

Q3 2024 – Alts quarterly update

August 2024

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for professional investors only

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There is significant macro uncertainty at present. This is particularly true in the US, where there are emerging signs of weakness in the US economy. While public equity markets have responded to recent mixed signals with quite violent swings, our base case is that the US will avoid a recession. A soft landing is still far from inevitable, however, and even if the soft landing is delivered, there could be potholes on the runway. That said, we should see some rate cuts in the US, possibly from September, but there is mixed opinion among commentators about the magnitude of the cuts during 2024.

While increased volatility is likely to continue into the short-term, there is limited immediate crossover into private markets. In our view, should the US economy, in particular, begin to weaken, it could lead to rate cuts and cheaper finance for leveraged buyouts. It could also lead to more opportunities to deploy capital at attractive valuations. The potential wider impact of any slowdown is still uncertain, and would depend upon the breadth and depth of the potential reduction in activity. But this all has some time to fully play out, regardless of the current noise.

Evidence is pointing towards a rise in deal making, regardless of the macro backdrop. Just four of the largest private equity firms have deployed \$160bn in Q2 2024 alone, according to regulatory filings¹. This bodes well for a positive end to the year, as we describe further below.

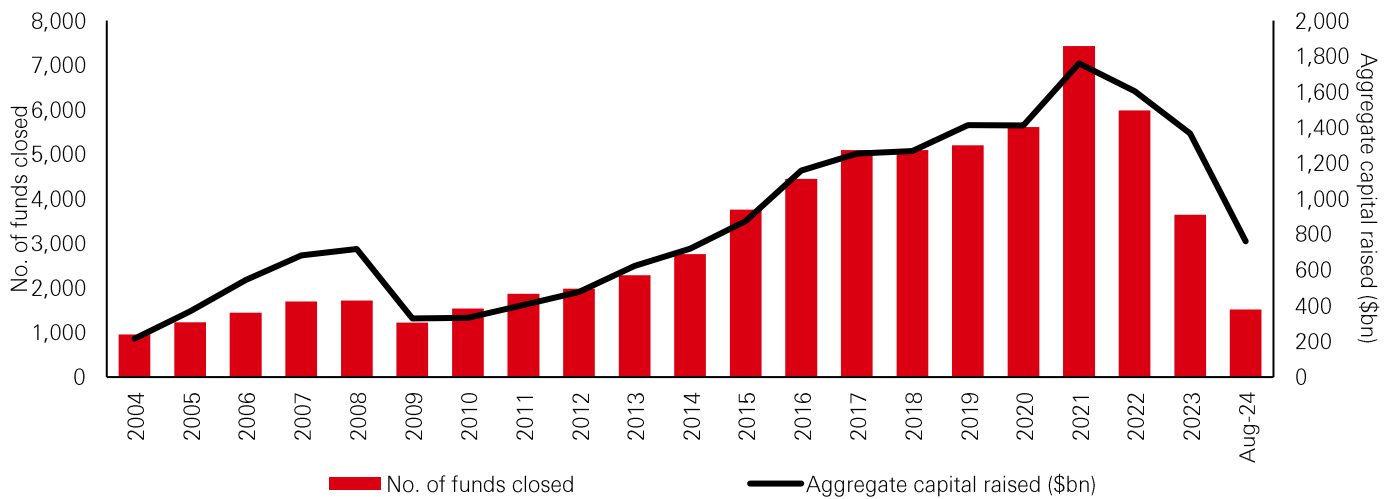
When it comes to private markets fundraising data suggests that the market is becoming more difficult in some asset classes. Coming after two years in which managers experienced a decline in both the number of funds closed and the volume of capital they received, this doesn't sound particularly positive. However, as is often the case, headline numbers mask some important nuances.

We have written at length in the past about the concentration of capital within larger funds. In some asset classes, such as private equity, this trend appears to be accelerating. Other asset classes, which were experiencing a short-term pause in activity have already begun to bounce back (private credit). Meanwhile, other asset classes are recovering following their own quiet period (infrastructure).



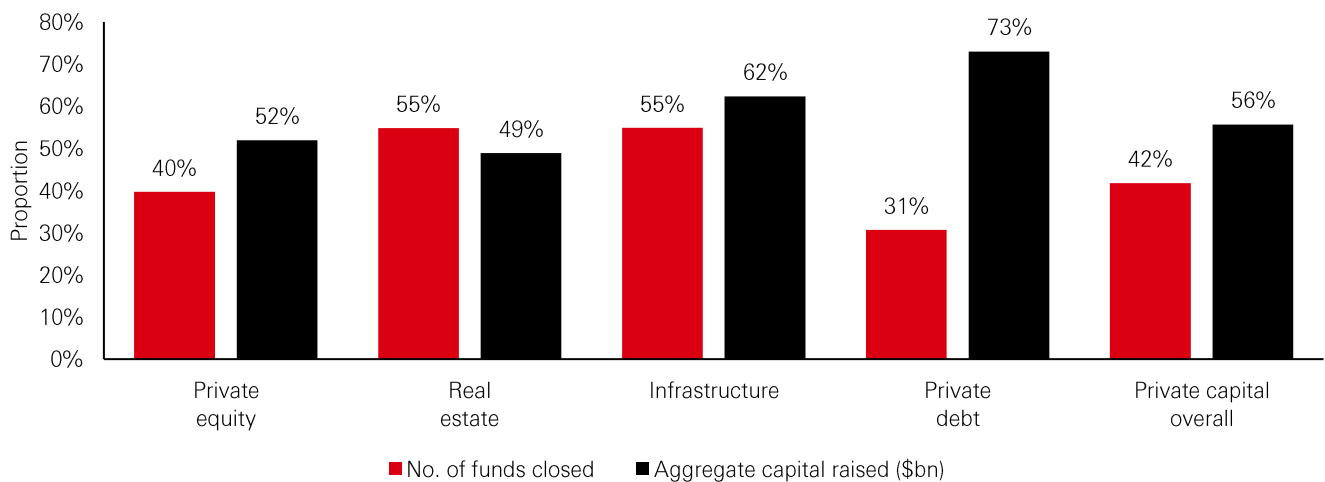
¹ [Private capital groups deploy \\$160bn as they prepare for deal revival \(ft.com\)](https://www.ft.com/content/2024/07/15/private-capital-groups-deploy-160bn-as-they-prepare-for-deal-revival)

Private capital fundraising



Source: Preqin, data as of August 2024

Private capital fundraising: 2024 YTD compared to FY 2023



Source: Preqin, data as of August 2024

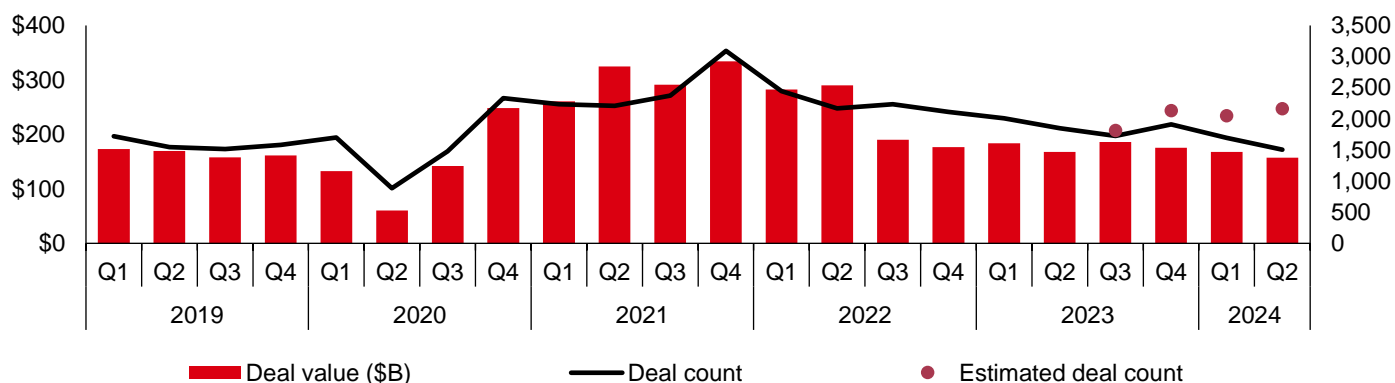
Regardless of the fundraising outlook, there are some tentative signs that activity may be finding a floor. In addition, anecdotal evidence suggests that fund managers (GPs) are building a sales pipeline, with the intention to alleviate some of the issues for investors (LPs), caused by the weaker distributions they’ve experienced in the last two years. Should we see a recovery in the exit market, in our view, we will begin to see fundraising markets improve. This would be good news for new or emerging managers, particularly, which have struggled to attract capital in what has been a tough market.

There is no guarantee that the trend illustrated by the chart above will continue.

Private equity – early signs of a recovery in activity

Our quarterly update covering Q1 2024² suggested that activity may recover in some asset classes. When it comes to private equity deal-making, we believe that early signs suggest that a bottom could have been hit. Data suggests that the decline in private equity deal activity may be coming to a close. While the number and value of deals remains below the 2021 peak, there are tentative signs that 2024 may see activity on a par with 2023. In the US, private equity deal activity is now tracking ahead of the previous year. It may not be powering ahead, but the 12.0% improvement during the first half of 2024, compared to 2023, is a meaningful change.

US private equity deal activity by quarter



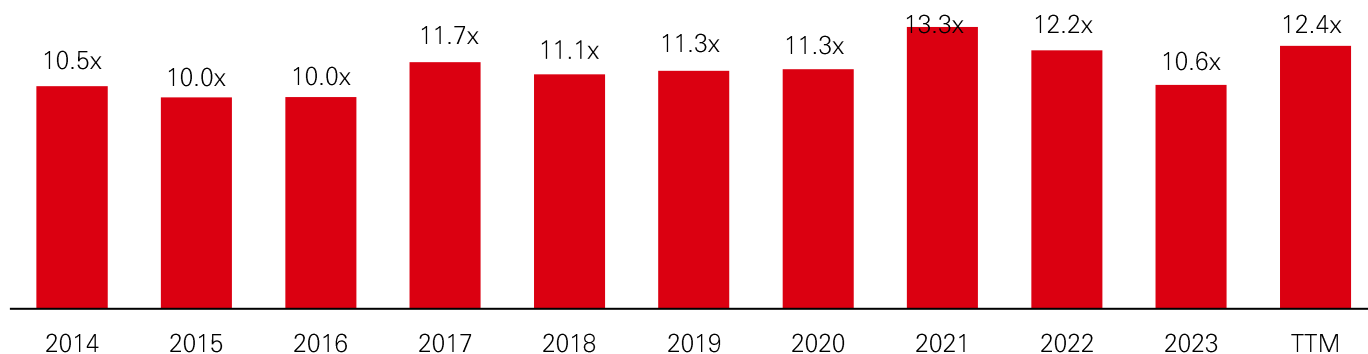
Source: Pitchbook, data as of July 2024

Pitchbook's estimated deal count reflects the fact that there is a drip-feed of additional deal information post at quarter's end. Over time, deal numbers and values increase as more information is gathered. Should we see the data improve to the extent that we have seen in the past, deal numbers in the US could overtake activity levels seen in the quarters leading up to the pandemic. According to Pitchbook data, platform leveraged buyout deal numbers and values are stabilising after being constrained by reduced access to debt and higher borrowing costs – both of which have improved, as the leveraged finance market has fully reopened over the last few quarters. Debt to enterprise value (EV) ratios on new leveraged loans moved up to 46.2% in Q2 from 45.7% for all of 2023, according to Pitchbook LCD data. This is a positive development, in our view. However, the 10-year average is 53.4%, so there is still some room for this to grow further.

Global private equity EV/EBITDA multiples

Source: Pitchbook, data as of July 2024

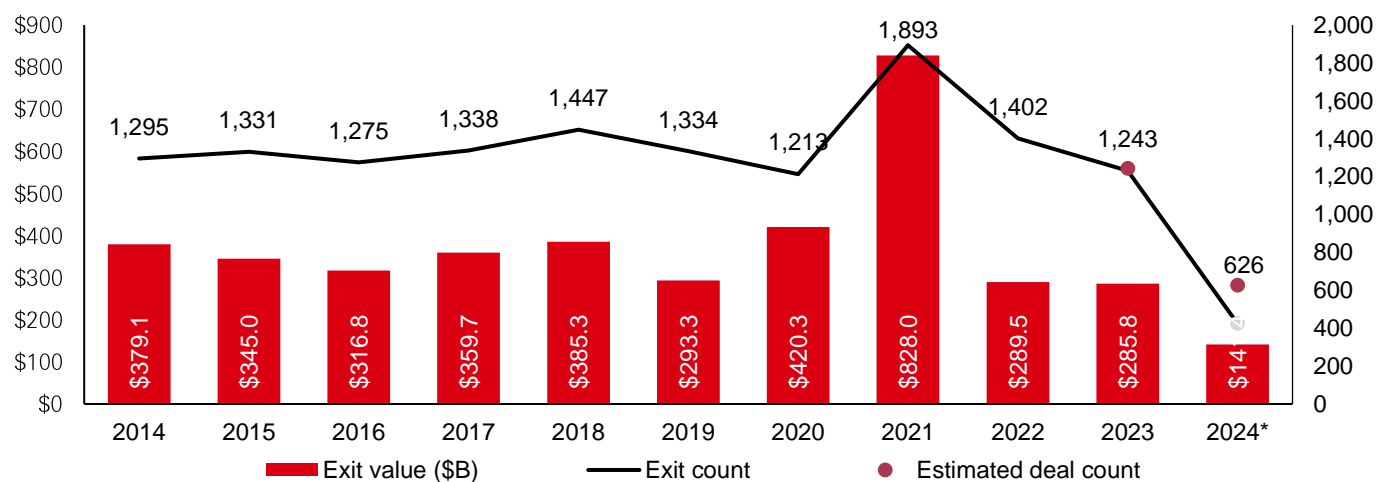
² <https://www.assetmanagement.hsbc.co.uk/en/institutional-investor/news-and-insights/alternatives-quarterly-update-q1-2024> There is no guarantee that the trend illustrated by the chart above will continue.



Exit markets remain mixed, but may be trending higher

On the face of it, growth in the value of private equity exits in the US is a positive sign. But delve below the surface of this data and it becomes clear that the foundations of the recovery may not be particularly strong - yet. During the first six months of the year, the number of exits reached 626 – largely unchanged on H1 2023, according to Pitchbook. Exit values have improved further, however, rising by 15% year-on-year to reach \$141.4bn at the end of H1 2024. While positive, this is not a strong bouncing back in either activity or sentiment. As with other deal and fundraising data, the value should creep higher over time.

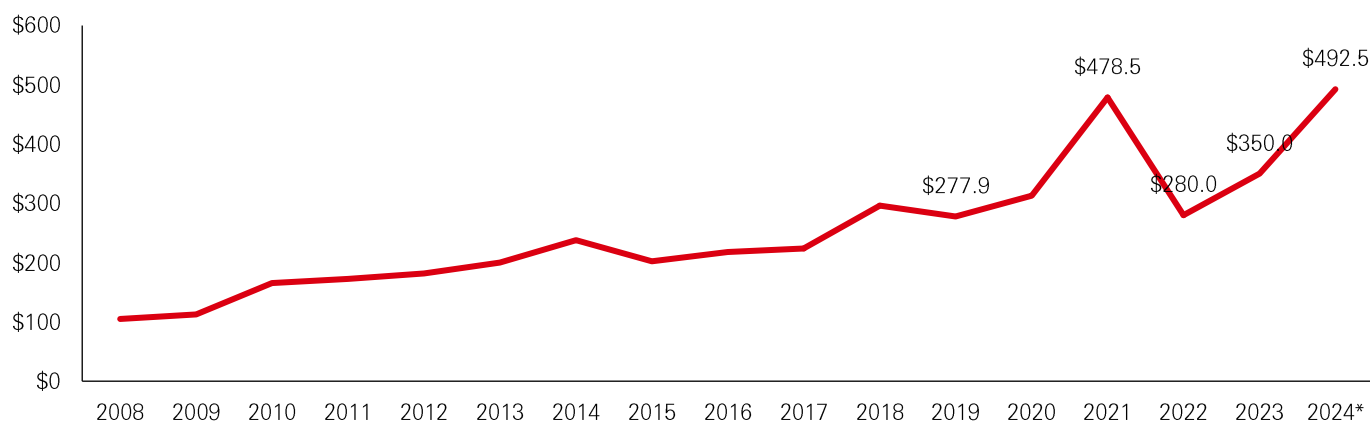
US private equity exit activity



Source: Pitchbook, data as of July 2024

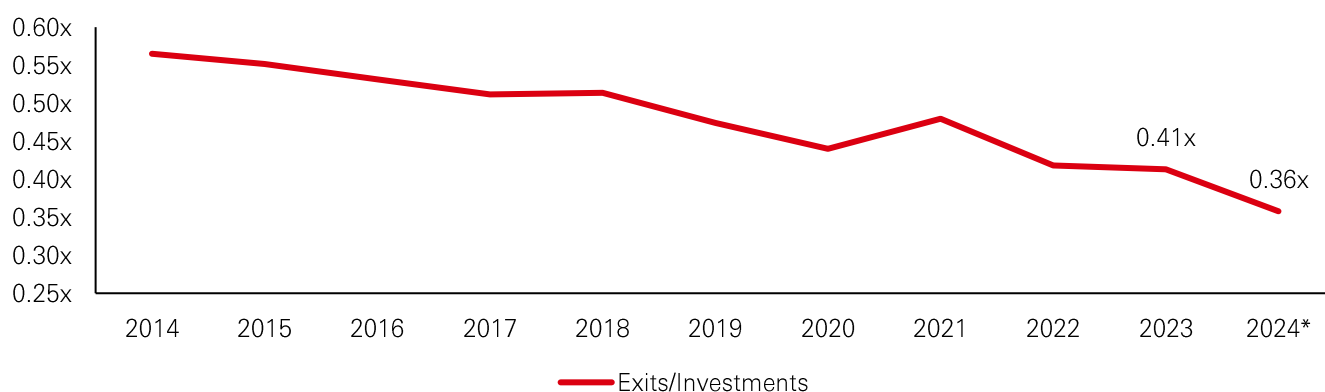
The median value of exits reached a new record in H1 2024. A new high of \$492.5m outshines the \$478.5m achieved at the peak of the market in 2021. However, while 2021 saw a huge flurry of activity at all price points, the new benchmark reflects GPs potentially selling their highest quality assets, leaving more time to hold the rest of their portfolio and try to improve both operating performance and valuations. Further highlighting the scale of the market challenge, the ratio of exits to investments fell to its lowest level on record in Q2. During the quarter, exit numbers were just 36% of investments. There is still clearly some way to go for the market to find equilibrium.

Median US private equity exit value (\$m)



There is no guarantee that the trend illustrated by the chart above will continue. Source: Pitchbook, data as of July 2024

US private equity exit / investment ratio



Source: Pitchbook, data as of July 2024

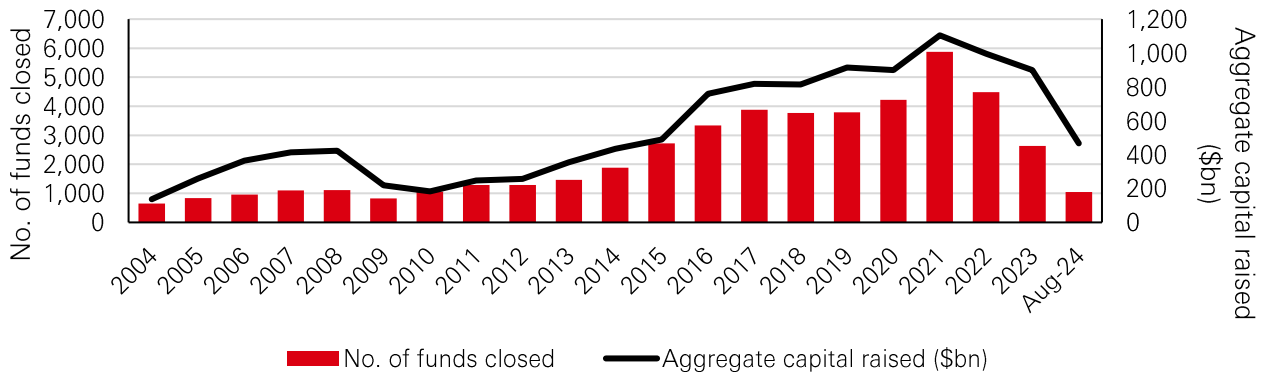
Fewer exits may begin to take a toll on a GP's active management. The relative dearth of exits when compared to the number of deals still being undertaken means many managers are now presiding over more portfolio company investments than ever. Analysis from Bain & Co shows 25 of the largest fund managers, within a given fund series, have seen the number of portfolio companies in their ownership double between 2013 and 2023.³

In private equity, fundraising markets are also mixed. On the positive side, stronger public equity markets might have alleviated some pressure on LPs when it comes to the denominator effect, allowing them to continue allocating to new funds. Despite this, while private equity funds are on track to potentially beat 2023's total capital raised, the number of funds closing has continued to fall during 2024. According to Preqin data, 1,047 funds had raised \$466.7bn by early August. During the whole of 2023, 2,637 funds closed, raising an aggregate \$899.1bn. When factoring in the usual Q4 bounce in fund closings, it is likely that 2023's total volume of capital raised will be beaten. When comparing the number of funds closed, as of early August, 2024 is tracking at just under 40% of 2023's level – already far down on the 4,489 funds closed in 2022. It is clear that capital continues to make its way towards the biggest managers, which are closing large-scale funds.

³ [Searching for Momentum: Private Equity Midyear Report 2024 | Bain & Company](#)

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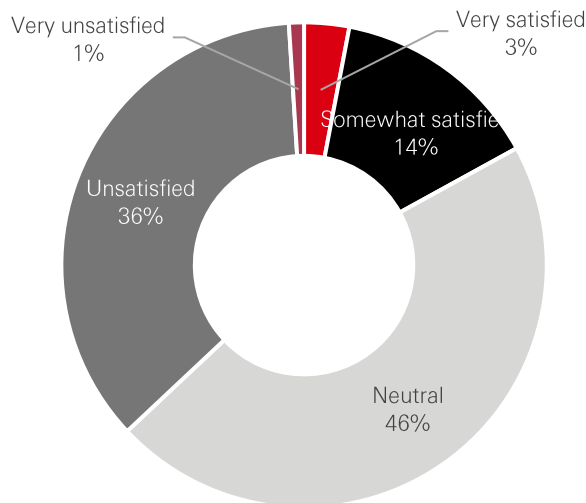
Private equity fundraising*



Source: Preqin, data as of August 2024 *includes venture capital

Taken together, it is positive to see encouraging signs of continued commitments to private equity managers and increased deal and exit activity. In our view, this is likely to prove timely for investors. A survey of LPs conducted by industry body ILPA⁴ suggested that a large proportion (37%) were unsatisfied with the level of urgency managers were placing on generating liquidity. Any improvement in the exit environment should be well-received, as this is likely to take some of the pressure off managers, in our view.

LP survey results: ILPA asked; “How satisfied are you with the level of urgency that GPs are placing on generating liquidity, outside of a fund-raise?”



Source: Bain & Co, ILPA survey of 148 LPs, as of June 2024

Private equity markets are clearly not as active as during the 2021 peak but we are encouraged to see that activity does appear to be recovering. Evidence of increased deal activity is a positive for the broader asset class, as capital can be returned to investors and then recycled into commitments to new funds. While there are still potential threats on the horizon, as is always the case, we are increasingly optimistic about the outlook for private equity.

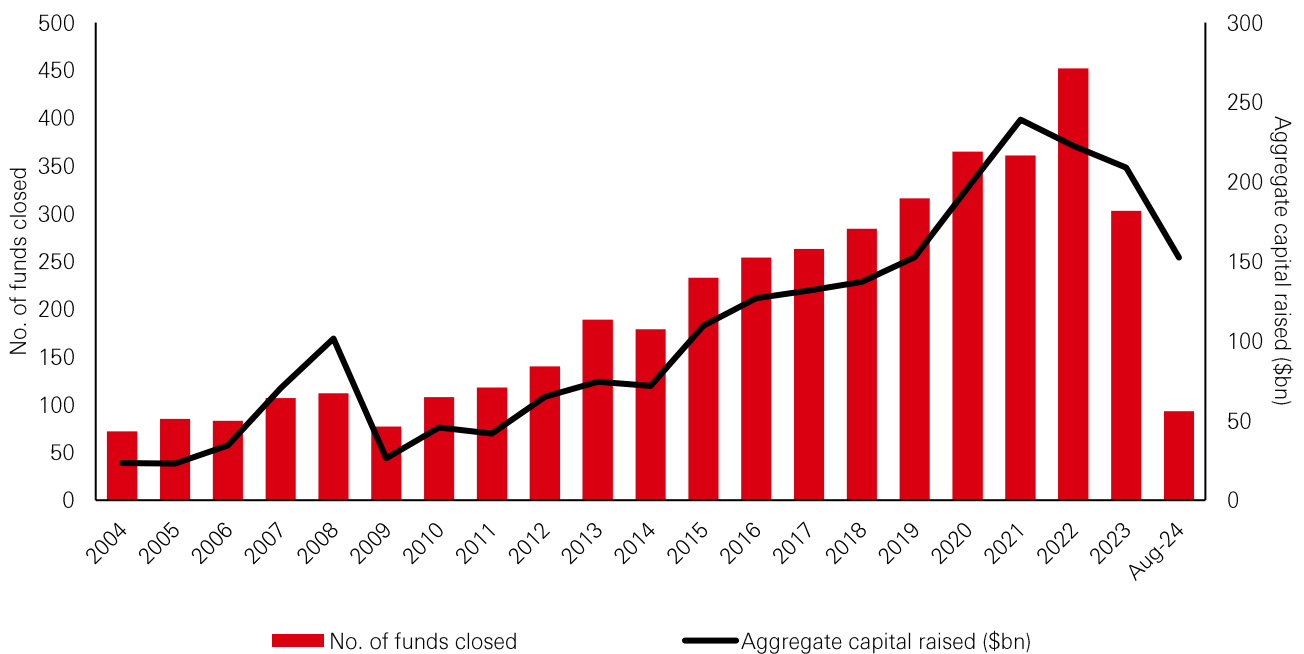
⁴ [Institutional Limited Partners Association | ILPA](#)

Private credit – a lull followed by a fundraising surge

Private credit fundraising experienced its worst start to a year since 2016, during Q1 2024, according to Pitchbook’s data. When adding in data to Q2, capital raised across the asset class in the year to 15th July was equal to just 37% of 2023’s total. But post the end of H1, there was a significant change. While there was no surge in the number of funds closing, Ares Management closed its US Senior Direct Lending (SDL) Fund III, with equity commitments of \$15.3bn, rising to around \$33.6bn when equity commitments in related vehicles and anticipated leverage is included. In a sign of the shift in total fund sizes, this fund is almost double the size of its predecessor fund, SDL II, which had \$14.9bn in total debt and equity commitments. In a sign of the immediate appetite for private credit exposure, around \$6.4bn of the debt and equity commitments for SDL III were raised during the second quarter of 2024 alone⁵.

As we have reported in the past, the concentration of fundraising towards the largest managers has clearly continued. That said, it is generally taking longer for managers to secure the commitments they are targeting, with the median fund taking 19 months to close – the longest period tracked by Pitchbook. Outside of a small number of outliers, at present, it is clearly a relatively difficult time for most managers to be raising new funds.

Private debt fundraising

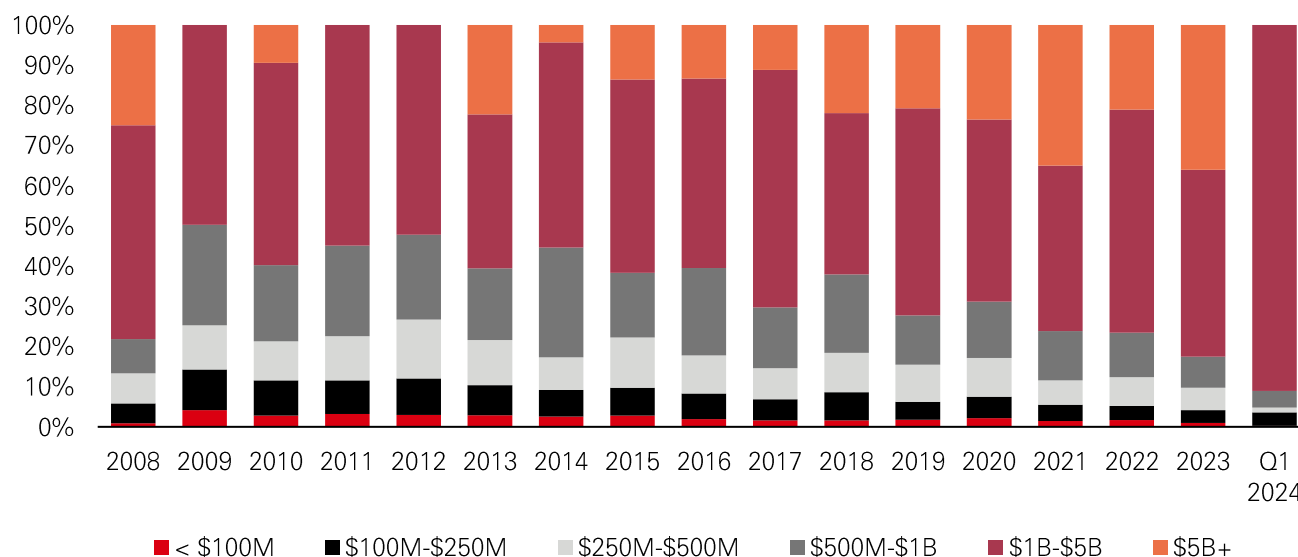


Source: Preqin, data as of August 2024

Private debt capital raised (\$) by size bucket⁶

⁵ [Ares Management Closes \\$34 Billion for U.S. Senior Direct Lending Strategy – ARES \(aresmgmt.com\)](https://aresmgmt.com)

There is no guarantee that the trend illustrated by the chart above will continue.



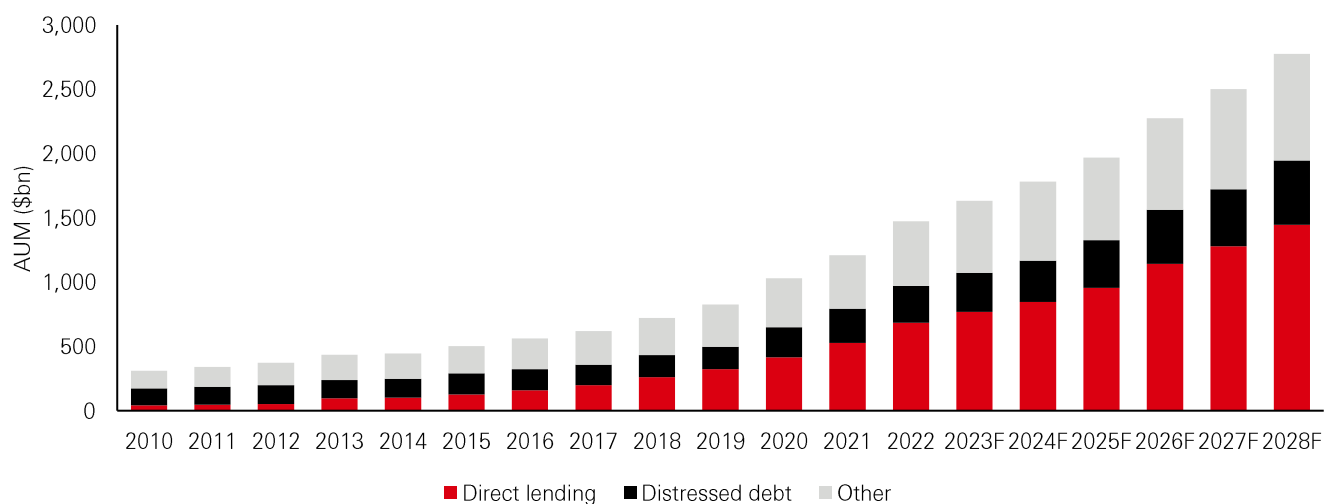
Source: Pitchbook, data as of May 2024

North America remains the dominant geography when it comes to private credit markets. Meanwhile, the market in Asia is still small but is growing strongly in some locations (such as in Australia), albeit from a low base. There are some key points making the US the centre of activity. Managing currency risk exposure and having a better understanding of the regulatory environment reinforces home bias for many US-based investors. This is appearing to create a positive feedback loop, with European funds seeing their share of allocations falling in recent years. From a fund manager perspective, there are fertile grounds in the Middle East to tap into, as LPs in the region have been increasingly active in private credit markets, boosting activity in the region.

Regardless of the regional composition of capital raising, the asset class continues to grow, with Europe and the US expected to see the strongest growth over the next few years, according to Preqin forecasts. At the end of 2023, closed-end private debt AUM is expected to sit around the \$1.6tn level. By the end of 2028, this is expected to rise to almost \$2.8tn – an annual increase of 11.1% between the end of 2022 and 2028.

Global private debt AUM by strategy

Diversification does not ensure a profit or protect against loss. There is no guarantee that the trend illustrated by the chart above will continue.



Source: Preqin forecasts, data as of November 2023

Direct lending is expected to remain the largest strategy within the asset class. The strategy's share of AUM is expected to reach 52.1% in 2028 – up from 47% at the end of 2022. This growth is likely to come at the expense of strategies such as distressed and mezzanine.

One potential issue for the asset class is the accumulation of dry powder. Since 2020, dry powder has plateaued at around \$525bn, according to Pitchbook data. Importantly, the proportion of dry powder which has been sitting on the sidelines, uninvested, for three years or more is the greatest it has been since 2011. In our view, while this points towards the slow pace of M&A deal-making in recent years, it also presents an opportunity.

For those managers outside the largest funds, which are not necessarily reliant on large deals for deployment, showcasing their origination and execution capabilities can be a key point of differentiation. What's more, for those funds seeking exposure to the potential increase in M&A activity, which recent investment banking results have flagged, now could be an opportune time to seek exposure.

As the private credit market continues to evolve, it is likely that the asset class will turn its attention to new growth markets. One such example is asset-backed lending. We believe that the attraction for many private credit fund managers is clear – access to a potentially large market, with banks stepping back due to the regulatory capital needs associated with these loans. There is a potential opportunity to partner with leading banks to enter this market, which, in our view, will see solid growth over the next few years.

Is smaller better, when it comes to infrastructure equity?

While this is a relatively simple question, it's not necessarily easy to answer. One thing generally missing from reported fund performance data is the level of risk taken to deliver returns. And it varies hugely from asset-to-asset and from fund-to-fund. We can group specific funds together, if we know they are investing in similar assets, and we can also segment by size to perform similar analysis. While this isn't perfect, it does offer an opportunity to compare returns across asset types and funds.

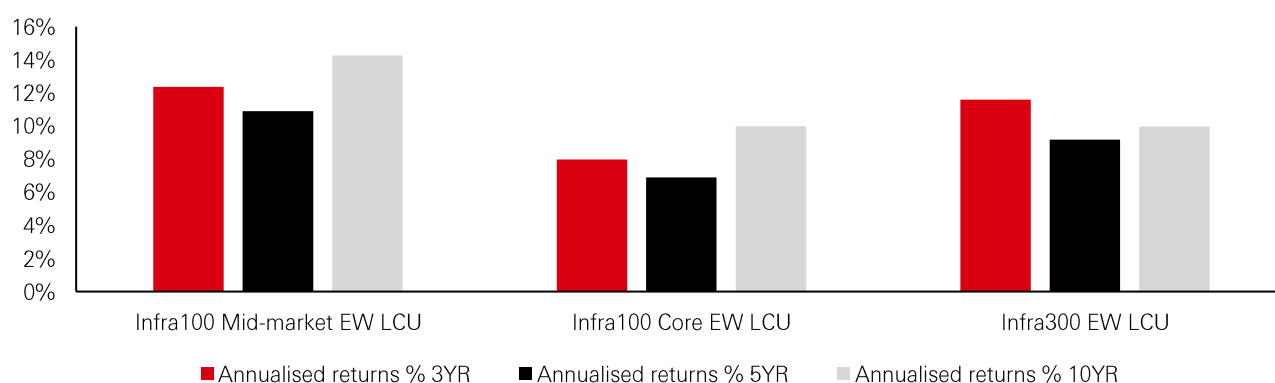
Using EDHEC / infraMetrics data as a starting point, we can segment the market somewhat, using their indices. Firstly, we can see performance for the Infra100 mid-market index, using equal weights and reported in local currency. Similarly, we can access similar data for core assets and for the broader Infra300 index, with data equally weighted and reported in local currency.

Segmenting the data in this way allows us to sense check some outputs that, in our view, would make sense in theory. Core infrastructure assets are generally, but not always, large-scale in size, can be producing revenues, may be profitable, or which might be subject to long-term contracts. Some assets may also benefit from quasi-monopoly positions within their respective markets. Given the nature of these assets, they are likely to be lower risk, and therefore deliver returns below those investments of a higher risk. Similarly, smaller assets may be earlier in their life cycle, may not be producing revenues and may not benefit from monopoly-type positions within their respective markets. They may also be subject to more competition, but this is far from always the case. As a result of the potentially higher risk for smaller or mid-market assets, returns are generally expected to increase to compensate.

We can see these trends within the infraMetrics data, in that over a range of periods, the mid-market index has outperformed both core and the broader infrastructure index more generally. The performance differential to core assets is quite large, at more than 400bps per year over a 10-year period. While there is likely to be some variation in risk across the indices, for many investors, the additional returns could make exposure to the mid-market more favourable.

All things considered, large-scale funds clearly have their own place within broad infrastructure portfolios. But, in our view, to focus solely on this part of the market would mean that investors are missing a potentially attractive route to drive additional returns. Smaller assets can provide a number of benefits, compared to larger assets, and are worthy of their position within a diversified portfolio.

Infrastructure performance



Source: infraMetrics / EDHEC, data as of July 2024

While performance is generally stronger for mid-market assets, they are not necessarily easy to access – or worthwhile for bigger funds. Large funds need to make large investments to deploy their capital and move the dial when it comes to overall fund-level performance. Often, large assets are sold through competitive processes, with many of the biggest funds competing – often with strategic non-financial firms, such as utilities or energy firms. Higher prices through competitive processes can also impact long-term performance if entry valuations bid up. The market can be very different for smaller and mid-market assets.

With larger funds competing fiercely for fewer larger deals, mid-sized firms are often off their radar and can be the focus of smaller funds, which can acquire assets on more favourable terms. Importantly, smaller or mid-sized assets can be acquired outside competitive auction processes, often through bi-lateral negotiations directly with sellers. However, to access the large network of smaller investment opportunities, firms need to ensure they have a broad and robust sourcing process, utilising many networks. This can be a labour intensive process and may simply not be worth the effort of larger funds and investors.

Representative overview of the investment process, which may differ by product and or asset class, client mandate or market conditions. There is no guarantee that HSBC Asset Management will successfully pick outperforming managers. Past performance does not predict future returns. Past performance does not predict future returns.

When it comes to exit opportunities, in our view, there are likely to be a broader range of options for those selling assets bought in the mid-market. Firstly, there should be more opportunities for value creation with smaller assets, with operating improvements, add-on acquisitions building scale and pricing power, improvement in capital structure or in the operating environment all contributing to returns. If the scale and profitability of an asset can grow, they can potentially be sold to larger funds in future, broadening the route for potential exits with the hope of attracting larger multiples.

Wide discounts in listed real estate present selective opportunities

Following a strong end to 2023, Listed Real Estate has had a sluggish H1 2024 as stickier than expected inflation alongside resilient labour markets has pushed back the anticipated timing of interest rate cuts by Central Banks.

However, the disappointing start to the year for listed real estate makes the sector more attractive relative to unlisted real estate and other asset classes. For some markets and sectors the listed market is pricing in further falls in the direct market, which we believe may be overly pessimistic. This has resulted in potentially attractive discounts in some parts of the market that have solid fundamentals. In addition, dividend yields from global real estate equities stand at a premium to both wider equities and developed market government bonds. Net-operating-income growth continues to be supported by solid demand and high occupancy levels across most sectors except offices, which should feed into future dividend growth, and provide a basis for healthy total returns.

Whilst a push back in expectations for the timing of rate cuts has generally weakened sentiment for the listed real estate sector, private real estate capital markets are already showing signs of reopening and we expect investment volumes to pick up during the second half of the year, with REITs well positioned to benefit from external growth opportunities that may exist. REIT balance sheets are generally sound with low leverage by historical standards and debt fixed at low rates with well laddered maturities.

Other market participants may have capital constrained by redemption queues or refinancing needs, whilst construction finance for development is expensive or hard to secure. This provides an opportunity for public market participants to supplement internal growth, and if the public market remains discounted, corporate activity is a further avenue to enhance shareholder value. We favour sectors that are less reliant on economic growth to deliver returns, which includes those with secular tailwinds such as senior housing, and sectors with embedded income growth such as industrial warehouses. Parts of the retail and office market also look attractive from a valuation standpoint, but we remain selective, focusing on the best managers in strong markets, and those that screen well within our ESG framework.

Opportunities abound in the hedge fund universe

The second quarter of 2024 witnessed considerable oscillation in pricing for both equity and fixed income assets. Bond yields ended the period higher, as investors weighed up the implications of increasing debt burdens in the US and many parts of Europe, which might be exacerbated by possible changes in political leadership in both regions. Equity markets overall advanced over the period, with Europe being the notable laggard – not helped by political concerns late in the quarter in France.

Indeed, unexpected political developments such as those witnessed in India with the Modi coalition, the UK with a surprising early election call and France seeing the far right making significant gains might be viewed by the casual observer as interesting opportunities for hedge funds to trade. However, their typically binary outcomes can tend to be more difficult to monetise in the very short term. Instead, managers of flexible investment strategies such as hedge funds will tend to seek out the more medium-term second order impacts that fall out from new policy biases.

In contrast to the first quarter, managed futures strategies were the performance laggards during the second quarter, as fixed income and certain currency and energy trends proved problematic over the period. At the other end of the

Representative overview of the investment process, which may differ by product and or asset class, client mandate or market conditions. There is no guarantee that HSBC Asset Management will successfully pick outperforming managers.

performance spectrum, equity long/short strategies found the stock-picking environment to be particularly supportive for returns. Many of these funds ended the quarter with gross exposures near historical highs while maintaining net exposures at sensible levels. Equity market neutral approaches also made money and appear to be becoming more popular with Multi-Strategy managers, who also enjoyed gains over the period.

We remain positive on the opportunity for discretionary macro managers. A casual analysis of the evolution of US interest rate forecasts going out over several years highlights the conundrum facing allocators. Rates are expected to fall, but not by much, and long-term rates are likely to be driven, at least in part, by the rising debt burden. Add-in electoral uncertainty and the potential for the imposition of trade tariffs, ongoing conflicts and discretionary macro managers arguably have a wide menu of opportunities to seek to extract value from. In short, all the major asset classes should deliver trading opportunities for this genre of hedge funds.

Within CTAs, managers gave back performance during the quarter. This was driven by a number of market developments. Overall, positioning long in equities was accretive, while fixed income positioning was mixed as yields fluctuated during the quarter. Within agriculture and energy, slower moving strategies handled price fluctuations better than their faster system peers. Within FX, losses were felt in emerging market currencies such as the Mexican Peso. Systems ended the quarter generally long equities, still long the USD in foreign exchange markets, and continued to be net short fixed income with mixed positioning in commodities. Mindful of the difficulty of accurately predicting a prevalence of trend across asset classes, we retain a neutral outlook on their performance credentials. For systematic equity market neutral strategies, we have a neutral / positive view due to the constructive market environment supporting the strategy. Markets have edged forward in aggregate over the quarter, but the earnings picture is supportive and there are potential positive catalysts for upside due to policy bias. This should be supportive of equity long / short strategies.

We maintain our outlook at neutral for event driven strategies. Fundamental equity strategies have driven returns over the quarter and year to date. Managers tend to differentiate themselves from each other with either a focus on hard catalyst strategies or soft catalyst approaches. In the former bucket, merger arbitrage allocations have grown, albeit from historically low levels, while in the latter bucket activism continues to be an interesting sub-theme for certain managers. The number of activist campaigns has risen to record levels across the globe in 1H 2024, led by Asia.

Our neutral outlook for credit long / short strategies is maintained. In our view, from a pricing perspective, valuations still look rather unattractive, although we witnessed some weakness in CCC rated issues more recently. In contrast, carry continues to be potentially attractive while credit quality remains mixed. The relative bright spot is dispersion, which both across and within sectors looks good, and is supportive for credit long / short managers. Within distressed, there hasn't been a meaningful increase in filings, rather, there has been more a continuation of elevated incidence debt exchanges – as a result, we remain neutral on the outlook for the strategy. Finally, we continue to favour structured credit within the wider range of alternative credit strategies.

We maintain our positive view on the operating environment for Multi-Strat and Multi-PM managers. They continued to deliver positive performance as a group during the quarter, led by equity focused strategies.

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