

## Satellite Alternatives:

### Complementing Alternatives portfolios with Alternative Private Credit

The post-COVID economic environment has presented significant challenges for the investment industry. Persistent high inflation and the resulting interest rate hikes by central banks led to increased market volatility in public markets and valuation uncertainties for private assets. This environment particularly affected core private market strategies, such as private equity and real estate, by reducing deal transaction activity, which in turn impacted exit opportunities, investor distributions, and capital raising efforts for new fund vintages. Consequently, certain investors have been looking for diversification within alternative investments that exhibit low correlation to traditional public and core private markets asset classes. While hedge fund strategies predominantly invest in public market instruments, certain established and emerging managers are offering specialized investment strategies that focus on bespoke private market deals.

In this Market Update, the focus is on “Satellite Alternatives”, which includes niche strategies within private alternative credit, such as bridge loans and asset-based lending as well as selected specialized liquid credit strategies, that have demonstrated uncorrelated return streams and present attractive investment opportunities for professional investors.

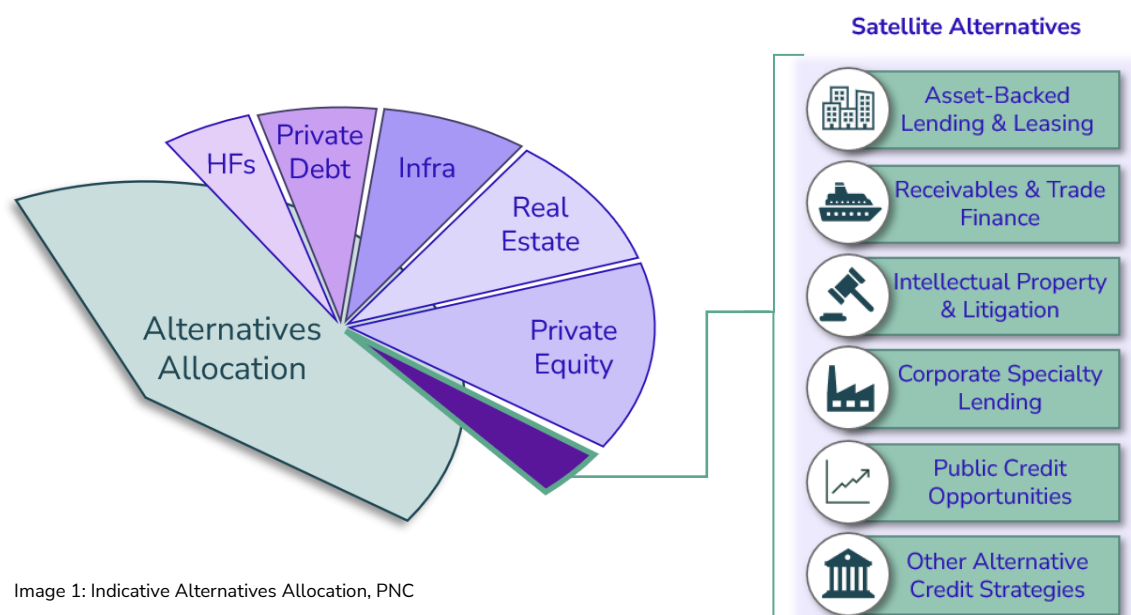


Image 1: Indicative Alternatives Allocation, PNC

### Economic Context

After the Covid pandemic, the investment landscape has undergone significant shifts due to monetary policies, which have been enacted by governments in response to rising inflation. Central banks, particularly the European Central Bank (ECB) and the U.S. Federal Reserve (FED), have hiked interest rates at an unprecedented pace leading to increased borrowing costs, which resulted in downward pressure on private assets valuations (e.g. real estate and private equity). At the same time, traditional fixed-income instruments also faced challenges as yields rose and bond prices fell. Moreover, cases of bank failures, including Credit Suisse and Silicon Valley Bank, underscored the fragility of the financial sector in a scenario with interest rates rising very quickly.

Throughout 2024, the global macroeconomic environment remained influenced by persistent geopolitical tensions and the threat economic downturns. The ECB's decision to reduce interest rates in June, September and October 2024 reflects a measured approach to stimulate growth within the Eurozone. Meanwhile, the FED maintained a hawkish stance early in the year but began lowering rates in September and October 2024, signaling a shift in policy<sup>1</sup>.

Further, ongoing conflicts in the Middle East and the war in Ukraine, coupled with upcoming political leadership transitions in key nations, such as the US and Germany, continue to fuel market uncertainty, impacting investor sentiment and economic outlooks. Policy decisions by the new U.S. administration are expected to have significant implications, particularly for Europe, which remains vulnerable to recession risks.

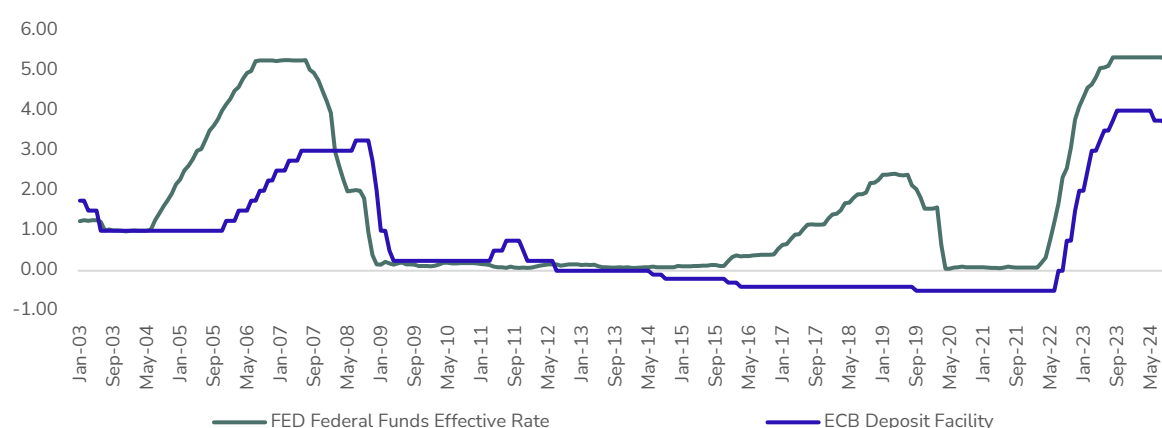


Chart 1: Federal Reserve (FED) & European Central Bank (ECB), Central Bank Rates

Looking ahead, the global economy is expected to soften in 2025. While there are concerns about a potential recession, the long-term outlook remains somewhat optimistic. Further expected rate cuts may support economic growth and corporate profitability, but central banks must navigate the fine line between enabling growth and avoiding inflationary pressures.

### Call for Diversification: Satellite Allocation across Alternatives

In this complex economic environment, private credit and other alternative asset classes present an interesting opportunity for professional investors to further diversify their portfolios. With potential for decelerating economic growth, recurring inflation and rate cuts by the central banks, investors appreciate factors, such as uncorrelated returns, asset-backed security, reduced volatility and regular cash distributions.

Particularly specialized strategies, such as asset-based lending and specialty finance, offer a compelling opportunity to capitalize on niche markets in the evolving credit landscape. However, specialized strategies on a stand-alone basis are not immune to idiosyncratic impacts and therefore require a thorough selection based on broad expertise and diversification across multiple segments.

<sup>1</sup> Federal Reserve (FED) & European Central Bank (ECB), Central Bank Rates

## Background on Satellite Alternatives Strategies

The strategies in this market update referred to as “Satellite Alternatives” are mostly part of the broader private credit asset class, which typically constitutes the issuance of financing to various types of borrowers by non-bank financial lenders. Stringent regulations after the GFC and changing risk preferences of traditional lenders resulted in a financing gap for more established borrowers, such as private equity funds and real asset managers, but also smaller companies and niche borrowers. Therefore, private credit lenders stepped in to provide financing to borrowers unable to access traditional pools of capital.

In 2024, the global private credit market is estimated at roughly \$1.4tn in assets under management (AUM)<sup>2</sup>. It is projected that the global private credit market AUM may reach up to \$3.5tn by 2028<sup>3</sup>. However, recent developments have driven a transformation in the private credit market. Historically dominated by corporate direct lending, private credit has broadened to include other segments, such as asset-based lending and specialty finance. In the US alone, this segment is estimated at \$5.5tn, with private credit currently representing less than 5% of this volume<sup>4</sup>. This paradigm shift reflects a broader trend reshaping how risks are sourced and financed in both public and private credit markets.

In general, private lenders can offer bespoke terms and have the ability to act quickly. In contrast to cash flow-backed direct lending, asset-based lending aims to ensure that the collateral being financed is excluded from the bankruptcy estate of the borrower. For asset-based lending facilities, the asset manager typically analyzes the collateral value of the assets and lends a percentage of that value, with the balance in the capital structure being covered by the borrower.

### Characteristics of Satellite Alternatives Strategies

- **Diversification:** Serve as complementing components to the investors' core Alternatives allocation, offering exposure to unique assets and strategies.
- **Enhanced Returns:** Access to less efficient markets provides the potential for enhanced portfolio returns with attractive risk-adjusted profile compared to core Alternatives universe and traditional investments.
- **Innovation Exposure:** Investing in emerging sectors and technologies can position a portfolio at the forefront of market developments.
- **Uncorrelated Hedge:** Certain Satellite investments can act as hedges against specific risks with low correlation with economic cycles and public markets volatility.
- **Strategic Liquidity:** Certain Satellite Alternatives offer open-ended vehicles with strategic liquidity and closed-ended vehicles with shorter tenure assets, compared to the core Private Markets universe.



Investors should consider that allocation to Satellite Alternatives require in-depth due diligence to effectively identify and manage risks, such as liquidity risks and valuation of investment instruments and underlying collateral.

<sup>2</sup> Bloomberg, Private Credit Muscles Out Banks, With Worrisome Consequences, January 13, 2023

<sup>3</sup> Congressional Research Service, Private Credit Apr. 2024

<sup>4</sup> Private Credit's Next Act, Oliver Wyman, 2024

The current economic and geopolitical environment has underscored the necessity for diversification beyond conventional asset classes. Satellite Alternatives strategies have gained prominence as they offer exposure to different risk factors and uncorrelated returns compared to traditional asset classes and the broader Alternatives markets. These strategies can provide a buffer against volatility, even during economic downturns, and serve as a source of attractive yields. Moreover, specialized credit strategies offer unique opportunities to capitalize on market inefficiencies and dislocations. These strategies can exploit specific situations where traditional investors may be unable or unwilling to participate, potentially leading to superior risk-adjusted returns. By incorporating these niche strategies, investors can diversify their sources of return, mitigate risks associated with traditional fixed-income investments, and better navigate the complexities of the current economic landscape.

Due to their high complexity, Satellite Alternatives strategies are typically offered by asset managers with deep expertise in niche markets. The focus is on specialized investment strategies, offering short-term loans or financing backed by real assets or financial assets. The asset managers leverage their specialized knowledge and flexible investment approach to navigate less efficient markets, aiming to provide enhanced diversification and the potential for higher returns to their investors.

### Risk-Return Comparison of Traditional and Alternative Asset Classes

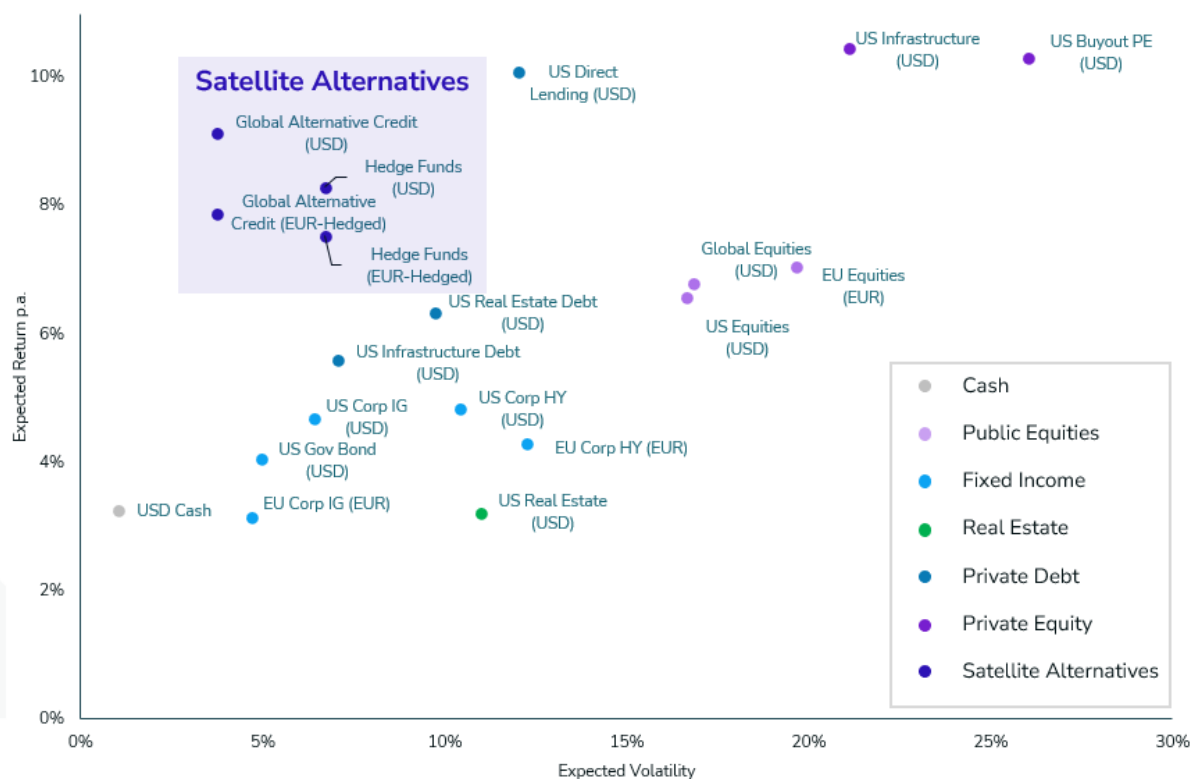


Chart 2: 10y-Expected Return and Volatility Figures: Neuberger Berman, The Case for Private Credit in Insurance Portfolios, May 2023; Amundi Capital Market Assumptions, Dec. 2023; BlackRock Investment Institute, Aug 2024; Preqin, information compiled by PNC

## Coverage of Satellite Alternatives

Satellite Alternatives encompass a diverse range of investment strategies and asset classes:



### 1. Asset-Backed Lending & Leasing

Lending and leasing secured by tangible assets, providing collateralized loans where the asset serves as security. Includes financing against equipment, inventory, real estate, and other physical assets.

#### Strategies:

- Asset-Backed Lending
- Real Estate Bridge Finance
- Asset Leasing



### 2. Corporate Specialty Lending

Specialized financing solutions for niche markets, often underserved by traditional lenders. Includes bridge lending to SMEs, debt financing to startups and growing companies, stressed companies and loan portfolios sourced by FinTech companies.

#### Strategies:

- SME Lending
- Special Situations
- Distressed Debt
- Venture Debt
- Speciality Finance



### 3. Receivables & Trade Finance

Financing that supports domestic and international trade by providing working capital solutions. Includes financing against receivables, invoices, and trade goods. Factoring involves purchasing financial assets.

#### Strategies:

- Trade Finance
- Supply-Chain Finance
- Factoring
- Receivables Finance



### 4. Intellectual Property & Litigation

Financing secured by intangible assets, such as IP and legal claims. Litigation finance provides capital to law firms to fund legal cases. IP finance involves lending against IP assets, such as rights to revenue streams from music, films and pharmaceuticals, benefiting from licensing fees or royalty income.

#### Strategies:

- Litigation Finance
- Intellectual Property Finance
- Royalties Finance



### 5. Public Credit Opportunities

Specialized public credit strategies that offer unique risk-return profiles beyond traditional fixed-income investments capitalizing on high complexity and asset mispricing.

#### Strategies:

- Event Driven Credit
- Distressed Debt Securities
- Leveraged Loans
- Structured Credit (ABS, MBS, CLOs)



### 6. Other Alternative Credit Strategies

Additional range of non-traditional financing solutions that serve niche markets or address specific financing needs not covered by traditional lenders.

#### Strategies:

- Life Settlement, Insurance-linked securities
- Regulatory Capital (Bank Risk Transfer)
- Net Asset Value (NAV) Finance
- Consumer Lending (CC, Auto Loans, Student Loans)

## Assessment and Selection of Alternatives GPs

Investors should recognize that in contrast to traditional asset classes, alternative investments asset managers/ general partners (GPs) are subject to higher return dispersion within the investable universe of funds and investment products. Preqin investment industry data shows significant performance variability among funds within alternative investments strategies, including private equity and private credit. For certain Alternatives segments, it is typical that the top-quartile funds outperform the bottom-quartile by over 10%:

### Net IRR Dispersion across Private Debt Segments

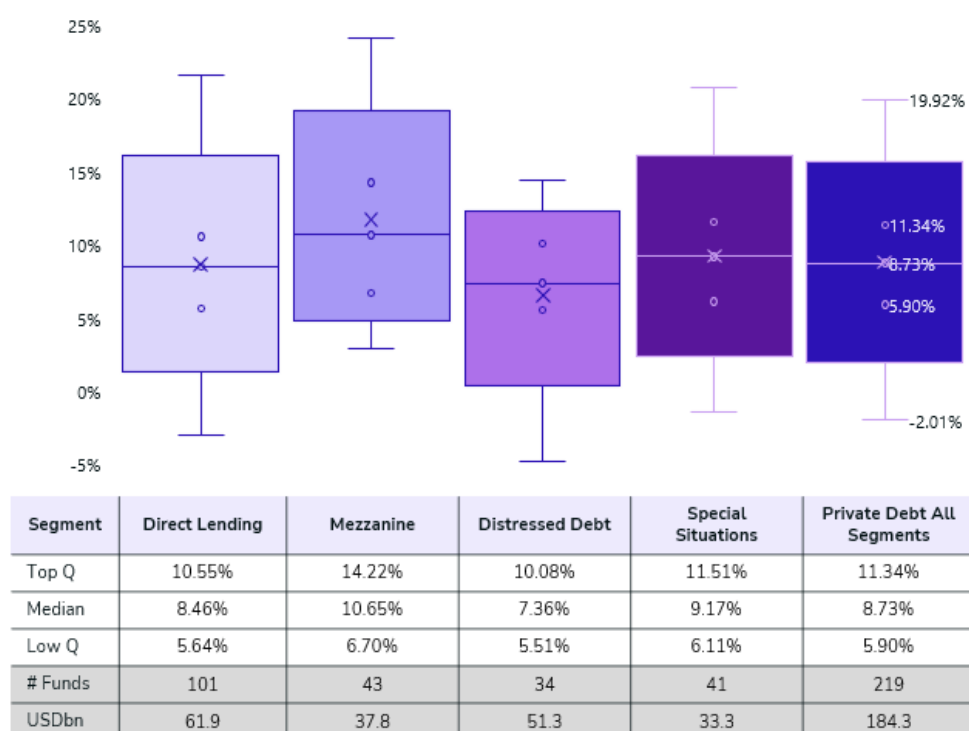


Chart 3: Global Private Debt Fund Performance Data (Fund Vintages 2024-2026, in USD), Preqin 2024

The return dispersion of alternative investment GPs may be due to factors such as the heterogeneous nature of investment strategies and underlying assets, illiquidity and the lack of standardized benchmarks. However, the varying levels of manager capabilities are also a significant factor for return dispersion, as alternative investment strategies require specialized expertise and the GPs ability to originate deals, underwrite risks and construct a robust portfolio. Moreover, differences in risk management and work-out capabilities as well as operational processes and execution efficiency can lead to significant performance variations.

This analysis emphasizes the importance of in-depth due diligence by the investors as choosing the right manager can greatly impact investment outcomes. Investors should thoroughly assess the managers' investment strategy and operational capabilities, with increased focus on the specialized expertise and track record as well as the alignment of interest.

### Characteristics of Satellite Alternatives GPs

Specialized Asset managers/ general partners (GPs) have distinct characteristics that enable them to effectively navigate niche markets and provide investors with access to unique assets and strategies not commonly found in traditional asset classes and core alternative investments:

- **Focus on Niche Markets:** Targeted investment strategies in less crowded markets, where inefficiencies exist, providing the potential for higher returns. This focus allows the GPs to exploit opportunities that are overlooked by larger, core Alternatives GPs.
- **Specialized Expertise and Knowledge:** Deep industry knowledge and experience in specific niche markets. The GPs' expertise allows them to identify and capitalize on unique investment opportunities.
- **Robust Risk Underwriting:** Proficiency in specialized areas like asset valuation, risk assessment, and legal due diligence. Implementation of rigorous risk management strategies to mitigate unique risks associated with niche investments, such as liquidity risk, regulatory changes or asset-specific risks.
- **Flexible Investment Structures:** GPs offer bespoke investment instruments tailored to the specific needs of their borrowers and considering the deal characteristics with specialized covenants.

## Conclusion

The Satellite Alternatives segment poses an attractive investment opportunity for professional investors who are looking to further diversify their return streams and risk factors in the portfolio. By incorporating these strategies, investors can enhance portfolio performance through funding specialized sectors and underserved or less efficient markets. The Satellite Alternatives allocation acts as a complementing factor to an existing core Alternatives portfolio, generating uncorrelated returns from bespoke debt instruments secured with real or financial assets.

The Satellite Alternatives GPs focus on niche markets, hence specialized knowledge is essential to navigate the complex investment strategies and risks. Therefore, investors should consider that thorough due diligence and risk assessment are crucial, as choosing the right manager can greatly impact investment outcomes.



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The founder, Eugen Lechner, has a track record of more than 10 years working as investment professional, servicing fund-of-fund mandates and institutional investors, which results in a thorough understanding of investment requirements of professional investors. Eugen Lechner has interacted with a large number of asset managers globally and has assessed numerous funds across alternative investment strategies.

Prior to launching Polar Night Capital, the founder, Eugen Lechner was part of the Manager Selection and Fund-of-Fund team at Prime Capital AG. Throughout his career, he was involved in numerous fund searches and due diligence across Alternatives and Private Markets strategies, such as Private Equity, Real Estate, Private Credit and Hedge Funds.



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