COUNTRY REPORT
ITALY

Funds go private

PRIVATE MARKETS

LAURA CARPI

Italy's institutional investors have kept their focus on private markets during the COVID-19 crisis

KEY POINTS

- **The crisis has forced institutional investors to reorganise**
- **Institutions have allocated extra resources to monitor private markets portfolios**
- **Some see an opportunity to further diversify their private market investments**
- **There is appetite for investments providing stable income**

The severity of the COVID-19 outbreak in Italy meant that life was transformed. During the state of emergency, Italian institutional investors faced their greatest challenge yet. The pandemic was the real-life event

"To deal with lower growth, demographic dynamics and lower productivity, combined with high public debt, an impressive amount of public and private investments is required and, in this sense, pension funds together with institutional investors would certainly finance strategic projects that generate returns for their members," says Andrea Nanni, a partner at Prometeia and head of pension funds and insurance advisory at Prometeia Advisor Sim.

European policymakers are generating new market opportunities for Italian pension funds through credit lines of the European Stability Mechanism, European Investment Bank (EIB) loans and the EU's Recovery Fund. Prometeia Advisor Sim recently signed a memorandum of understanding with the European Investment Fund (EIF) to reinforce the cooperation for equity investments through pan-European institutional funds of funds. "The strategic partnership has the goal to facilitate the access of Italian institutional investors, including pension funds, to vehicles that the EIF will promote at European level," Nanni says.

Investments in infrastructure, however, require patient capital. In this phase, despite the dry powder available, Prometeia says private equity is particularly attractive for pension funds and in line with capital needs of Italian and European companies that compete on a global scale. "Here you can see a potential virtuous circle of growth, employment, profits and returns for investors," Nanni says.

For Brambilla, investments in private equity and in part in private debt "have to be strongly encouraged", although private debt carries a higher dose of risk than private equity. Private equity firms control a company with managers and long-term plans. "With private debt, there is not always control of the company, and a lack of control of subjects that manage the money of the investors is a risk, therefore it must be more regulated."

Private equity is an asset class that often does not show up in portfolios, and the first rule when approaching a new asset class is caution, according

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to Nanni. He argues that investment in private equity needs appropriate diversification that can be reached using funds of funds, or mandates. As a blueprint for investment in the asset class, Nanni points to the Iride project, an asset-pooling initiative by several second-pillar pension funds to access private equity funds. Prometeia acted as consultant to the project since its inception.

According to Nanni, Iride is replicable only if there is a clear focus on the goals. "Governance remains complex, since all decisions still need to be ratified by individual boards of directors. This aspect should not be underestimated, it is no coincidence that Iride was the only project born out of an agreement between pension funds," Nanni says. The hope is that another project of this type will start shortly, perhaps with a smaller number of pension funds, with specific targets including private debt, private equity or multi-asset mandates. "We are working on it with our clients," he says.

The expert committee that drafted Italy's recovery plan holds a critical view of Alternative Investment Funds (Fondi di Investimento Alternativi), because they effectively prevent most savers from participating. Prometeia prefers FIAs specialising in small and mid-markets firms, with potential to grow in Europe and especially in the Italian market. "Given the size of the portfolios and resources of pension funds, regional diversification is essential," says Nanni.

He adds that Italian pension investors understand the importance of monitoring risks and opportunities. They also take seriously their role as responsible investors, particularly in relation to climate change, the energy transition, conservation of biodiversity and the reduction of social inequalities. Overall, the mission of pension funds to generate returns for members at this stage is compatible with a significant amount of investments in Italy, a market that is still small but is growing, he says.

In the near future, pension funds may review expectations based on a prolonged period of low interest rates. "It will be necessary to further intervene on allocations, increase diversification and allocate the risk budget effectively, by quantifying and taking on market risk, credit risk, currency risk and, where possible, liquidity risk," Nanni says. This holistic approach to assessing portfolio risks should be seen as a standard and, for Prometeia, is a pre-requisite to approach complex investment instruments.

"Funds should carry out an accurate projection of cash flows, or an asset and liability management [ALM] study, and assess their capacity to commit capital for long, illiquid but hopefully more profitable projects. The Italian pension fund market is close to reaching maturity. Performance is increasingly important and, as such, it is important to focus on the liquidity profile of the portfolios," Nanni says. In his view, more can be done, as the resources to invest are available and the operational structures of pension funds are improving.

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Laura Carpi

that stress tests had tried to simulate for years.

Several different starting positions and different approaches can be identified among Italian institutional investors, in terms of their readiness for this event and how they reacted by taking quick decisions in unstable markets.

This event did not only test the investment capabilities of each investor but involved their organisations in a deeper way, affecting different areas. Remote work and digitalisation completely changed communication, staff organisation and decision-making processes.

When it comes to portfolio management, it has become clear to everyone how important it is to allocate resources to monitoring portfolios, particularly of private markets assets. In this area, it is more difficult to have, at any given time, a clear picture in term of valuations, covenants and cash flows. It is generally more complex for private markets investors to maintain a deep understanding of risk and, as such, build a detailed measure of the impact of an event like the COVID-19 outbreak on portfolio valuations.

At the same time, private market investments have shown more resilience compared with public market ones during all of the three previous financial crises (2001, 2008 and 2013). Indeed, for long-term investors this crisis can also be seen as an opportunity that has to be grasped in the next months.

There has been a generalised repricing in terms of multiples in the private equity sector. In private debt,

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loan counterparties have become more solid, by offering better covenants features. Many Italian investors are considering increases in their real assets and private market allocation, including real estate. Such increases, however, will be gradual and carried out according to contingent needs.

The crisis has led institutions to act in support of their stakeholders. Most casse di previdenza, the privatised first-pillar funds for professionals, have decided to temporarily suspend the contributions owed by members, as one of many measures to support them during this difficult time.

This decision has reduced the resources available for investment. In some cases, planned new investments have been postponed. In other cases, investors have carried out a robust portfolio re-allocation exercise, undertaking significant changes in their usual way of managing assets.

Casse di previdenza have made extra efforts in monitoring their portfolios, especially in terms of valuations. While they tend to monitor their portfolio actively and on an ongoing basis, during this specific period they invested more time and added extra human resources. The monitoring exercises also required strong involvement at the funds' general partner level, to reach a deeper understanding of portfolio positions.

In general, these investors have not found the more structured and international managers to be lacking in terms of reporting. However, it is still too early to get a comprehensive overview of the impact of COVID-19, owing to the time lag in valuations and to the scarcity of information on specific investments.

The lockdown rules made it particularly difficult to assess the status of investments into domestic smaller companies. Historically, private capital has focused on northern regions, which were also the worst affected by the outbreak.

In some cases, monitoring investments was made extremely complex owing to the direct involvement of underlying businesses with the management of the emergency. This was the case, for instance, for real estate investments into private hospitals and care homes.

At the same time, this unprecedented situation is seen by some investors as an impulse to push further with sustainability agendas. Cassa Forense, the first-pillar fund for lawyers, and Inarcassa, the fund for engineers and architects, along with others Italian and international institutional investors, have signed up to the UN PRI and recently became members of the Green Economy Alliance, whose goal is to develop green recovery investment packages that accelerate the transition to climate neutrality and create a healthier ecosystem.

These investors now apply those principles to their due diligence and investments process, prioritising managers and investments involved in the development of energy efficiency solutions, the supply of renewable energy and the transition to a low-carbon transport system.

Private markets investments represent a relevant share of the asset allocation of casse di previdenza, which had total assets of €83bn as of the end of 2018. The average allocation to private market assets including real estate is about 25%. In some cases, where these investors hold large real estate portfolios, the share of private markets allocation can exceed 30%.

For the more sophisticated investors that already have significant exposure to private markets, this time can be seen as an opportunity to diversify their portfolio and add new strategies. Owing to the particular market conditions, some see 'special situations' as a particularly interesting strategy within the wider private debt space. Generally speaking, investors have an appetite for investments with a coupon feature or that provide a stable income, which ensure greater stability of short to medium-term returns.

Several investors are increasing their exposure to infrastructure. So far, casse di previdenza have allocated small percentages of their portfolios to foreign infrastructure. These investors have an opportunity to support the Italian economy in the near future through shared projects involving infrastructure, where investment has historically been lacking, particularly in areas such as digitalisation, logistics and healthcare.

There are also plans to increase institutional investor participation into key areas like Italy's highway network. Italian media report that F2i Sgr, one of the country's largest infrastructure managers, is surveying interest from institutions, including Cassa Depositi e Prestiti, the partly state-owned institution, for an investment the highway network.

These investments themes have become particularly topical and urgent for a number of investors. Among these are also Italian second-pillar pension funds, known as fondi negoziali, but these funds are still taking their first steps.

The behaviour of Italian insurance companies offers an interesting perspective on the real estate market. Insurers have historically owned suitable real estate portfolios. They have focused on geographical diversification and the quality of assets in order to keep valuations stable.

Certain sectors and geographies have proven to be more resilient in term of valuations. Many insurance portfolio managers are expecting

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significant reduction in valuations for retail shopping centres. The sector has been particularly affected by the lockdown measures, along with hospitality, with luxury hotels seen as the worst performer. However, those holding assets in continental Europe, particular Germany, have enjoyed more stable valuations and rental income, thanks to strategic support from the German government.

Those investing in real estate debt expect that deals written in the post-COVID-19 world will feature lower loan-to-value (LTV) levels and improved covenant packages. This is also the result of financing conditions, as real estate managers face higher costs of funding from banks. Ultimately, future transactions are likely to have a more conservative risk/reward profile.

Many insurers see an opportunity to allocate a higher share of their portfolio to the logistics sector, which features high-quality tenants and is diversified across different sectors. The more experienced ones are starting to consider investments in data centres, an asset class with a risk/return profile that sits between real estate and infrastructure. At the same time, they are feeling the impact of the crisis on long-term investments into energy infrastructure, particularly oil and gas, and transport, especially airports.

The market's shock reaction to the COVID-19 outbreak was an important test for insurers in terms of solvency requirements and solvency ratio adequacy. This is particularly true for some Italian insurance companies, which have historically held large positions in Italian government bonds within their portfolio. As a result, for the months to come insurers will have to maintain a larger share of their portfolio invested in liquid assets, to comply with regulatory requirements. This is likely to slow down their plans to diversify further into private markets.

This contrasts with the fact that portfolios with diversified exposure to private market assets has provided investors with a high degree stability in terms of valuations.

This time of market stress may not be over as the overall impact of the economic fallout is not yet known. The lesson learned so far is that portfolio diversification and having a strong monitoring process in place are essential to manage a crisis of this scale. While Italian investors have become used to navigating difficult markets, they must seize the opportunity to push for structural changes that modernise the Italian economic system. Investing in private markets is an efficient way to achieve that goal.

Laura Carpi is founder and managing director of 3Peaks Consulting, an Italian consultancy dedicated to helping global institutions that invest in private markets

IORP II in limbo

REGULATION

MARIA TERESA COMETTO

The EU's IORP II directive has yet to be fully implemented by Italian pension funds

KEY POINTS

- **The regulator has yet to issue the new rules necessary to fully adopt the EU's IORP II directive**
- **Many pension funds have decided to outsource the new function of risk management**
- **Some funds are working on the basis that ESG criteria are only a fad but a few have already started adopting them**
- **In Italy, only one out of three workers is voluntary enrolled in a workplace pension fund**

Italian workplace pension funds are in limbo as the national pension regulator COVIP has yet to issue the new rules that are necessary to fully adopt the EU's IORP II directive. However, from last year, pension funds have started to take measures to comply with the new EU regulation.

"Actually, the new EU regulation is already effective because the Italian law 252 of 2005 regulating pension funds is in line with the IORP II directive," points out Claudio Pinna, head of retirement for Italy at Aon. "COVIP must issue some guidelines and clarifications, and has decided to wait and do it along with the revision of other rules concerning all pension funds."

One of the most important changes for Italian pension funds concerns risk management. "Until now, it has been incorporated into the finance function, which is responsible for monitoring volatility and the performance of the external asset managers," says Pinna. In fact, none of the mostly defined contribution (DC) Italian workplace pension funds manages assets in-house. "But with the new rules, risk management will involve all kinds of operative risks – in other words, anything that could jeopardise the fund's functionality, such as cyber risks," he says. In his view, the coronavirus pandemic has raised awareness of such risks. "Smart working from home implies more possible cyber attacks on pension funds, which should build business continuity plan."

Silvio Bencini, managing partner at European Investment Consulting says: "Many pension funds – such as Alifond, Espero, Pegaso and Priamo – have launched calls for tenders to outsource the risk-management activities." His firm has been appointed to carry out risk management functions for Byblos (graphics, paper and publishing industry) and Pegaso (local public utilities), two funds for which EIC already monitors external asset managers, according to Bencini.

> "Pension funds should have an internal system to double check contributions through random checks"
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> Andrea Scaffidi

The new rules allow outsourcing of all functions but Andrea Scaffidi, head of retirement for Italy at Willis Towers Watson, says it is advisable to keep risk-management activities in-house. "Today, Italian pension funds have a very slim structure, even when they manage billions of assets. In practice it's just a few employees lacking an organic vision

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