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PREQIN'S HOUSE VIEW: COVID-19'S IMPACT ON ALTERNATIVE ASSETS

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About the Preqin House View

In this publication we analyze how COVID-19 is affecting six alternative asset classes, and offer our perspective on how the industry might evolve.

For more analysis and insights on the impact of the pandemic on alternative assets, please visit our COVID-19 Knowledge Hub.

Download the data pack for this report.

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Foreword

In Preqin's Alternatives in 2020 report back in January, I observed that – despite significant caution driven by the long bull run and high asset valuations, and a sense that a correction was on the cards – investors were 'sticking with the program,' and continuing to allocate increasing proportions of their programs to alternative assets. Meanwhile, fund managers were continuing their work of searching for value and opportunity in a challenging environment for returns. I pointed out that investors recognized that alternatives have a strong record of delivering superior returns through the cycle, in bad times as well as good times.

Then along came COVID-19.

How has this changed the outlook for alternative assets? What will the impact on the industry be? How is the industry likely to adapt and evolve over the short, medium, and long term?

A dispassionate and logical analysis based on previous crises like the dot-com crash in 2001 and the 2008-2009 Global Financial Crisis would suggest three likely outcomes:

- A significant short-term slowdown in all activities – fundraising, deals, and exits – as liquidity reduces and market participants pause to take stock of the 'new normal';
- A medium-term resumption of the established growth trend: alternative assets have delivered good relative returns through previous market downturns and will do so again;
- Some of the very best investments will be those made during the depths of the downturn and the recovery from it; the significant stockpiles of dry powder that fund managers have built up will be put to good work and, as a result, 2019-2022 vintage funds are likely to stand out as top performers.

That's the theory; how are things evolving in practice?

To answer these questions, Preqin surveyed nearly 300 LPs and GPs in April 2020. We asked them how they view the current situation, how they are adapting to it, and what this means for future allocations and commitments. Here's a brief summary of the results:

- LPs and GPs alike recognize that returns on their existing portfolios will be reduced as a result of the impact of COVID-19. However, they are not reducing targeted returns for new investments (i.e., there will be attractive investments to be made);
- Fund commitments will slow in 2020. The reasons for this include the difficulty of completing assessment and due diligence without face-to-face meetings, and the 'Denominator Effect 2.0' as the rest of the portfolio is revalued downwards;
- LPs are bullish about their medium- to long-term plans, with a continued trend toward higher allocations (and if anything, they consider COVID-19 more likely to accelerate this trend than to slow it down);
- LPs and GPs are actively considering which sectors and industries are most attractive in the new environment (healthcare, logistics, software, distressed debt), and which are less attractive (retail, retail real estate, energy);
- LPs and GPs alike are confident that alternative assets will adapt to COVID-19 and will emerge stronger from it.

Mark O'Hare
CEO, Preqin

In other words, yes there is a major short-term impact, but LPs and GPs are thinking long term and continuing to invest in alternative assets.

As ever, Preqin is continuing to serve our customers and the industry – in fact, we are increasing our investments in new data and new services for our customers.

With best wishes for your continued success – and above all, for your health and safety and that of your loved ones.

In Brief

All asset classes are affected by the pandemic, Preqin data shows. Here's what we expect to see going forward

COVID-19 is affecting all six alternative asset classes we track: private equity (including venture capital), private debt, hedge funds, private real estate, infrastructure, and natural resources.

We see emerging evidence of the impact of COVID-19 in the results of our multi-asset fund manager and institutional investor survey. Fifty-five percent of fund managers we surveyed in April 2020 told us their fundraising process had slowed due to COVID-19's impact, though just 1% chose to abandon their fundraising efforts. Overall, the largest proportions of managers that responded to the survey said that COVID-19 had negatively affected fundraising from potential investors (69%), operations at portfolio companies (61%), and deal origination (59%).

Meanwhile, 59% of surveyed investors said that the number of commitments they plan to make to alternatives in 2020 has "slightly" or "significantly" decreased. Just 9% of investors said they are planning to increase commitments. That said, looking beyond 2020, investors plan to stay the course: 63% said they see no change to their future alternative investments strategy as a result of COVID-19. And 29% said they plan to invest more in alternatives.

We are starting to see evidence of COVID-19's impact on alternatives in **Preqin Pro** data. In this publication, we summarize our main findings. In Part 1, 'What We Saw in Q1 2020,' we take stock of key developments across all six alternative asset classes. In Part 2, 'What We Expect to See Going Forward,' we draw inferences from our data to suggest how the market could respond in future.

What We Saw in Q1 2020

Private Equity

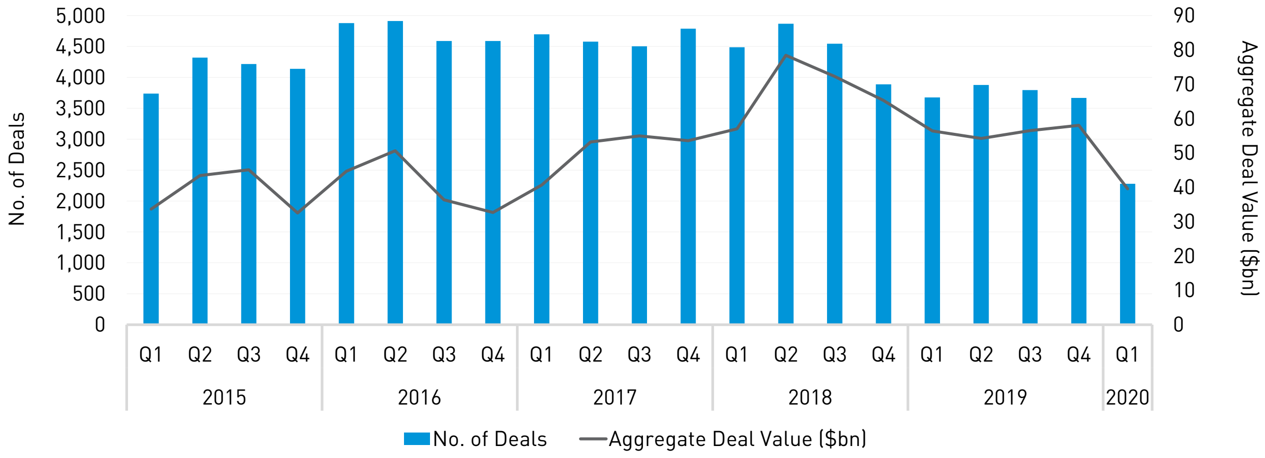
Fewer private equity funds reached a final close in Q1 2020. A total of 267 funds closed, marking a 27% drop vs. Q1 2019. But the total amount of capital raised was significant: at $133bn, it surpassed the Q1 2019 figure of $119bn by almost 12%. Large funds helped to boost the total amount collected. For instance, in January 2020 Lexington Capital Partners IX closed on $14bn, continuing an industry megatrend we noted in our 2020 Preqin Global Private Equity & Venture Capital Report – **large funds from more established fund managers are securing considerable capital commitments.**

On the deals front, fewer transactions were completed as managers held off on M&A activity, anticipating that asset prices would fall amid a global recession. The impact is most clearly seen in venture capital data. Globally, in Q1 2020 the number of **venture capital deals dropped by 23% vs. Q1 2019**, falling to 2,851 (Fig. 1). And there were nearly 1,000 fewer deals completed since Q4 2019. The drop-off in the number of deals could reflect the disruptions to typical due diligence amid a lockdown – for a start, fund managers were unable to have face-to-face meetings with start-up founders because of social distancing.

Aggregate venture capital deal value slipped by 12% to $50bn when comparing Q1 2020 with Q1 2019, while the drop from Q4 2019 was 18%. By region, the Greater China (GC) market was hit the hardest, though local fund managers said they expected deal activity to pick up in the third quarter of the year as the number of new coronavirus cases in the GC region continued to fall.

In **buyouts**, the number of **deals in Q1 2020 fell 12% compared to Q1 2019**, down to 1,211. And the value of buyout deals completed in Q1 2020 was $94bn, vs. $113bn in Q1 2019. A key issue for fund managers is how to value portfolio companies and potential targets at a time when many businesses are seeing declining revenue as a result of the global economic hiatus. That also makes sourcing debt capital difficult.

Fig. 1: Global Quarterly Venture Capital Deals*, Q1 2015 - Q1 2020



Source: Preqin Pro

*Figures exclude add-ons, mergers, grants, secondary stock purchases, and venture debt.

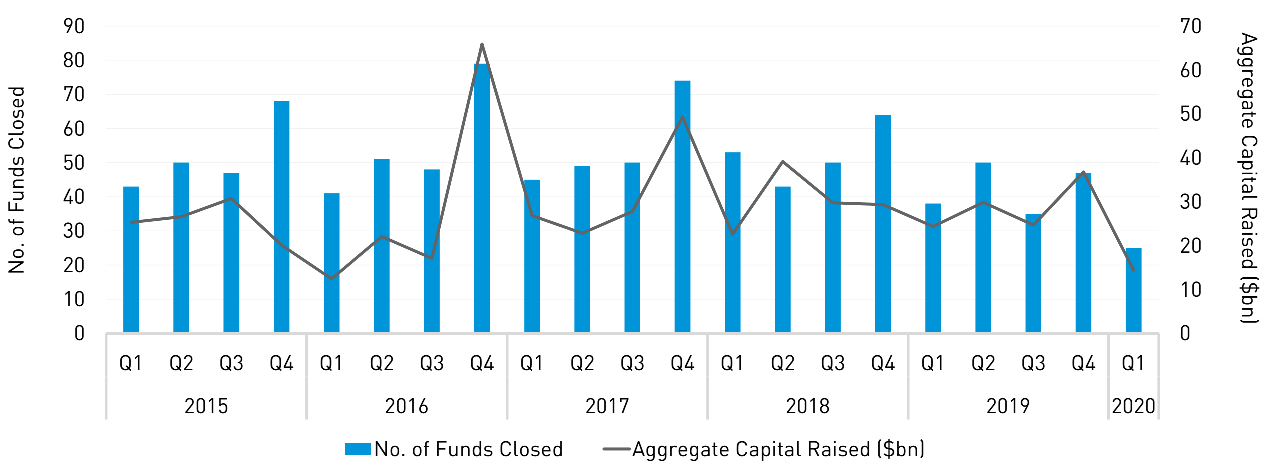
Private Debt

Fundraising slumped in Q1 2020. Just 25 funds closed for an aggregate $14bn in capital raised, which is a 41% drop from Q1 2019, when 38 funds secured $24bn (Fig. 2). Q1 2020's total is also the lowest amount raised since Q3 2016.

In terms of strategy, **direct lending continued to dominate the market** with eight funds closed and $9.4bn raised, the highest amount of any fund type.

Special situations funds, which could benefit in a recessionary environment, accounted for over 20% of total private debt fundraising, up from 17% in Q1 2019. Three special situations funds closed, amassing a total of $3.2bn. These include the $1.8bn AG Credit Solutions Fund, managed by New York-based alternative investment manager Angelo, Gordon & Co.

Fig. 2: Global Quarterly Private Debt Fundraising, Q1 2015 - Q1 2020



Source: Preqin Pro

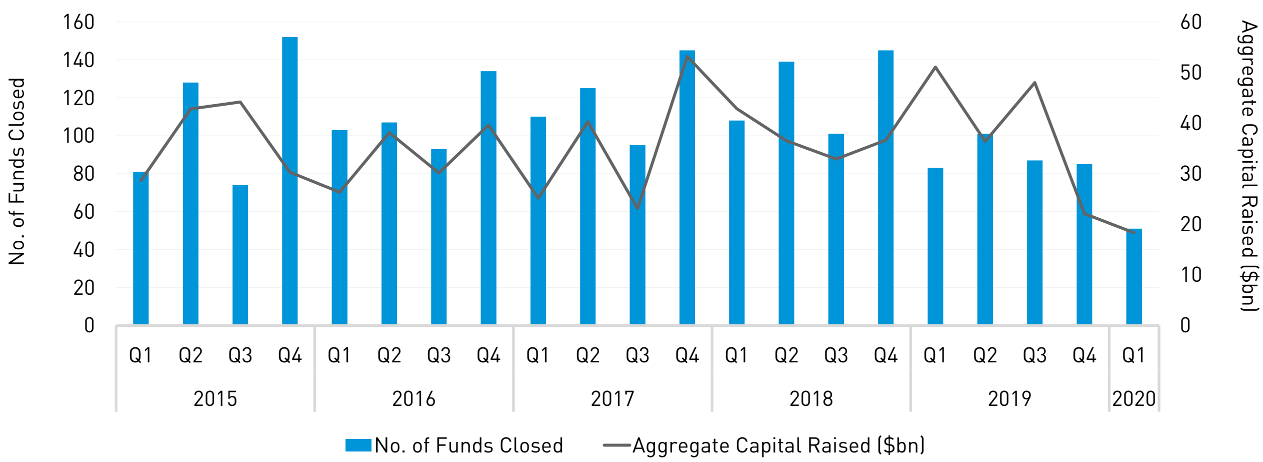
Real Estate

Private real estate **fundraising fell in Q1 2020**. Managers raised $18bn from 51 funds closed, vs. $51bn raised from 83 funds closed in Q1 2019 (Fig. 3). Investors directed their capital toward funds managed by larger, more established GPs, a megatrend we highlighted in the 2020 Preqin Global Real Estate Report. An example of such a fund is Westbrook Real Estate Fund XI, managed by US-based Westbrook Partners, a value-added real estate fund which closed at $2.5bn in February 2020.

In terms of strategy, **opportunistic real estate funds** – which offer higher reward at higher risk – **raised significantly less capital** compared with the same period last year. Opportunistic funds collected $0.9bn, which is sharply down from $22bn in Q1 2019, but it's important to note that the $22bn figure was boosted by the closing of the $15bn Brookfield Strategic Real Estate Partners III in January 2019. Excluding this fund, the drop in the total amount secured by opportunistic funds is 88%. That suggests investors may be taking a more cautious stance. It also marks a reversal from a trend we noted in the 2020 Preqin Global Real Estate Report: in 2019, aggregate capital raised by opportunistic funds surged by 38% to almost $70bn.

On the deals front, **activity declined across all property sectors and regions** in Q1 2020. In total, 1,797 private equity real estate (PERE) deals were completed globally for an aggregate value of $73bn. This compares with 2,417 deals for a combined value of $101bn in Q1 2019. Retail real estate recorded 276 deals completed in Q1 2020, vs. 299 deals in Q1 2019. This reflects the challenging economics for bricks-and-mortar retail stores as online sales continue to grow their market share, a trend that has accelerated as a result of the lockdown in effect across cities around the world.

Fig. 3: Global Quarterly Closed-End Private Real Estate Fundraising, Q1 2015 - Q1 2020



Source: Preqin Pro

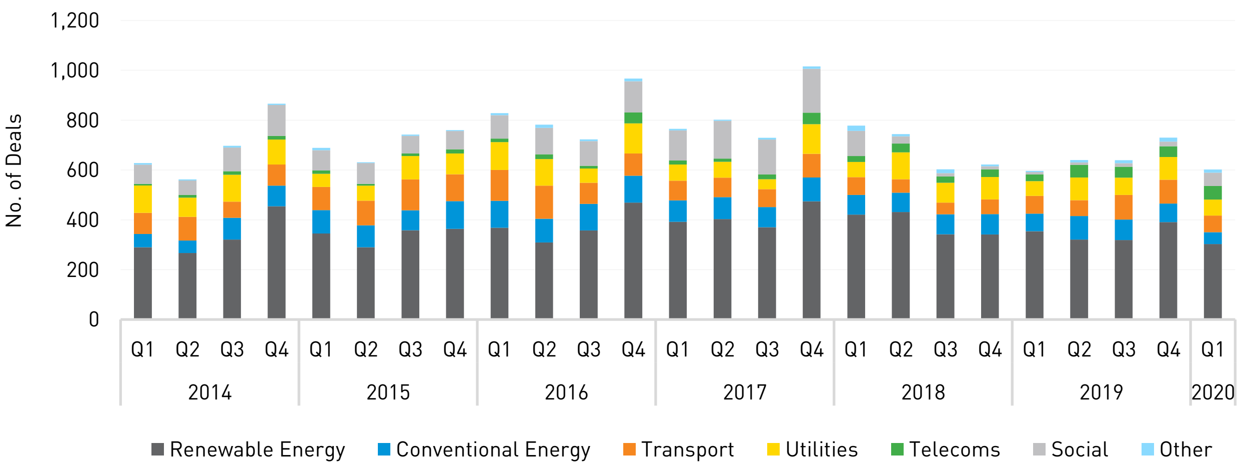
Real Assets

Across both unlisted infrastructure and natural resources, **the number of funds closed fell**. In infrastructure, 17 funds closed in Q1 2020, compared with 24 in Q1 2019. In natural resources 22 funds closed, vs. 36 in Q1 2019. That said, both asset classes secured more capital. Infrastructure funds raised $38bn, a 46% increase, while natural resources funds raised $44bn, a 52% increase. In both cases this was supported by the closing of a mega fund: North America-focused Brookfield Infrastructure Fund IV, which amassed $20bn.

On the **infrastructure deals** front, the **volume of transactions was in line** with the number recorded in Q1 2019. Six-hundred and three transactions were completed in Q1 2020, a slight increase from the 596 deals completed in the same period last year. Meanwhile, aggregate deal value rose by about 14% to $79bn.

We noted a shift in the types of assets being funded: the **energy** sector, traditionally one of the most active sectors, observed a **slowdown in deal activity**. The number of renewable energy deals dipped from 354 to 303, while the number of conventional energy deals slid from 71 to 47 (Fig. 4). In contrast, the **telecoms** and **social infrastructure** sectors registered an **increase in the number of deals** compared with Q1 2019. The number of telecoms deals rose from 27 to 55 as demand for digital connectivity continues to rise, a trend that is accelerating during the global lockdown. And the number of social infrastructure deals jumped from 10 to 53, supported by growing demand for healthcare facilities.

Fig. 4: Global Quarterly Infrastructure Deals by Industry, Q1 2014 - Q1 2020



Source: Preqin Pro

Secondaries

The global secondary market is almost 5x the size it was back in 2008, when the Global Financial Crisis (GFC) was starting to ramp up. **Industry assets stand at a record $274bn** as of September 2019, the latest available data, compared with $55bn in 2008. Large secondaries funds that closed in recent months include Lexington Partners IX, which amassed $14bn in January 2020. The closure of this fund drove aggregate secondaries fundraising in Q1 2020 to almost $20bn, close to 2019's annual total of $21bn.

Hedge Funds

The Preqin All-Strategies Hedge Fund benchmark **generated a loss of 10.38% in Q1 2020**, all but erasing the annual gain of 10.97% made in 2019 (Fig. 5). But given that the S&P 500 Index fell by 20.00% in the first quarter of this year, hedge funds performed better than traditional stock market funds.

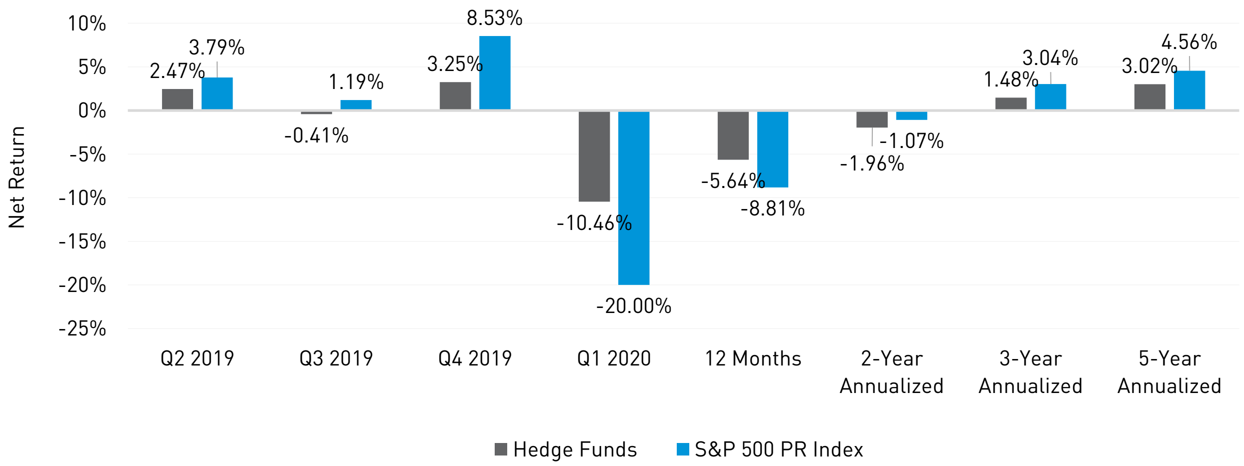
Two strategies were especially hard hit. **Equity-focused hedge** funds fell in February and March as global equity markets plunged. **Long bias funds** underperformed, losing 22.59% in the first quarter of 2020. **Merger arbitrage funds** have been affected as deals are put on hold, losing 8.21% in Q1 2020. Fixed income arbitrage funds typically help investors to defend their portfolios when equity markets are falling, but the strategy is down 7.57% in Q1 2020 as price relationships deviate from historical patterns.

Two strategies performed better than the rest. **CTAs** – which offer a defensive strategy typically uncorrelated to public markets – were the best performing top-level hedge fund strategy in Q1 2020, and the only one to make gains. A March return of +2.76% drove the benchmark to +2.15% for Q1 2020. Strategies that are less correlated to traditional markets, such as **macro strategies**, typically have significantly lower drawdowns than equity hedge funds. Macro strategies were underwater in Q1 2020 but managed to limit their losses. With a return of -3.35%, they were the second-best performing strategy in the quarter.

The number of new hedge funds launched has been understandably low so far this year: just **87 funds launched in Q1 2020**. While this is an increase from 79 launches in Q4 2019, it is down by two-thirds compared with Q1 2019, when 235 new hedge funds launched. Equity strategies as a share of total fund launches fell from 48% in Q4 2019 to 32% in Q1 2020, while the proportion of macro strategies fund launches increased from 8% in the previous quarter to 10% in Q1 2020.

Heading into 2020, funds with significant government bond holdings performed well as investors flocked to safe-haven assets like US Treasuries. The market sell-off in the previous quarter presented fund managers with an opportunity to snap up assets at lower prices. Nordea Asset Management launched its Flexible Credit Fund in March specifically to focus on price discrepancies in US credit markets.

Fig. 5: Performance of Hedge Funds vs. S&P 500 PR Index*



Source: Preqin Pro

**Please note, all performance information includes preliminary data for March 2020 based upon net returns reported to Preqin in early April 2020. Although stated trends and comparisons are not expected to alter significantly, final benchmark values are subject to change.*

What We Expect to See Going Forward

The longer government-mandated lockdowns last, the more likely it is that fundraising will continue to be impacted. When surveying investors across the alternative assets industry, we asked whether travel restrictions and social distancing are affecting their ability to make new investments in 2020. Eighty-two percent said that face-to-face meetings matter: 35% called them “essential to decision-making,” while 47% called them “fairly important.” But as the market adapts to a world where all meetings are virtual, the impact of travel restrictions and social distancing on fundraising could start to diminish.

Private Equity

The level of **dry powder** in the private equity industry stands at a record **$1.48tn** as of April 2020, so firms have a huge amount of capital to put to work. About **$314bn** of that total is in **venture capital funds**.

Given the difficulty of valuing businesses at present, **venture capital financing rounds are likely to be smaller in size and take longer to complete**. The increases in valuations between financing rounds are also likely to be smaller. Investor appetite for IPOs is limited in a recession, so venture capital firms looking to monetize their investment in later-stage companies will be considering alternative exit routes.

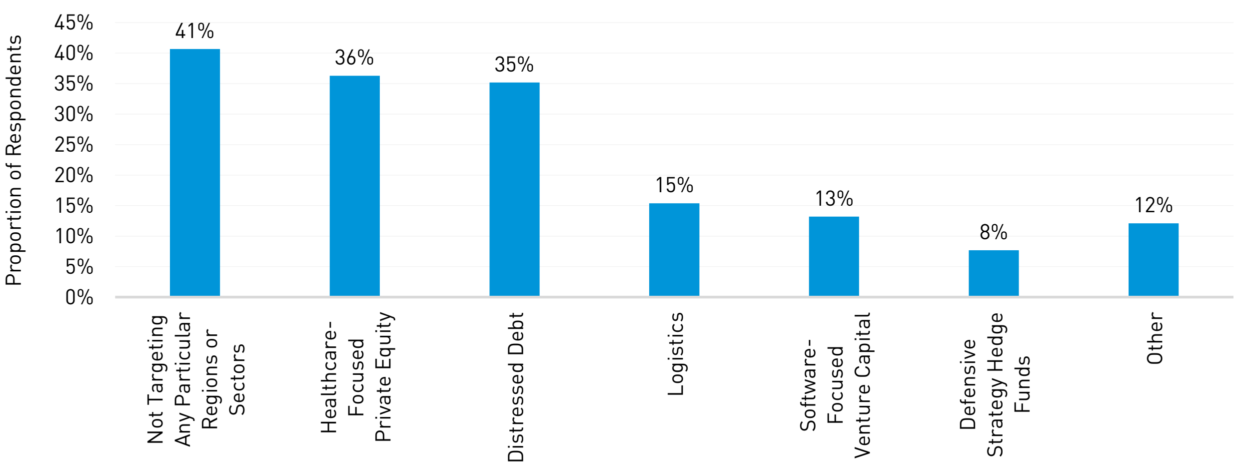
The global recession is likely to **weigh on deal-making** in the near term, particularly in sectors such as **retail**, **leisure**, and **hospitality**, which have been hit especially hard by the global lockdown. As mentioned on page 7, retail – especially brick-and-mortar stores – faces considerable headwinds as shoppers increasingly opt to buy online. This trend is accelerating at a time when in many cities, only stores deemed to offer essential services, such as pharmacies and supermarkets, remain open to the public. The impact on retail has been so significant that more than a quarter (26%) of LPs we surveyed in April 2020 said they planned to avoid retail-focused private equity this year, because of COVID-19.

Where are we likely to see more deal activity? Opportunities in non-cyclical sectors, particularly **healthcare**, are set to grow. Indeed, more than a third (36%) of investors we surveyed in April 2020 said they planned to target healthcare-focused private equity in 2020, because of COVID-19 (Fig. 6). **Healthtech** – a fast-growing industry we highlighted in our 2020 Preqin Global Private Equity & Venture Capital Report – is likely to attract more investment, with demand for telehealth solutions increasing due to social distancing. Given that healthtech is a relatively young sector, we expect a higher volume of deals in the venture capital space: in 2019, 1,000 venture capital deals were completed in healthtech, an 18% jump from 2018.

The **technology** sector is likely to benefit as **digital transformation** becomes even more business critical. In a lockdown situation where remote working is a requirement rather than an option, demand for **digital technologies** such as cloud computing services and cybersecurity is likely to soar.

What about performance? In a recent analysis, we modeled the potential effects of a recession on buyout returns. We used a Pandemic Scenario developed by US-based risk management firm FRG and applied it to the Preqin-FRG Cash Flow Forecaster, an innovative tool powered by Preqin's fund-level cash flow data. We then compared the results with a Baseline Economic Scenario in which there was no pandemic. We found that as valuations fall, 2018 and 2019 vintages – previously considered the vintages that were more likely to underperform because of the high-valuation environment in 2019 – are now more likely to outperform, given that asset prices are set to drop as a result of the global recession. That suggests **fund managers with significant amounts of financial firepower are well positioned to generate strong returns**.

Fig. 6: Sectors that Investors Plan to Target in 2020 Due to the Impact of COVID-19



Source: Preqin Investor Survey, April 2020

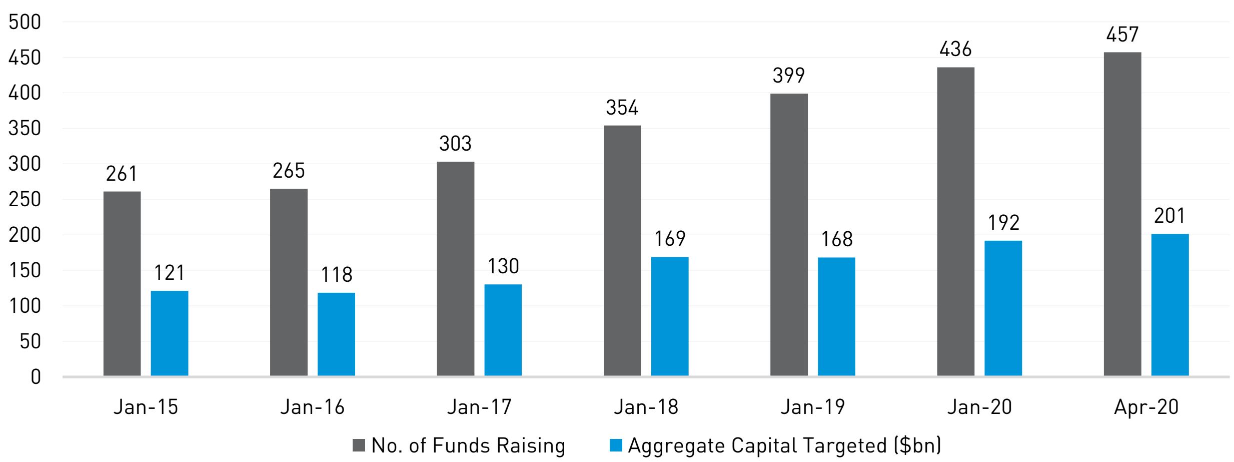
Private Debt

As of April 2020, there are 457 private debt funds in market, seeking a combined $201bn (Fig. 7). These are the highest figures ever recorded. Given that the industry is sitting on **$292bn in dry powder**, we expect deals to pick up as market participants get comfortable with valuations.

The private debt industry as we know it today took off in the wake of the 2008-2009 financial crisis. A key question for investors is how the industry will fare amid its first major test: a global recession triggered by COVID-19. As the 2020 Preqin Global Private Debt Report highlighted, the market in 2019 was characterized by intense competition and looser loan terms. Investors will be watching to see how funds exposed to covenant-lite deals perform.

According to S&P Global Ratings, a surge in defaults is likely as a result of the pandemic. The default rate on US nonfinancial corporates could rise above 10% within the next 12 months, up from 3.2% as of February 2020, the credit ratings agency said. A surge in defaults would create opportunities for distressed debt funds. In our April 2020 survey, **more than a third (35%) of investors** said they expect to target **distressed debt opportunities** in 2020 as a result of COVID-19. We expect fund managers specializing in this strategy to be **on the hunt for fresh capital**. US-based Oaktree Capital Management, a global alternatives investment firm with expertise in credit strategies, is already targeting $15bn for Oaktree Opportunities Fund XI, which would be the largest distressed debt fund ever raised.

Fig. 7: Private Debt Funds in Market over Time, 2015 - 2020



Source: Preqin Pro

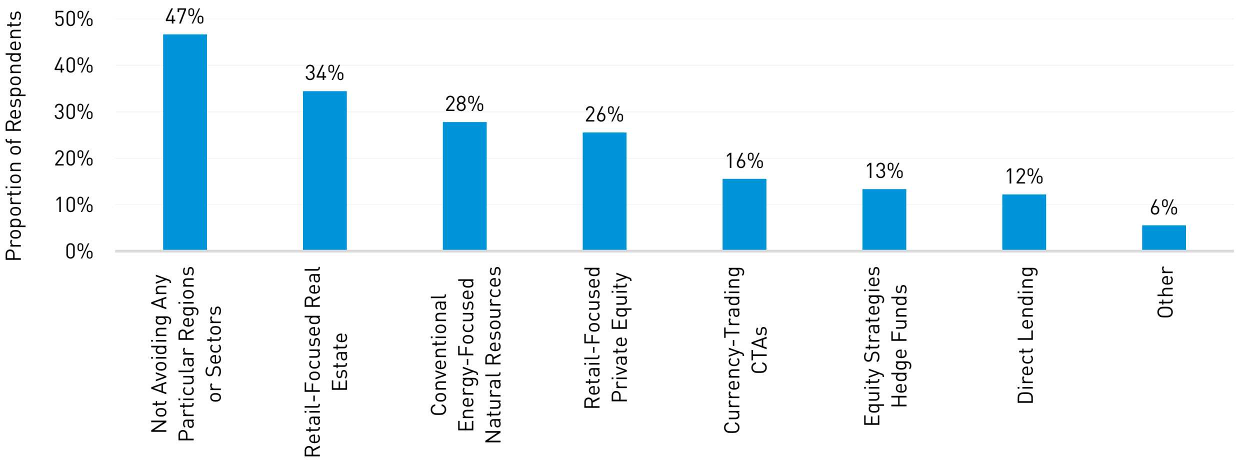
Real Estate

For real estate managers, a key risk is the loss of rental income as businesses facing reduced cash flows may no longer be able to afford their rent. This is the danger many retail tenants currently face, even more so the longer the lockdown continues. Indeed, just over a third (34%) of investors we surveyed said they plan to avoid **retail-focused real estate** in 2020, because of the impact of COVID-19 (Fig. 8). Given the current challenges, we expect **reduced deal activity** in this space.

A sector we see as likely to drive deal activity is **logistics**. Demand for logistics assets, especially last-mile distribution, has been soaring, driven by trends such as the rise in e-commerce. It will be difficult to top Blackstone's $18.7bn acquisition of Singapore-based GLP's US logistics portfolio, the largest-ever private equity real estate deal. But with **dry powder at $344bn**, and a growing need for efficient distribution systems, we expect logistics to continue to attract significant investment.

Whether they operate in the public or the private market, commercial real estate industry professionals will be studying economic relief plans to understand the potential impact on the sector. The US Government's $2tn CARES Act, for example, includes a variety of measures to help commercial as well as residential tenants with rent payments. Under the CARES Act, small businesses that qualify for forgivable loans known as paycheck protection loans or PPLs can use up to a quarter of their PPLs to cover their rent. Government support will be increasingly critical the longer the lockdown lasts.

Fig. 8: Sectors that Investors Plan to Avoid in 2020 Due to the Impact of COVID-19



Source: Preqin Investor Survey, April 2020

Real Assets

COVID-19 is having a **severe impact on short-term cash flows for toll-based infrastructure**, such as toll roads, airports, and railways/rolling stock, where the assets generate earnings by charging for use. Sectors like airlines and privatized rail are seeking government bailouts. For example, as part of the US's $2tn economic relief package, the federal government will offer almost $60bn in loans and grants to air carriers and may hold an equity stake until the loans are repaid. Given the sector's challenging economics, we expect to see fewer deals in this space.

In natural resources, the conventional energy sector is likely to be especially hard hit as oil prices plunge in response to falling demand. Indeed, more than a quarter (28%) of investors we surveyed said they plan to avoid conventional energy-focused natural resources in 2020 because of COVID-19 (Fig. 8). Weak investor demand could **weigh on fundraising** for such funds.

In contrast, as COVID-19 heightens awareness of the **need for investment in social infrastructure** such as hospitals, we expect to see increasing activity in this sector.

Privately held businesses offering essential services such as utilities – which benefit from long-term contracts with customers – should be better positioned to withstand the impact of COVID-19, though highly leveraged companies may come under scrutiny. Counterparty credit risk could also come to the fore as an area of concern for managers and investors.

Secondaries

The secondary market plays a vital role in helping LPs to manage their liquidity and rebalance their portfolios as needed. For buyers and sellers in this market, the question is: how might COVID-19 affect secondary market activity?

Preqin survey data suggests that right now, investors aren't hugely worried about meeting capital calls. When asked if liquidity and their ability to finance capital calls in 2020 is a concern, almost three-quarters (73%) of investors said no. This could be because investors expect capital calls to fall in the near term as deal activity drops. That's also the main finding of the Preqin-FRG model described on page 12, which assumes a 25% contraction in US real GDP in Q2 2020 followed by a sharp rebound through 2020. We expect to see a sharp reduction in capital calls and distributions in H1 2020, followed by net positive cash flow in H2 2020.

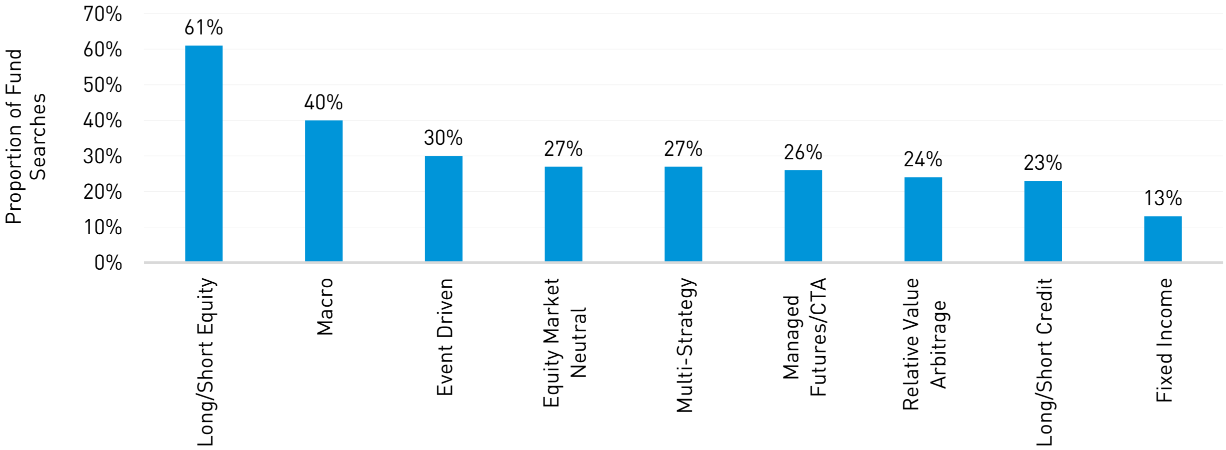
What does this mean for secondaries? It could indicate a **reduced incentive to tap the secondary market** in the current environment. LPs may also prefer to wait for prices to settle to avoid crystalizing short-term losses. After all, pricing fund interests is especially complex at the moment, as this is based on historical net asset value (NAV). What's more, most transactions take a few months to close after being signed. Secondaries sellers may see **buyers attempt to reduce purchase prices** or **withdraw from signed transactions** in the meantime.

Hedge Funds

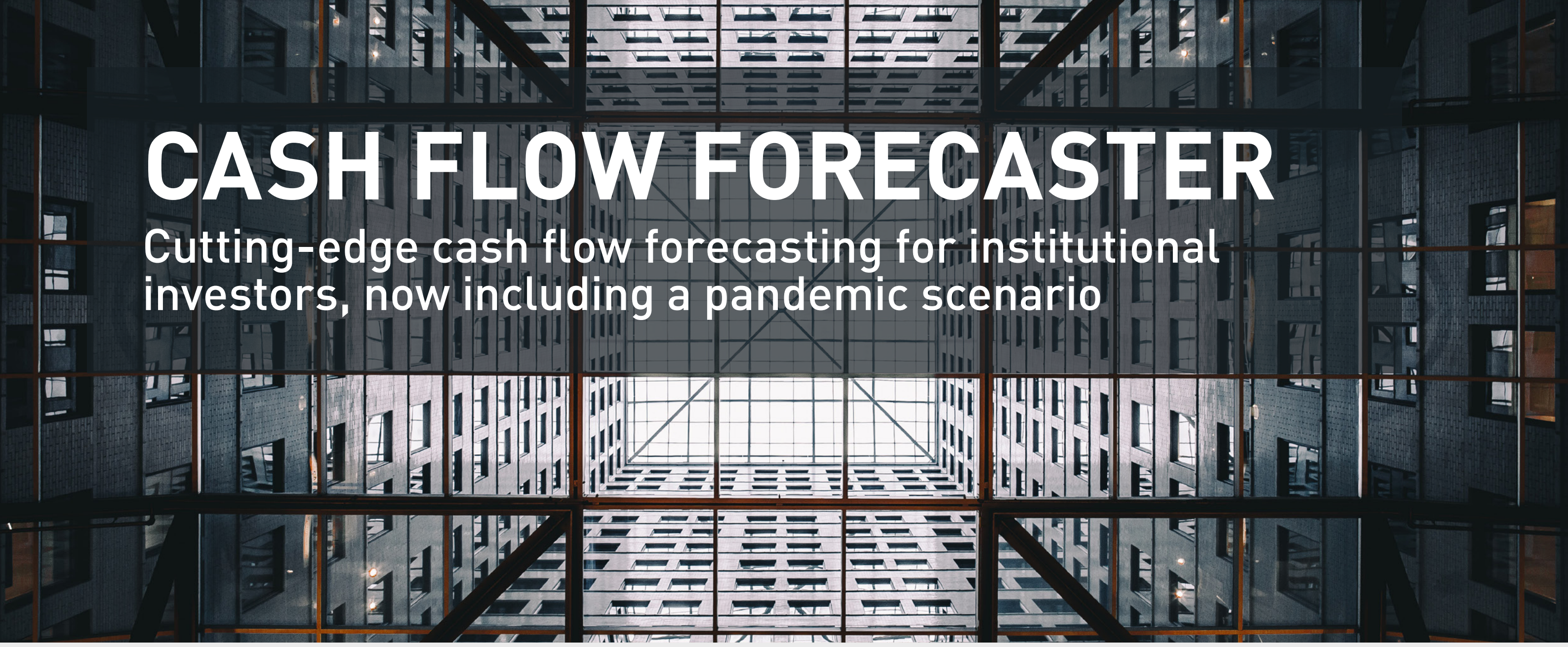
The economic fallout from COVID-19 negatively impacted hedge fund returns in the first quarter of this year. But by helping investors to limit their losses relative to equity markets, the asset class continues to serve a vital defensive role in investment portfolios.

While overall the number of new launches is down, some high-profile managers are raising capital and reopening their funds to investors. Angelo, Gordon & Co., Baupost Group, D.E. Shaw, Marathon Asset Management, Rokos Capital, and Varde Partners have all reportedly raised capital amid the market turmoil. We expect fund managers to continue finding promising opportunities as they capitalize on market volatility. As equity markets rebound strongly, equity strategies could be in a position to do well this quarter.

Fig. 9: Core Strategies Targeted by Hedge Fund Investors in the Next 12 Months



Source: Preqin Pro



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