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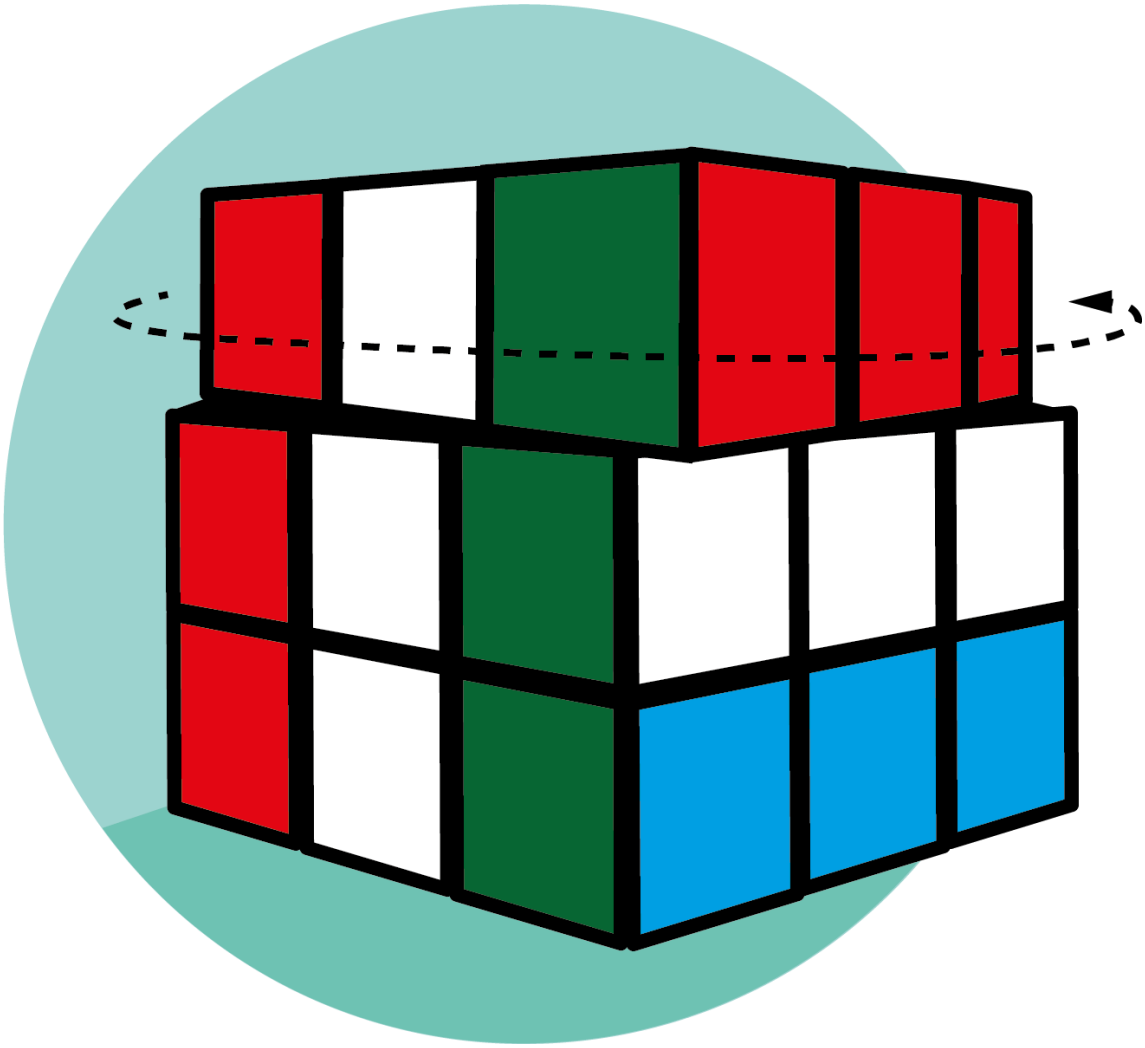


Alternative investment industry in Italy

Executive summary

July 2021

MAKING AN IMPACT THAT MATTERS since 1845

Contents

Introduction

This paper, which aims to analyze alternative asset classes in Italy, focuses on the private equity, private debt and real estate markets. These are expected to be the most robust growing alternative investments in Italy. This paper also evaluates each asset class in light of the increasing influences of ESG investing, technological change, and the consequences of the COVID-19 pandemic.

Since 2010, the rise in global assets under management (AuM) across alternative investments has vastly outpaced gross domestic product (GDP) growth, reaching EUR9.64 trillion globally in June 2020. This shift towards alternative asset classes was triggered by the low-interest-rate environment, driving investors to seek other opportunities for above-average returns.

Assuming this low-interest environment will persist for the foreseeable future, given the economic downturn and the structural changes to the socio-economic landscape, alternative asset classes will continue to attract new investors and an expanding amount of capital.

Economic context

The alternative investment market is firmly anchored to the recent recession's economic developments and is likely to continue to grow.

While the COVID-19 pandemic's economic disruption was less severe than expected in Italy—contracting GDP by 1.8% in 2020 following a V-shaped recovery—the Italian market's outlook is less encouraging than in other leading economies. While the economies of China and the United States returned to their pre-pandemic levels by Q1 2020[1], the Italian economy has tended to recover more slowly from past crises due to its structural weaknesses, and is only expected to return to pre-pandemic levels by the end of 2022.[2]

In this economic context, "safe haven" assets like government bonds offer weak returns, and experts predict the low-interest-rate environment will endure for the foreseeable future. Regarding equity markets, the price-to-earnings ratio of major indexes is close to an all-time high. The Shiller P/E ratio of the S&P 500 climbed to 37 (as of 1 June 2021), a level that was only previously eclipsed by the dot-com bubble.

The fear of overvalued equity markets, low bond market expectations as well as the favorable track record of alternative investments—which many private investors perceive as a source of comfort in times of crises—indicate that this rush to alternatives will persist.

[1] Ben Winck, "US GDP will return to pre-pandemic highs by the end of March, Morgan Stanley says," *Insider*, 9 March 2021.

[2] European Commission, *Spring 2021 Economic Forecast: Italy*, 12 May 2021.

Private equity

Italian private equity investments have surged in recent years.

The number of operators expanded with a compound annual growth rate (CAGR) of 8.3% over the past 10 years, and a record-setting fundraising round of EUR6.2 billion was enjoyed in 2017[3]. Nonetheless, the Italian private equity scene remains significantly below the levels of other developed economies.

From 2014 to 2018, Italian investors only comprised 3% of the total private equity capital raised in the EU, and Italian firms were the target of 7.2% of European private equity investments. Given the Italian economy's contribution of 11% to the European GDP, the Italian market's room for growth is obvious.

This relatively low activity in Italy is due to two structural factors.

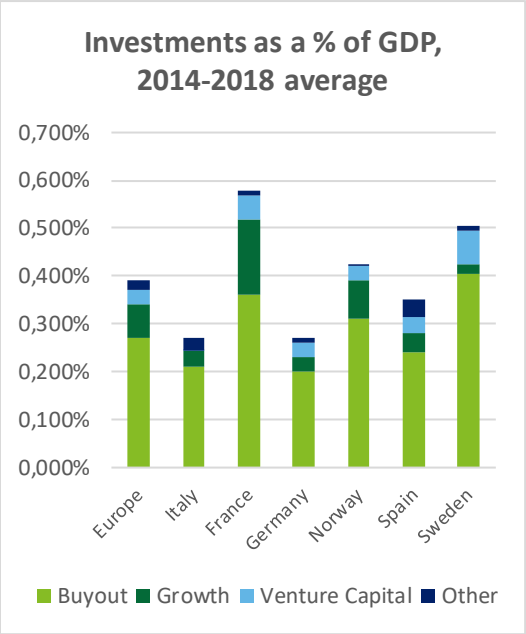
First, there is an exceptional number of privately-owned, small- and medium-sized enterprises (SMEs) in Italy. On the one hand, these companies frequently oppose changes to their processes and management, as owners wish to continue their family traditions.

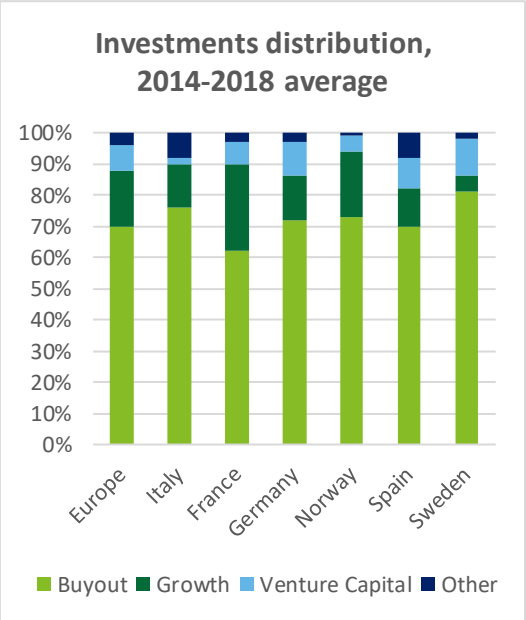
Therefore, outside investors, especially private equity ones, are often viewed as hostile aggressors rather than valuable partners that may support necessary transformations. On the other hand, these SMEs are often overlooked by large funds, resulting in a considerable untapped potential for an underdeveloped scene of small private equity funds.

Second, the Italian regulatory landscape is complex, discouraging investors from entering the market due to high transaction and operation costs that take their toll on expected returns. Because of these challenges and costs, large deals with values above EUR150 million prevail in Italy.

However, the Italian alternatives market is set to flourish. Italy is the third-largest economy in Europe, with significant potential for further growth in private equity investments. Its renowned companies in fashion and luxury products have remained private despite their success, such as Dolce & Gabbana or Max Mara.

Also, the Italian market's traditional barriers are expected to recede after the recent economic turmoil. Companies under economic stress may cave in to the pressure to secure liquidity and outside guidance, welcoming private equity at relatively beneficial terms for investors. Italian policymakers have already announced their intention to ease regulation in support of this trend.





Source: OECD Capital Market Review

[3] 2019 The Italian Private Equity, Venture Capital and Private Debt market - AIFI

Private debt

The Italian private debt industry was essentially created by a decree to spur economic activity after the global financial crisis of 2007–2008 (GFC).

As an economy that has traditionally relied on bank debt and private savings, Italy's private debt market is still underdeveloped. However, the impact of Brexit seems to be driving activity toward continental Europe, and a share of this flow is expected to pass through Italy.

Similar to the United Kingdom, most of the investments in Italy are made to SMEs—particularly those in the business product and service sectors, which make up around one-third of all investments in private debt.

Stringent regulations still require private debt funds to apply for banking licenses to carry out direct lending operations. This bureaucratic hurdle has driven funds to seek alternative routes to provide financing. For example, the borrower issues bonds subscribed to the fund, or the fund provides financing to an affiliate of the borrower in another jurisdiction and then passes the funds by using inter-company loans.

These alternative routes have generated a lot of potential for FinTech platforms. Direct lending by non-banks to Italian SMEs reached a total of EUR1.7 billion throughout 2020, with many platforms working with invoice financing. Another growing player in this field was lending crowdfunding, which grew 35% from 2019 to 2020.

Italian debt funds offer loans with relatively short maturities, not only compared to advanced economies but also some developing economies. This could signal skepticism by investors about the long-term prospects of the Italian economy; however, it could also be due to the relatively recent development of the Italian debt fund industry. As investors become more familiar with the product in Italy, maturities should start to rise.

Before the pandemic, the private debt industry in Italy was flourishing, reaching a peak of EUR1.31 billion in 2019. This was evenly split between foreign and domestic investors, although the local market was leaning more towards the international players.

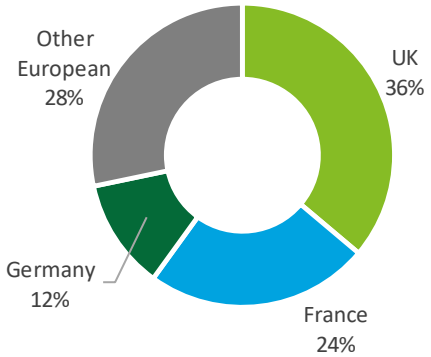
Even among the market uncertainty of 2020, the industry continued to grow in Italy, with evidence of more companies turning to private debt financing during the year. This forecasts the important role the sector could play in post-pandemic recovery/restructuring. The pandemic's only significant impact was on the amount of local fundraising; however, this was still in line with the expectations of international markets.

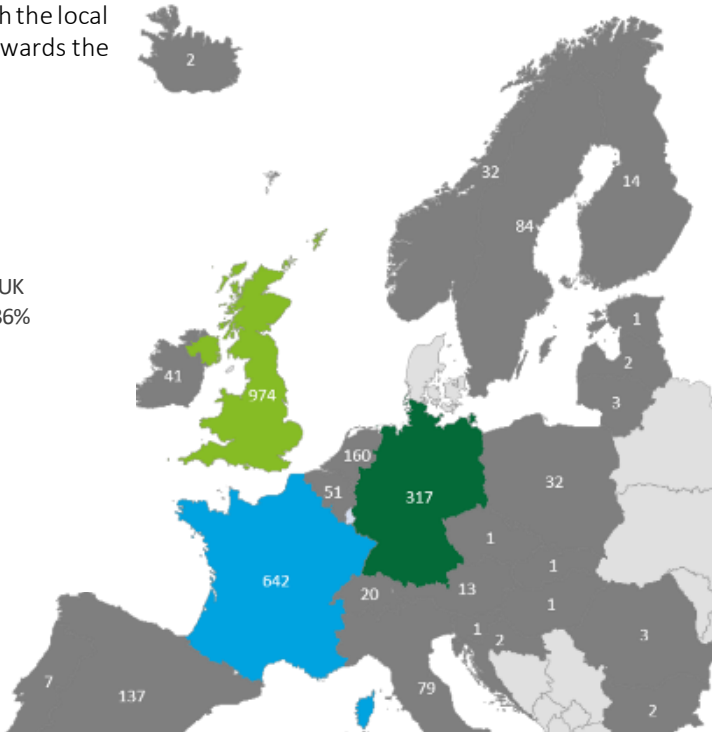
The prospects of Italy's private debt industry look favorable, especially in a recovering economy that will require the strategic flexibility of the instrument. The industry is operating significantly below its potential, and the prominence of banks in direct lending should be slowly superseded by private debt. Going forward, technology and ESG will both play essential roles—with the former representing both a target and a growth factor for the industry, and the latter intertwined with private debt instruments through green bonds and similar securities instruments.

Total deals across Europe

In the last 33 quarters, 2689 (974 UK and 1715 other European) deals are recorded in Europe.

Source: Deloitte Alternative Lender Tracker H2 2020





Real estate

The recent pandemic has shaken up the Italian real estate market, with general investments plummeting by 29% over the past year.

While the COVID-19 crisis has accelerated trends in the logistics and e-commerce sectors, it has hindered others, such as the residential and commercial real estate markets. The *Hotellerie* industry experienced the most significant downturn, due to the health and safety restrictions on movement and travel.

Investments in commercial real estate have increased over the past few years, with Milan and Rome as key markets. Despite their high prices, these two cities still sustain a significant and growing gross rental yield. However, with the recent pandemic, major uncertainties surround this asset class, as customer preferences regarding living conditions shift.

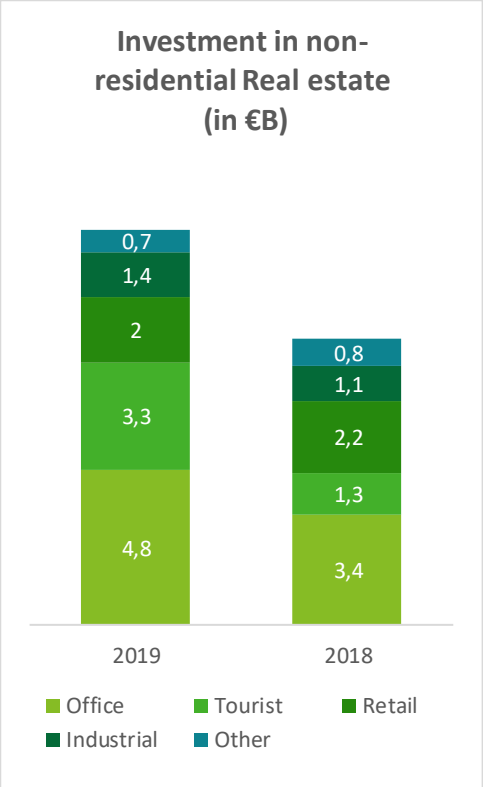
Professional foreign investors dominate the Italian market, accounting for 80% of total investments. Players commonly use one of the following investment types: real estate companies, REIFs, RE SICAFs, SIIQs and direct investments. These differ in passport rights, the extent of hands-on management of assets, and the general legal structure.

Given the current uncertainties, the sector's outlook suggests it will return to normality in 2023. Logistics and residential developments are the most attractive asset classes of the coming years. Moreover, the hotel and shopping center markets are expected to endure the biggest drops in asset value, triggering substantial price discounts.

Looking to the near future, the office and retail sectors will progressively transform rather than disappearing entirely. Offices will require open spaces and coworking rooms to encourage more collaboration, while retail stores will remain an essential part of the customer purchasing experience. Concerning logistics enterprises, their turnover represented 5% of Italian GDP during 2020, and the sector still offers great potential. Lastly, the hospitality sector in Italy's major cities, especially in the luxury segment, still presents a significant opportunity for investors, despite an increase in new online marketplaces.

Residential real estate is surrounded by less uncertainty, given the population's foreseeable preferences in the short term. Higher demand for multifunctional homes with outdoor spaces and condominium services is expected, along with a growing interest in purchasing second homes.

However, there is a discrepancy between demand and supply. While large funds have a considerable spending capacity, they are only willing to spend a small portion—meaning supply is not following demand. This has resulted in a large amount of dry powder in the real estate investment sector.



COVID-19 pandemic

The COVID-19 crisis will go down as one of the most unique economic events in modern history. It led to extensive fiscal measures in Italy that far exceeded those of the GFC—in an effort to cushion the shocks to both demand and supply.

Regarding the pandemic's impact on the private equity industry in 2020, the data shows a large, though short-lived, shock.[4] This resulted in buyout value falling globally and transactions being put on hold amid uncertainty. Most shops focused on stabilizing their existing portfolios, using government support. In Q3, activity strongly rebounded, even amid the expectation of more distressed debt deals and deal delays.

In Europe, the total value of all buyout deals over the first three-quarters of 2020 was relatively resilient, even if the volume sunk by 17% over this period. However, this total buyout value was mainly boosted by the EUR17.2 billion carve-out of ThyssenKrupp's elevators business. When looking at Italy in particular, 2020's total investment activity ended only around 9% lower than 2019, demonstrating remarkable resilience amid the crisis' uncertainty. There is a consensus among fund managers that many deals have been put on hold due to valuation problems. Many entrepreneurs are seeking to be valued based on economic results that do not reflect the pandemic's effects, as they are deemed transitory. As we exit the pandemic, professionals in the industry believe that valuations could start to be performed based on a six-month run rate. This foresees a significant flow of deals being restarted, as economic conditions are expected to improve in 2021 and 2022.

Venture capital in Italy is also thriving, in large part due to support by large corporates who have expanded their interest to innovative Italian firms. In 2020, 234 initial and follow-on deals took place, with those focused on information and communications technology (ICT) firms representing more than 45% of all investments.[5] This trend is mirrored globally, with private equity's appetite for ICT only accelerating during the pandemic.

While fundraising was negatively impacted on a global scale, surprisingly the amount raised in Italy more than doubled, driven by domestic investors who allocate most of their capital to infrastructure. However, the uncertain environment, at least in the short term, may result in longer maturities as investors wait for exit conditions to improve—a trend already being observed in Italy, with exits decreasing.

The private debt sector in Italy remained notably active throughout the pandemic, with the number of transactions increasing. This demonstrates that the industry's positive potential is eclipsing the pandemic's negative constraints, with indications the sector in Italy will reach US$1.46 trillion (EUR1.23 trillion as of June 30 2021 UTC) by the end of 2025.[6] The rise of private debt in Italy during the pandemic can be partially attributed to the growth in basket bonds, which saw record issuances in 2020 and are likely to be a popular instrument in Italy's recovery.[7]

Unlike private equity, fundraising in private debt fell during the pandemic in Italy. This was in line with the rest of the world, which witnessed the most significant decline in fundraising after a 10-year exponential growth. Furthermore, unlike private equity, private debt in 2020 focused on industrial goods and services, although ICT still boasted a significant share. However, the pandemic boosted private debt's attractiveness due to its higher flexibility and efficiency, increasing competition against banks. Looking forward, it remains to be seen if the industry will still benefit from the market's need for increased flexibility and more strategic support.

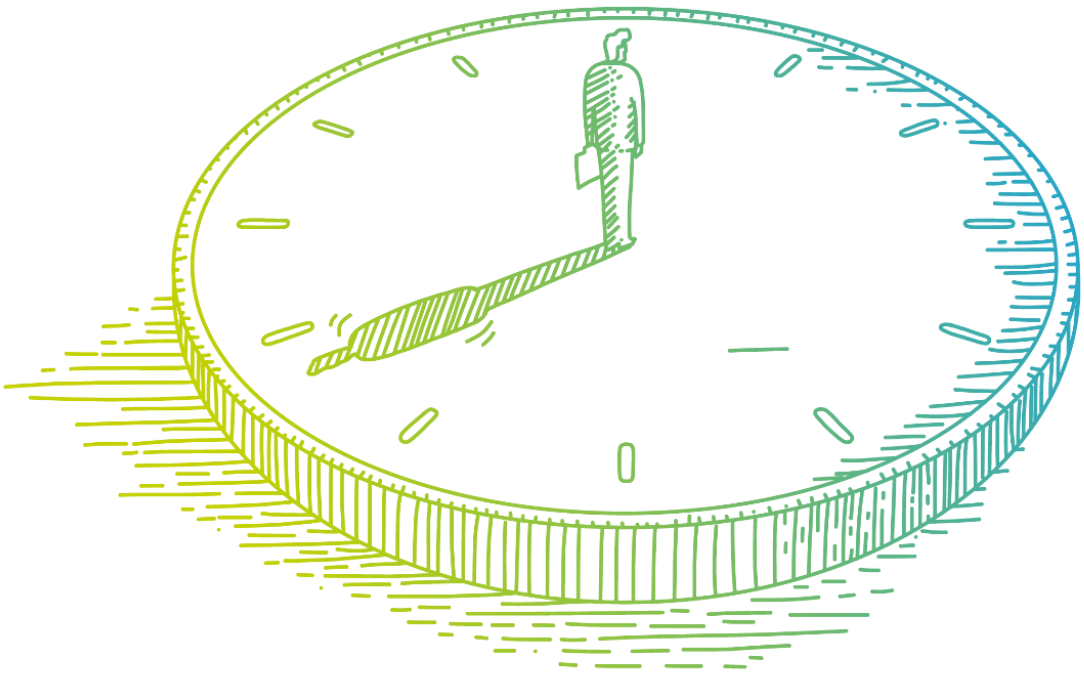
[4] Dechert LLP, Mergermarket, "2021 Global Private Equity Outlook," 2 December 2020.
[5] AIFI, "Venture Capital Monitor. Rapporto Italia 2020,".
[6] Abby Latour, "Private debt to grow 11% annually to 2025, Preqin survey says," S&P Global, 16 November 2020.
[7] Cerved Rating Agency

The pandemic's impact on the real estate industry followed a similar trajectory as other asset classes, with transactions plummeting. The retail sector was the most affected, recording a 28.6% drop in transactions. Going forward, it is unclear how house prices will respond since they will determined by Italy's recovery from the crisis as well as new customer demands. However, given the low-interest-rate environment and the accumulation of savings by the upper-middle class, the recovery of the real estate market should be strongly supported.

Real estate funds in Italy still grew to a forecasted 4% in 2020, despite their growth being slowed down by the pandemic, in line with expectations.[8] Moreover, there was an influx of capital between January and March 2020, followed by six months of contraction. Logistics and data centers, the best performing asset classes, were the focus for most funds due to their relatively safe natures.

The widespread move to remote working, one of the biggest trends that emerged during the pandemic, is likely to significantly influence the real estate market, with 50% of investors expecting the demand for physical office spaces to decrease.[9] Likewise, the traditional residential sector is expected to evolve, as people seek out properties away from city centers.

Professionals in the industry hold an optimistic outlook in the medium to long term—and, as a separate note, they expect the pandemic to deliver an influx of capital for opportunities related to the difficulties in the tourism and hotel sector.



[8] Laura Cavestri, "I fondi immobiliari e Reits battono il Covid-19," Il Sole 24 Ore, 8 July 2020.

[9] CBRE, "Investor Intentions Survey 2021,".

Technology

Increasingly bolstered by new technologies, the alternative investment industry is experiencing a rapid transformation. Technological advancements are the shot in the arm the sector needs to exploit its enormous growth potential.

On the one hand, big data and cross-cutting technologies such as artificial intelligence and quantum computing are changing the market's dynamics by enhancing operational efficiencies and driving insightful decision-making. On the other hand, asset tokenization drives faster transactions, greater liquidity and more transparency, which increases trade volume. The current pandemic has undoubtedly accelerated these trends.

The technology sector has always played a significant role in the private equity market. Over the past decade, the number of buyout deals involving technology firms has increased by more than 10% globally, boasting the largest share of total private equity activity. In Italy, 38% of all private equity deals in 2020 concerned technology businesses[10]. These values are expected to rise due to the COVID-19 pandemic, with a specific focus on BioTech and MedTech, as well as ICT.

Technology as a solution is also a hot topic for private equity firms, as they shift from legacy systems to cloud-based solutions. With the availability of big data rising, artificial intelligence will become a fundamental tool for target selection and investment decision-making. Moreover, blockchain technology could deliver a substantial competitive advantage in the coming years, as it provides a single source of immutable data to stakeholders. However, firms will also need to escalate their cybersecurity alongside these shifts to ensure the highest protection of this ensitive data.

In the private debt industry, technology has increasingly become an attractive investment sector. During 2020, investments in ICT advanced by around 10% with respect to 2019, reaching 16% of total private debt activity[11]. This trend is expected to continue in the coming years, due to technology firms' low loan default.

The private debt sector's growth is a key driver for technology adoption. Due to the inefficiencies of current tools, deep-tech and data analytics solutions are set to transform the industry and reshape the current underwriting, risk assessment and credit scoring process. At the same time, blockchain will open the market to the masses.

Meanwhile, technology encourages new market entrants such as FinTech and InvesTech firms, who are slowly displacing traditional banks' activity due to their resilience. As the investor generation transitions from baby boomers to millennials, the Italian FinTech market has considerable growth potential.

Lastly, technology is revolutionizing the real estate industry in how properties are designed, constructed, sold, and maintained. The COVID-19 pandemic has accelerated trends in smart real estate and new asset classes such as data centers or virtual reality, creating many new opportunities in the market.

New developments in the internet of things (IoT), 5G, automatization and touchless technologies will give tenants an enhanced experience in terms of autonomy and efficiency.

At the same time, building information modeling (BIM) will improve cost-benefit analysis. In the current shift towards the digital world, logistics solutions and data centers have gained momentum. In 2020, spending in the Italian logistics sector increased by 7% with respect to 2019[12], a trend that will likely progress in the upcoming years.

As new opportunities are created, some asset classes may become outdated. Therefore, it is vital that market players understand the dynamics of these technologies to ensure positive outcomes.

[10] https://www.datocms-assets.com/45/1618492026-private-equity-venture-capital.pdf?ixlib=rb-1.1.0

[11] AIFI Report 2019, AIFI Report 2020

[12] Italian Real Estate Overview 2020 - Cushman & Wakefield Report

ESG

Businesses are increasingly considering sustainability as an opportunity to create shared value for society, employees, shareholders, and other stakeholders.

Corporate social performance has been found to increase corporate financial performance and reduce exposure to risks, as policy changes may render unsustainable assets prematurely obsolete. As a result, leaders would be willing to pay around a 10% premium to acquire a company with solid ESG credentials; and, during interviews with industry professionals, the same was true regarding products with higher ESG standards that enhance financial performance.

In January 2020, the European Union presented the European Green Deal investment plan, which will mobilize EUR1 trillion of sustainable investments over the next decade. Italy has also demonstrated a strong commitment to the transition to green, with initiatives such as the Italian Green Deal and the National Energy and Climate plan, as it is the second-most affected country in the EU when it comes to climate-related events.

In recent years, ESG investing appears to have enhanced equities' performance, with a STOXX index of global ESG leaders outperforming the STOXX Global 1800 Index by 37% from 2004 to 2020. Reasons for this correlation are diverse, ranging from reduced risk stemming from policy changes to improved quality, brand image, employee retention, and resource efficiency.

Across the private equity industry, the importance of ESG activities is also growing. These factors contribute positively to the environment and society and are seen as critical to developing a resilient and successful modern business. Also, investors, government incentives and the evolving regulatory environment are demanding greater ESG integration.

ESG is also becoming a hot topic in Italy, based on increasing demand from institutional investors, particularly pension funds and insurance companies, and by leveraging managers' greater awareness of the opportunities of active involvement in sustainable investments. Italian private equity firms should primarily focus on social issues when selecting and managing their portfolio firms. In 2020, social inequalities were amplified by the pandemic, and funds may be more reluctant to consider layoffs for their cost-cutting strategies.

ESG is becoming a more natural part of debt instruments. Performance concerning ESG factors acts as an insurance-like asset that is correlated with lower costs of debt and higher credit ratings, especially for longer horizons. The effects are even more significant in highly turbulent markets, as was seen during the March 2020 downturn.

Two of the most promising categories of ESG-related private debt offerings are green and sustainability-linked loans. In 2019, these represented a volume of US$170 billion worldwide, a growth of 200% on the previous year. These global trends are also mirrored in Europe, where green bonds and sustainability-linked loans are leading to sustainable debt growth.

Europe is leading the world when it comes to sustainability lending. The European Green New Deal and the Next Generation EU are expected to drive growth in green debt securities across Europe and in Italy. Italy's ESG-related debt market of EUR24 billion represents just 6.9% of the overall European market. Recently, the Italian government tapped into the sustainable debt market for the first time, raising EUR8.5 billion in Europe's most prominent green bond debut.

The development of the Italian sustainable real estate sector is still at an early stage. In July 2020, COIMA SGR started Italy's first real estate fund with measurable ESG goals, the "COIMA ESG City Impact Fund", which expects to collect EUR1 billion during its 20-year lifecycle. Academic research forecasts the asset classes' considerable potential, due to a positive or neutral correlation between financial performance and corporate social performance.

The above-average importance of sustainability in real estate is not surprising. The segment is directly affected by the rising risk of climate change and a consequent increase in insurance costs. Furthermore, industry surveys and professionals have highlighted that investors in Italy and international markets are increasingly pursuing retrofit projects to lower operating expenses.

The increasing focus on reduced emissions puts assets at risk of stranding. Buildings are the single biggest driver of climate change, representing 36% of European greenhouse gas emissions. Therefore, the sector must significantly reduce its emissions to achieve Paris Agreement commitments.

Conclusion

The COVID-19 crisis, the increasing integration of technology, and ESG trends have boosted the prominence of alternative asset classes in investors' decision-making.

The current environment has generated critical growth opportunities for the alternatives industry. Turnaround funds have the chance to exploit the liquidity crises of many companies and profit from an effective reorganization of businesses and improving economic conditions. Advancements in technology, especially tokenization, could open the door to retail investors, generating a significant inflow of liquidity into the alternatives market.

However, there may be some threats ahead for Italian market players. The stringent regulation and the fragmentation of ownership that typify the market are unlikely to change in the short term. Moreover, as the market grows, it will attract more international investors that may exploit profitable opportunities and drive some Italian players out of the market.

In the short term, the biggest challenges faced by the Italian alternatives industry will be related to the unpredictability of future economic developments, the dialogue between funds and family-owned businesses, and the exploitation of the large pool of savings held by Italians

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