidity needs generated by hedging programs remains a focus, especially with extending asset hold periods.

4. An effective policy

Every fund will have a different risk management strategy – striking a balance between necessary hedges and mechanisms, and the cost of mitigation. Technology can play a crucial role in optimising these processes, and tip the balance in favour of mitigation while allowing funds to meet other cost and liquidity goals. Adoption continues to grow, though private markets require a nimble approach as fund structures and LP preferences evolve.

ABOUT VALIDUS RISK MANAGEMENT

Independent specialists in market risk

We provide market risk and capital markets solutions to institutional investors and fund managers with a focus on alternative, private and illiquid assets. Since 2010, we have been delivering hedging services and technology designed for the specific needs of this market, helping many of the world's leading private capital managers to mitigate market risks from their exposure to foreign currencies, interest rates and inflation.

Our award-winning service includes turnkey solutions to the operational challenge of implementing, managing and monitoring hedging programmes, and leverages our proprietary Horizon technology platform. Our trading desk executes more than $520 billion in hedging trades per year, processing more than 7,500 derivatives trades per month.

Our fund finance advisory services allow our clients to benefit from our unique position in the market to enhance fund performance and maximise investor returns through the intelligent structuring and benchmarking of alternative capital market solutions. With offices in London, New York, Toronto, Eton and Oslo we work with some of the largest institutional investors in the world who manage more than $2 trillion in combined assets under management.

For more information, visit: www.validusrm.com

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