Interim Results for the six months ended 30 September 2022

Presentation Transcript

17 November 2022

Chris Hunt

Good morning and welcome to ICG's results for the six months, ending 30th of September 2022. I'm joined by our CEO Benoît Durteste and our CFO, Vijay Bharadia, who will give a short overview of our performance during the period and will then take questions. The slides along with the accompanying results announcement are available on our website. For those of you joining online, you can submit questions through the webcast messaging function, or via telephone, and you can find the details in the online portal. As a reminder, unless stated otherwise, all financial information discussed today is based on alternative performance measures, which exclude the consolidation of some of our fund structures required under IFRS. At this point, I'll hand over to our CEO and CIO, Benoît.

Benoît Durteste

Thanks Chris. Good morning and thank you for making the time and joining us this morning. We, of course, will be discussing our H1 performance and numbers in detail, and I would also like to share my observations about the market context, our experience of the environment, and how we are positioning ourselves. As a spoiler, you will find that many of our strategies are very well positioned to benefit from the prevailing market conditions. I gave my first results presentation as CEO five years ago almost to the day, and during this period our growth has dramatically accelerated. Our Fee Earning AUM has grown by more than two and a half times, our client base has doubled, our LTM Fee Income today stands at over half a billion pounds. That's over three times greater than in 2017. And our LTM Fund Management Company Profit Before Tax has almost quadrupled in the five years to just over 300 million pounds.

Importantly, this growth has been entirely organic. We have also distributed in the period over 850 million pounds in dividends, while simultaneously degearing the balance sheet significantly. As investors ourselves, so with our investor hat on, ICG is the type of business that we like. Its strong growth, highly recurring revenues, with long-term visibility and high cash flow generation. ICG has changed a lot in that period and today we are better placed strategically and financially than we have ever been. One of the key developments is the step change in resilience and growth prospects of ICG compared to 10 or even five years ago.

From a fund performance perspective, we have an established reputation for a strong investment culture, a preference for more complex structured transactions with a focus on downside protection. Consistency of performance across cycles is what we have delivered and it's what our LPs value most. You will have heard from me over the years that we are emphasizing downside protection, discipline around realizations, exits, anchoring, fund performance. This is part of our investment DNA. This is what we always do. What we have been doing over the past couple of years, and why our funds and portfolios are in a strong position today, and I will come back to that.

Strategically, ICG is both more resilient and enjoys greater growth prospects as we have broadened our product offering and client franchise, thereby diversifying our sources of fee income and widening the pool of assets we can potentially invest in. From a financial perspective, we have focused on growing management fee income, building and maintaining our high operating margin and strengthening our balance sheet, which is as you know a highly strategic engine of growth for us.

I've spent the better part of October meeting many of our existing or prospective clients around the world, and there were several themes I was hearing consistently against a backdrop of a more challenging and nuanced fundraising market. First of all, LPs are not going risk off, unlike post-GFC. They are being much more selective and focusing mostly on re-ups, coming back into funds that they were previously invested in. This favours larger, well-established and diversified managers. There's also significant demand for products that give LPs exposure to higher rates, and/or inflation protection, so think debt, structured products, or real assets.

Importantly, there was general feedback that long-term allocations to alternatives would continue to rise, and in some cases may even accelerate. For instance, many investors with significant exposure to private equity have modest and sometimes no allocation to private debt, but when we are able to offer, for the first time in history, double-digit returns, unlevered for senior debt, and something that I haven't seen since 2005, mid to upper teens pricing on subordinated debt, that approach is being rapidly and seriously reconsidered to our benefit.

On the investment side, the world is unsurprisingly going through a period of price discovery as buyer and seller expectations take time to converge. This translates into lower deal activity in traditional buyouts. Where there is no slowdown is in the level of demand for financing in any shape. With traditional debt markets having basically closed and banks having further retrenched. Managers with available capacity are, as a result, enjoying exceptional pricing and negotiating power. And with over $16 billion of dry powder, and hopefully more to come as we continue to fundraise, we have ample capital available to deploy in into these opportunities.

Turning to our performance in the last six months, which illustrates some of the characteristics I've just discussed. In an off-cycle year, we have raised nearly $6 billion in the last six months, very much in line with our long-term guidance. We continue to progress on our sustainability and people agenda, with some notable senior hires, and we're also exploring the potential of making our Life Sciences fund Article 9 under SFDR. We don't have an Article 9 fund today and I'm reasonably confident we will succeed. Financially. Our third-party fee AUM is up 16% year on year, which has driven a 33% increase in our third-party fee income to 265 million pounds, and a profit before tax for the fund management company of 144 million pounds. That's up 19%, year on year.

As we have consistently said, fundraising this year was always likely to be a low point in our fundraising cycle, while last year was a high point. The close to $6 billion we have raised in this period is comfortably ahead of what we might have expected, regardless of market conditions, in a low point in our own fundraising cycle. We've grown at such a pace in recent years that I think we still underestimate the impact on fundraising of a much broader diversified product offering, as well as of larger and therefore more relevant funds. During the period we had final closes for Europe VIII, for Strategic Equity IV, for APAC IV, that's Asia, all above their initial targets, and all seeing material increases in third-party AUM compared to their previous vintages. We have raised over $28 billion since the beginning of this fundraising cycle 18 months ago, and you will remember that we were targeting $40 billion over four years, so we're well ahead.

Looking forward, the strategies we are fundraising for should be well received, given their exposure to floating interest rates, inflation-protected income, or structured solutions. As well as continuing to raise for SDP V, that's direct lending and SLB II, Sale and Leaseback, we have recently launched the third vintage of our North American subordinated debt strategy. To name a few more that could launch during the remainder of the financial year, so in the coming months, our mid-market fund in Europe, real estate, several strategies there, infrastructure, where the first vintage has performed incredibly well, thanks in part to significant exposure to renewables, and Strategic Equity V, which finds itself in a sweet spot of the market with very significant supply-demand imbalance.

Supporting this fundraising performance, our client base has continued to grow during the half, and we have a very diversified range of clients now numbering well over 600, I think we're over 620. We are continuing to attract new clients to both existing and established strategies. For example, some 30% of Europe VIII third-party AUM is coming from clients that were completely new to ICG, and that's for an eighth vintage. This is a function of our growing brand, our increasing scale, and the fact that LPs are prioritizing allocations to managers with a strong track record.

We are constantly assessing and enhancing our Marketing and Client Relations platform. In recent months, we have been making selected hires to focus on certain products, such as real estate, and certain client types such as insurance. We're spending time around the wealth channel as well. We've recently made a marketing hire in the US to support our distribution efforts there, and are likely going to do the same in Europe in the coming months. We've already had several successes within wealth. For instance, approximately 10% of Strategic Equity IV was raised through the wealth channel, but we're being targeted and deliberate here. We're focused on creating long-term value through this channel, rather than taking short-term tactical steps. This is obviously a strategic area and will be the topic of a shorter seminar we will be holding in January, so watch this space.

Turning to our investment activity, despite a globally slower environment, we are continuing to deploy and realize capital at scale. Indeed, the levels of deployment and realization activity we executed on during the last six months are second only to last year's exceptionally high levels of activity. And again, our breath is important here. Private debt driven by direct lending saw strong deployment, largely because alternative sources for debt financing as I've mentioned before, are basically shut. Within our structured and private equity strategies, our flexibility to invest up and down the capital structure is the key point to note, and it comes particularly to the foreign, more challenging market conditions enabling us to execute bespoke transactions. Our current pipeline for this strategy alone is in excess of 17 billion euros.

From a realization perspective, we have continued to find opportunities to crystallize gains and anchor portfolio returns. This approach has had real benefit for our funds performance, as I will discuss shortly. We have no material exposure to exits via IPO, never have, but obviously that's a more volatile part of the market. Importantly, given our very strong DPI, distributed to paid-in, how much capital we've returned to investors on any given fund, we are not under any pressure to realize assets, and as you will be aware, holding assets for longer is beneficial for management fees. For a number of our strategies, and notably all strategies with a debt component, the current market environment is extremely favourable, and I see this continuing well into 2023, very likely into 2024.

I have pointed out our preference for structured transactions. I've highlighted that even one of our most equity-exposed strategies, our flagship European fund, has significant downside protection and is therefore much less exposed to fluctuations and equity valuations than a plain vanilla private equity fund. To bring this to life, I thought I would share a slide that I showed at our investor AGM a couple of weeks ago in Paris. Garnica is a family-owned Spanish business. It's a global leader in the plywood industry. We initially partnered with a founder and management team in a completely off-market transaction. We structured our investment at the time with approximately 80% of subordinated debt instruments and the balance in a minority equity position. Despite very low leverage, at the outset, it was around 1.5 times EBITDA of senior leverage. The subordinated debt was priced at over 14%, with a full [inaudible]

Even our equity position benefited from downside protection, being stapled to our debt, and with a minimum 18% IRR contractually agreed. And so structured in such a way, you could see that our equity investment was in fact no longer really an equity risk, but did benefit from all of the upside. We exited this deal just a few weeks ago. Our equity realized over three times the money. And across all of our instruments, we realized a 2.3 times multiple, for what was essentially a very well priced debt risk with a low attachment point. And importantly, this advantageous risk/return profile was structured and negotiated in a very buoyant market environment. It was three, three and a half years ago. Current market conditions are obviously further improving our negotiating and pricing position.

Turning to the performance of our portfolio companies, which are, as you can see here, continuing to perform strongly, seeing double-digit growth in LTM EBITDA and relatively modest levels of leverage. It's important to remember that our focus on operational performance, growth, and transaction structuring, drives our returns, not an over-reliance on leverage, as was just illustrated by the Garnica case study. And a word on case study. And a word on valuations, which remain prudent in our view. As a point of reference in our flagship European Fund, the average exit EBITDA multiple we use for valuation purposes is less than 11 times. And furthermore, our valuations are supported by the fact that our realizations during the period, including very recently, were in line with or above the holding values of the businesses and their respective funds. So, where we have equity exposure, and of course that's not the case in all of our strategies, we do build in conservatism in our valuations, which brings us to the performance of our key funds.

Our funds continue to perform well and in many cases are showing flat to outperformance half on half, as you can see here. And this should not come as a surprise given our focus on downside protection and the debt component structured into our transactions. That said, as I've underlined before, short-term movements in fund valuations and NAVs is not a particular focus of our clients. Actual realized performance of a fund at exit is really what matters, which is why they care so much about DPI, and so do we.

To give you an idea of how investors assess a strategy, if we take the European corporate strategy, it's our flagship and incidentally, that's also the strategy in which we are the most invested in via our own balance sheet. Investors will be looking at performance vintage by vintage, and we have four live vintages for the European corporate strategy.

Fund Five is essentially done. There's one asset left and the fund has outperformed, so that's done. Fund Six on the back of strong exits in the past 18 months, has already returned 1.7 times the money, which was the target for the fund. And there's still about a billion euro value left in this vintage. So, that vintage will be a huge success no matter what happens. Fund Seven, so Europe Seven on this slide, will have returned subsequent to a very recent exit, almost half the capital, with just three deals having fully exited and in just four years, and we have up to 12 years to realize this fund.

So, not only is Europe seven off to a very strong start, but we have a lot of time to ride out any cycle. And finally, Europe eight, our most recent vintage, finds itself with significant dry powder just when market conditions are extremely favourable for the strategy as we've discussed. That's how an investor would look at this strategy and you can understand therefore why we had to increase the hard cap twice for Europe eight by the time we close this summer. This is also important as it's the best indication of potential LP appetite for Europe nine when it comes to market and therefore, of future fee generation and profit for the fund management company.

The headline on today's announcement is that the current market environment highlights our strengths and I think from a strategic perspective that is clear. The scaling of our product offering is increasingly evident. We have raised $28 billion since the beginning of this fundraising cycle just 18 months ago. Today we are raising for strategies within private debt and real assets with floating rate and inflation protected income characteristics, which should be particularly attractive in the current environment.

In periods of uncertainty, our scale, our breadth, flexibility of approach are incrementally meaningful and differentiating, and we are seeing the benefits of that in both our client franchise and our investment activity. We have built and will continue to strengthen a broad product offering, a sophisticated client strategy, a differentiated, very local origination capability, and a track record of managing portfolios to generate value through cycles. Importantly, this is underpinned by a strongly capitalized firm with a dynamic, very investment-focused and entrepreneurial culture.

I'm confident in the supportive long-term structural tailwinds for the private markets and I believe we are well positioned to be one of the managers to emerge stronger from the cycle and therefore, should disproportionately benefit from the favourable long-term structural trends of our industry. And on that note, I'll hand over to you, Vijay.

Vijay Bharadia

Thank you Benoît, and thank you all for your time today. First, a brief snapshot of our key financial results and I will touch on each one of these in more detail later on. These results underlying the strength of our business, the resilient nature of our fee-centric fund management company with long-term visibility that drives impressive growth through uncertain times and supported by a very strong balance sheet. I'm extremely proud of the performance of our business during the period.

I will now go through each of our key financial results in detail. First, a word on currency. During the period, we saw some significant swings in foreign exchange rates with the dollar strengthening and particularly during September, the sterling weakening significantly. For ICG, the most important currencies that impact our financial results are sterling, the US dollar, and the euro. There are two important elements here to note.

First, the impact of FX on our reported financials. Fees are charged on the underlying fund currency, which are predominantly denominated in euros and dollars. Therefore, although our dollar reported AUM had a negative impact given the strengthening of the dollar, this does not matter from a P&L perspective. Indeed, a stronger dollar and a weaker sterling generated a positive benefit of about 11 million pounds on our fee income during the period.

Secondly, the impact of our hedging. We seek to hedge non-sterling income to the extent that it's not matched by non-sterling costs and report the changes in the value of the hedges through the revenue line. Because these net income hedges relate to future periods as well as the current period, the change in value of the hedge is greater than the impact on fees in any given period. During the period, we reported a negative change in value of such hedges of about 46 million pounds, of which around 5 million related to this period, and the remainder relates to future periods. Given that sterling started recovering in October, a portion of that, about 12 million, has reversed. Excluding the impact of our foreign exchange hedging, a weaker sterling is positive for our financial results and we provide more detail and a sensitivity analysis of that in our RNS.

Moving on to our AUM and how this provides visibility on our management fees. Our fee earning AUM on a constant currency basis grew by 16% in the last 12 months and 6% during the period. Our fee earning AUM is what generates our management fees, and it is impacted by three things. Firstly, it is increased when we raise funds that charge fees on committed capital. Fundraising during the period increased our fee earning AUM by $3.4 billion.

Secondly, it is increased by us deploying from strategies that charge fees on invested capital, such as private debt. Our deployment from such strategies increased our fee earning AUM by $4.1 billion during the period.

And finally, it is reduced by realizations which had a 3.8 billion impact in the fund. In the event of a slowdown in transaction activity, therefore, our fee earning AUM may grow slowly, but it continues to generate substantial and visible management fees. And because our funds are closed ended and almost all charge fees that are not impacted by fund NAVs, the management fee potential is very visible.

And to illustrate this, as you can see on the right-hand side, as at 30th of September, we had 57 billion in fee earning AUM, with a weighted average fee rate of just over 90 basis points. If nothing happened, no fundraising, no deployment, no realizations, and no changes in FX, we estimate that that AUM would generate approximately 464 million pounds in management fees in a year. We also have 8.3 billion of AUM not yet earning fees, largely within our private debt strategies that earn fees on invested capital. And we estimate that that AUM has an additional annualized management fee potential of approximately 70 million pounds. So, that impressively translates into over half a billion pounds in annualized management fee potential.

This dynamic of long-term fee visibility that is not impacted by market volatility is at the heart of what we are so confident about in the resilience of our management fee income stream, which is an incredibly powerful economic foundation of our business model.

Turning to our fee income, this grew by 33% year-on-year. 95% of our fee income this period was management fees and includes a 29 million pound catch-up fees predominantly from European Fund Eight and Strategic Equity Four, as well as around 11 million pounds of a positive impact from FX that I mentioned earlier. More generally, our fee income has grown at an annualized rate of 28% for the last five years, and we are now generating over half a billion pounds in LTM third-party fee income, which is really quite notable.

Moving onto our operating margin, this grew by roughly 370 basis points year-on-year to 55.9%. This substantial growth in part was due to the catch-up fees that I mentioned earlier, as well as a strong focus on cost control that we continue to maintain. At 113 million pounds, our operating expenses were up by only 2% year-on-year.

Employee costs increased broadly in line with headcount, and we are carefully controlling administrative and other expenses within the fund management company. We continue to hire during the period and headcount grew by just under 10% in the six months. In the medium-term, we will continue to strategically hire to support our growth ambition, and in the near-term, particularly during the second half of this year, we expect the pace of hiring to slow.

Turning to fund management company profits. The step up in our fee income, along with a higher operating margin, has driven a year-on-year increase of 19% in our FMC profits before tax. And over the last 12 months, we've generated over 300 million pounds in FMC profits. You can see the impact of FX hedges here, and as mentioned earlier, about 41 million of the 46 million shown here, relates to hedges of future fee income. Excluding that, our FMC profit for the year was 185 million pounds.

The progression of our FMC profits is closely linked to the increase in our fee earning AUM, and over the last five years, we have grown our FMC profits at an annualized rate of 27%. Our progressive dividend policy remains in place and in line with our policy of paying an interim dividend of a third of prior year's total dividend. We are today declaring an interim dividend of 25.3p per share.

Turning now to our balance sheet, this remains robust, well capitalized and very valuable. We have total liquidity of 1.3 billion pounds, including an undrawn revolver of 550 million pounds. Our drawn debt is all at fixed rates with a weighted average cost of 3.3% and a weighted maturity of 4.2 years. During the period, we were upgraded by S&P to BBB, which we were very pleased about and means that we are now rated at BBB with a stable outlook by both S&P and Fitch.

Our NAV per share was 658p down just 5% from March '22, despite the negative net investment returns or NIR, which I will discuss in a moment, that resulted in 108 million loss in our investment company. This underlines the resilience of this component of shareholder value. The largest component of value in our balance sheet is our investment portfolio, which at 2.9 billion pounds, was broadly flat since March year end. We continue to focus on deploying capital efficiently to maximize shareholder value. Both Europe Eight and Sale & Leaseback Fund Two, for example, have lower commitments from the firm than their previous vintages. And we also sold down a substantial portion of our balance sheet exposure in one of our credit funds during the period.

Turning now to the performance of the balance sheet investment portfolio during the period. Our balance sheet invests alongside our clients and seeds new strategies. During the period, we invested 315 million pounds, including 118 million for seed investments in respect of strategies we expect to launch in the future, and had 437 million pounds of realizations. This resulted in the balance sheets investment activities generating 122 million pounds of cash. Of note, all those realizations were higher than or in line with previously reported NAVs. The net investment returns, of course, mirror the fund valuations, and as a result, it is no surprise that the NIR in structured and private equity and real assets are below historical averages, whilst private debt is performing in line with historical averages.

So, in summary, a very resilient performance across those asset classes. In respect of credit, the unrealized loss of 46 million pounds includes a reduction of around 24 million pounds in the CLO equity to reflect CLO dividend receipts, and around 18 million in respect of changes in the value of CLO debt and co-investments in our other liquid credit funds. The remainder is a net effect of increases in default rates and discount rate assumptions offset by the unwinding of discounts in the valuations, which are detailed further in our announcement today.

It is important to recognize that whilst NIR may fluctuate in a given period, as they've done this year, or indeed did last year, over a typical fund performance life cycle of around five years, we expect the NIR to be in the low double digit returns. As you can see from the right inside on here. Against a backdrop of uncertainty and lower transaction velocity, our balance sheet has once again demonstrated considerable financial resilience as well as enabling us to invest for future growth. In essence, it's behaving exactly as you'd expected it would.

Our confidence in the business model and our future prospects is underlined by the fact that our guidance remains unchanged from what we set out at our FY 22 year end results. Fundraising is on track with $28 billion raised in the last 18 months, and a substantial performance fee potential embedded within a number of our strategies in the coming years. Our margin remains strong and our portfolios are performing in line with expectations supporting our medium term guidance on net investment returns. And as we expect to continue to grow by launching a number of new strategies supported by our balance sheet, we remain committed to having a long-term target of zero net gearing.

Pulling that together, I believe it is important to reflect on the financial strength of our business model. Benoît discussed earlier how today's results underline our strategic strengths and our financial strengths are equally evident. We have a very attractive model that has delivered long-term value. It starts with our attractive strategic positioning, broad product offering, and a growing client franchise. That results in us having multiple levers to build an incredibly diversified AUM base, both by growing up and by growing out. This in turn, drives a growing fee income with a long-term visibility and a substantial operating leverage as strategies scale.

The components of our equity value are therefore clear. Most importantly, we've almost quadrupled our FMC profits in the last five years, which has been driven almost entirely by third party fee income. That has led to a notable and a growing program of capital returns to our shareholders through our progressive dividend policy, over 850 million since FY 18, as can be seen here with a DPS CAGR of over 25%. And finally, the combination of strong fund performance combined with our policy of reducing gearing has led to growth in equity value of over 600 million on our balance sheet, equivalent to an annualized growth rate of 10%.

To conclude, I will reinforce what Benoît said at the beginning. Over the last five years, we have broadened and strengthened ICG across many dimensions. The uncertain environment we are in today is highlighting our strengths and we are very placed strategically and financially to capitalized on the substantial opportunities that lie ahead of us. Thank you very much for your time today. This concludes our presentation. And Benoît, I'm happy to take any questions from now. We'll start with those in the room and then we'll take questions online.

Nicholas Herman

Thank you very much for the presentation. This is Nicholas Herman from Citi. Three from me, if that's okay? Just one on private debt, and then two on financials. So on private debt, we've seen banks take provisions against their lending positions. It doesn't seem that you are. Doesn’t appear that you're seeing any signs of stress in your portfolio given such strong EBITDA growth, I guess, across the industry, have you seen any signs of stress across the broader direct lending sector? And for you specifically, how much would EBITDA have to shrink or begin to contract before you had seen any signs of stress in your portfolio?

Benoît Durteste

Okay. I'll take that. So a couple aspects there. We're in buyouts, where banks have taken a hit is on hung syndication. It's not on portfolio transactions, it's on deals that were syndicated pre the crisis at levels of pricing for the debt that just do not match with current pricing. And so they've had to take a hit to syndicate those transactions. For now, there's been no sign of stress in private debt and that's across geographies. To your question as to how much EBITDA reduction, you have to look at it deal by deal, right? You can't take an overall view. I think what's worth mentioning, if you try to make a comparison to what has been experienced in previous crisis, and what we've pointed to before, is the in current structure, the level of equitization is much, much higher than it was pre GFC. Deals that were done in the past few years typically had roughly 50% of equity in those deals.

So a different way of looking at it is before you start hitting the debt, you have to eat through a very significant, well, half of the capital structure. And also the other aspect is pre the GFC, there had been a huge wave of recaps. So private equity sponsor essentially distributing themselves dividends in order to de-risk themselves. This hasn't happened this time. So you're having situations with private equity sponsors that have very significant investment at stake in this transaction and therefore much more likely to keep on supporting them. So overall, for debt strategies, I think it would take a very, very severe recession over several years to start to see a meaningful impact.

Nicholas Herman

That's very helpful, thank you. And then moving to the financials, on the revenue side, thank you for the disclosure of run rate management fees, I think that's very interesting. I guess not withstanding FX, more than half a billion of management fee potential would appear to imply that market expectations for management fee revenues are a bit too low? I guess, considering how constructive the private debt deployment environment is. So any comment you have there would be interesting. And then on the cost side, hiring in the first half was strong, but it looks like cost control was very good despite FX inflating your costs. So particularly on the non-com side. So just curious what drove that decline in non-compensation costs? And should we expect to catch up or some large investment spend in the second half, please? Thank you.

Vijay Bharadia

Sure. So on your question on management fees, as I touched on, there are one-offs in the management fees. I talked about the catch up fees as well. There's an element of FX as well. So if you take roughly 29 million of catch fees, 11 million of FX, you're looking at 40 million worth of one-offs in the management fees. So, that needs to be the thought about when you're thinking about a run rate on that. The half a billion that I touched on was all things being equal based on the AUM we have in the dry powder that we have. So we expect over a long period or a medium term target to expect to get to those levels of management fees. In terms of for this financial year specifically, we are very confident in terms of where the consensus is, generally speaking for the FMC profits at a high level, there may be some ups and downs in terms of the fee line items, but that's where we are on management fees.

In respect of costs, you're exactly right to point out, yes, we did have some hiring during the year and Benoît touched on specifically in some areas that we've had some hiring, we expect to slow down on hiring. On the non-compensation costs particularly, we are very conscious around administrative expenses. We have a number of noncom expenses, professional fees, other parts of the organization, travel and entertainment as well, of course, agents recruitment fees, et cetera. So there's a number of areas that we continue to monitor as we continue to go through. Over the second half of the year, in the near term, I expect to slow down in terms of the hiring and therefore you'll see that come through. Year on year, you will see it an uptick on costs when you compare this financial year to last financial. And the reason is purely because you've got an annualized effect of prior years hires coming through this year, as well as high as for this year. But overall, we are very confident in terms of where the costs are for this year.

Luke Mason

Luke Mason from BNP Paribas Exane. Just first question on fundraising. Just wondering if you could give an outlook by the different buckets of your LPs, so pension funds, insurers, sovereign wealth funds, et cetera. Are you seeing certain stresses in certain parts of the market? And secondly we've heard from peers about some pushback in fundraising, some pension funds, et cetera, pushing back to 2023. Are you guys seeing that in terms of delays to next year from those allocators? And then just on the pace of deployment in private debt, just in terms of taking share from the banks, but then the overall activity in the market is lower, how do you see the outlook there and I guess, within the mix deployment for buyout funds and deployment for refinancings, et cetera? If you can give any comment there, that'd be interesting. Thank you.

Benoît Durteste

Sure. Several aspects. So fundraising and deployment. On fundraising, I mean, with a few exceptions, Middle East for instance, there's stress everywhere, for sure. We've mentioned the denominator effect where all LPs or most LPs find themselves in a situation where because public market values have dropped significantly, they just mechanically find themselves with over exposure to alternatives. So technically, some are constraints, for some of them it's even a statutory constraint. So yes, you're seeing that through the market. As I was pointing out, and I've been talking to a lot of LPs over the past few months, going to see them, none of them are going risk off. Okay, I haven't heard that anywhere. They're just managing how they're approaching their deployment in the near term. 22/23, I mean, 22's done anyway, we're in 23, so I don't know how that's hugely relevant. We haven't been impacted that much by that, but that may be just linked to our own timing of our own funds.

So again, I would take that with a pinch of salt. In any event, for fundraising, you have to look at overall longer period than just six months or one year. At the end of the day, what really matters is, even if it takes a bit longer to raise, do you get to the end result that you were expecting or not? I still think, by the way, that yes, obviously as you're getting into 23, some have new budgets to spend into 23, because that's how they're organized. Overall, I still expect the environment to remain more difficult than it was a year ago where, I mean, there was so much capital being invested that we were hitting historical highs. So I still expect 23 to be more subdued. Having said that, we are in a position where we're fortunate that the main funds we have in the market are more debt or real assets fund, which happen to resonate right now with LPs.

It's certainly more difficult if you are going out with a pure plain vanilla private equity fund. But even then, there is, there's fundraising happening. And we don't have pure private equity fund, but for those raising for those, I mean they're still raising, the market hasn't stopped. On deployment and sorry, and importantly, I mean, I mentioned that during the presentation, but that's a really important one because, if you're thinking about our industry, in a sense the current environment is important, but it's not terribly important. What really matters is the long term. And so the real question is long term, are we seeing a shift in our investors' approach to alternatives? And the answer is clearly, no. At least, that's the answer from CIOs. And that's from whether it's insurance, whether it's Southern Wealth Fund, whether it's pension funds, and pension fund is mostly the large US pension funds.

They're still on a path to increase allocations to alternatives. And for some, quite meaningfully. Because for some they have a 10 year target of increasing by 5, 10% their allocation, and that's very significant capital that will therefore move into the space. On deployment, yes, you're right, there's a balance between lack of debt, scarcity of debt in the system, and overall lower deal flow. Having said that, if you think about it, what we are seeing today is, private equity sponsor need significant amounts of financing in addition to... There are still a few new transactions getting done, right? The market hasn't stopped. But setting aside the new transaction, if you think about it, private equity sponsors today have a few difficulties they need to deal with. One is on their existing portfolio, depending on where they see valuations evolving, clearly they need to at least, protect, maybe enhance the valuation of their portfolio company.

The only way to do that is to do a creative M and A. So take advantage of the current market environment to buy companies at lower valuation level, and so average down their overall entry price for their deals. The only way to do that is you need financing for that, and there's lack of financing so suddenly there's significant demand. We could deploy a large part of our direct lending fund just with these add-ons, given the demand there. But there are also other situations, private equity sponsors are also looking at returning capital to their LPs. So I was mentioning how DPI is important. Now, we happen to have very strong DPI numbers, we're top decile for many of our funds, that's not necessarily the case for all private equity sponsors. And as they're going out to fundraise, it's not uncommon for LPs to say, "Yes, I'm interested in your fund, but can I please see a little bit of electronic capital from the previous vintage."

And the current market, if they don't want to exit deals because they don't like the current valuations, they don't have that many options. I mean, either they do some sort of recap and they need financing for that, or they try to roll the asset and they do a continuation deal, which is good for our strategic equity strategy, which is why that strategy is also thriving. So overall, the net balance of all that is, yes, there's less traditional buyout deal flow, but the demand for financing has actually increased, and there's a lot less competition.

Because the banks are not there, public markets are not there. And even in private markets, they are a number of players who find themselves with much lower capacity because the bulk of their AUM was in evergreen vehicles. And these are essentially frozen, because they need to get money back in order to lend again and no money's coming back. So even in private markets, you're seeing that capacity has shrunk. So if you have dried powder right now, you're in a very, very strong position. And it's true for every debt, by the way, it's true for senior debt, it's true for subordinated debt, and it's true for alternatives to financing such as selling these back, same observations.

David McCann

Hey, morning, it's David McCann from Numis. And there's a slide in the appendix, I think a couple along from this where you've kind of got the expected returns and the various asset [inaudible]. I don't know if you can get that up on the screen. I think it's that one, yeah. I mean obviously in the current environment, you talked about the denominator effecting some shorter term issues around fundraising, but just thinking about if LPs are seeing this as the opportunity sets where they can invest within at least your strategies within private market and what they might realistically achieve. I mean, are you having conversations about do these return expectations still stack up compared... Now that they do have some nominal return from fixed income, let's call it 4 to 7%, [inaudible] public equities is it pretty low valuations? Are these still competitive return expectations for LPs? That's I guess first part of that linked to that slide. And then secondly, I guess, how realistic is it to expect that those kind of returns that you have on that slide are achievable on a 5 or 10 year basis, given all the stresses that are out there in the system. Can companies really deliver these EBITDA growth needed to generate these returns. That would [inaudible], I do have another question, but perhaps we'll leave it there...

Benoît Durteste

There's a lot there to unpack. I mean you have to break it down by strategy. For debt strategies there's no debate because that strategies, the returns have just gone up to levels that either have never been reached before for senior debt or haven't been reached in a really, really long time. So actually, if anything, the returns have gone up. And actually that's what we're indicating to our LPs. So senior debt, we've increased the target return for our senior debt fund because now you're generating double digit return on senior debt with no leverage. So in terms of investor appetite, it's going the other way. For the first time we're having investors who are interested in direct lending because it is generating double digit return. So the impact actually goes the other way. There's greater appetite because you're suddenly hitting returns that you couldn't achieve before

Sub debt now is well north of 15%. We're actually seeing things where it's edging towards 20 with some combination of warrants and peak. That hasn't happened... I think last time we did a deal that was in '05. And then the market started degrading. So right now for investors, it's a really interesting window of opportunity. It will last as long as this cycle lasts, I don't think it will... It's only a window. It will revert back to more normal levels at some point. But right now, that's an unusually high opportunity. I think where your question is very valid, is on equity, but we don't have pure equity strategies. But in equity, the question is can you still generate, whatever, let's say 25% for a traditional private equity fund in the next few years? Well, yes, but that will require evaluations to adjust and they haven't yet. So of course it will happen, but I'm not sure. I think it's still early for the equity cycle.

But for instance, in real assets we've already seen it. So in infrastructure equity, infrastructure equity deals are now being priced to generate north of 15%. Nine months ago they were being priced to generate 11, 12. So the asset classes are moving with the general market environment. We can talk about this for hours because it does mean that not every company will be able to support this sort of debt service in transactions. So you're narrowing down the pool of potential transactions to highly cash flow generative businesses that can support that. But then again, these are the type of businesses we liked anyway in order to do buyouts, so that it shouldn't come as much of a surprise. But again, it means lower leverage. It also means it should mean lower valuations for equity sponsors. Does that answer your question on this?

David McCann

Certainly food for thought. Thank you for the colour there. And the final question, nice segue actually onto valuations. Accepting the very reasonable point you made earlier that for yourselves and indeed for LPs, the shorter term to market of how you're valuing the positions in the portfolios, does that really matter versus what you actually sell them for and the dividends and coupons you take out on the way for... That's what arguably does matter, but are you getting any kind of pushback from the valuations that you are presenting, the short term valuation you're presenting to investors? You mentioned the denominator effect being sort of a symptom to this as well, that people are saying that if public equities are down 20%, fixed income down double digits a percent, and then you are presenting them figures that essentially flat, do you get pushback on that and is it...

Benoît Durteste

So in our case, not really. But then again, we have the luxury of not having pure equity strategies. So even our European corporate fund, which is the one that has in a sense the most equity exposure, it's three quarters debt. So that's giving you a big cushion of... Because that's not moving, it's just accruing with interest. So that puts us in a more comfortable position to take more conservative views on equity. So as a result we have no questions from the LPs on that.I don't know of an exception, but almost principle, when we have a transaction that we share with another private equity sponsor where we have a minority position in a deal that's owned by a private equity sponsor, our mark is always lower than theirs, almost as a matter of principle, sometimes meaningfully. But then again, it doesn't mean we're right, by the way. But then again we can take that view because we've got so much of a debt cushion to absorb that in our overall fund performance. So that's what you're seeing today.

The other thing that you're seeing today, which is why the answer to that is not so easy, by and large, take the overall equity world, by and large, valuations haven't moved very much, except for people who are heavily in tech because that was difficult not to, but overall valuations haven't moved very much. But there's a reason for that is that the performance of portfolio companies has remained incredibly strong. It changes by manager, but overall in the market that's been the case. You've seen our numbers and they're in the mid teens, the EBITDA growth. So if you're being prudent and essentially you don't move your nav, what you're doing is you're implicitly lowering the EBITDA multiple for the valuation of these businesses because they keep on growing. So that's why it's not so easy right now to say, "Well, they must be overvalued," because given the performance, the cash flow generation of these business, including in 2022, you are easing down the implied valuation. So it'll be interesting to see into next year.

But again, for us, we're much less exposed to that. So it's an easier debate. No, I mean with LPs... I mean they're interested in our view precisely because in a sense we're unbiased. So they're interested in our view on the market and how we view general valuations, because they're also trying to form their view. But on our own portfolios, there's never been... When there's a discussion is because we share a deal with another sponsor and they're asking us why we're marking it at a lower level than they are, and that's a discussion.

Chris Hunt

[inaudible] in the room there are two questions, couple questions coming online. Vijay first for you, a question on any comments you would have around the outlook for H2 and beyond for CLO dividends and for performance fees?

Vijay Bharadia

On CLO dividends, we are not seeing anything that shows any deterioration in terms of the credit quality of the CLO portfolios yet. So our outlook remains pretty much in line with prior years. In respect to performance fees, just as a backdrop, the way we recognize performance fees is a very conservative approach. We tend to look at two years out from a given period and see which particular funds would actually exceed the threshold, and that assessment is done at an asset level in an aggregate basis, and where we see realization forecast for those assets. Now, given the low velocity of investment activities that we've touched on earlier, we expect to slow down in realizations and therefore a lower performance fees compared to recent periods.

However, the key to recognizing respect to performance is two things. First of all that's happening is pushing out when we'll be able to recognize performance fees. So on an absolute basis, we would still expect to generate what we had envisaged for a particular fund, given the returns that we tend to target. And the second thing is it's important look at the performance fee profile over a medium term rather than a point in time. So you should think about performance fees over a typical fund life cycle. So we expect to be in the region of our guidance of 10 to 15% of third party fee income.

Benoît Durteste

[inaudible] performance fee, the key question is are you at risk of having a lost vintage, essentially? You have a crisis vintage. It can happen, by the way, long term, typically LPs look through that. But that's the question. And in our case, that's not the case. I mean I discussed for the larger European strategy, the various sequences of vintages, but Europe 6 has already triggered carried interest. It's generated 1.7 times, as I mentioned. And Europe 7, which could be the one where you say, "Well, that could be the one that is..." The lost vintage is the one that hits the cycle in full. Because of what we've already returned actually the probability of not triggering performance fees has become incredibly low on this one just because of how much performance we've already anchored up to today. So that's how, looking at it...

And then you need to look at by fund by fund, but the one ones that tend to generate the most performance fees, strategic equity, it doesn't really follow exactly the cycle because it comes in at significant discounts into deals, so it's a different dynamic. So as a result, you shouldn't expect something there where you have a potential lost vintage. And then we have infra, but infra actually it's the other way. So infra, we didn't mention it, but this is one where we haven't taken uplift in valuations, but in infra we could, because all of the renewable deals that we did pre the Ukraine crisis with assumptions on energy prices that were way lower, all of these deals could be marked up significantly. So we already know that vintage is going to be a great vintage as we get into the future. So if you look at this, to Vijay's point, then there's a question of timing, but fundamentally, in terms of performance feed generation from these vintages over time, there's nothing that tells us that we should revisit downward or medium long term expectations at all.

Chris Hunt

Thank you. You mentioned that you had a number of things planned in real estate, which you've obviously mentioned beforehand. Do the current market conditions extend the time horizon? How should we think about ICG's plans in real estate in the coming periods?

Benoît Durteste

If the question is about fundraising timing, yeah, I think the answer is yes, but that's true everywhere. I think the fundraising environment is more difficult. We've discussed some of the constraints that LPs have to deal with. So you have to anticipate that fundraising will take longer for any fund. But again, as I said, it matters and it doesn't really matter in the end. It's the ultimate outcome that really matters. And that will be particularly difficult for new strategies. So we have to acknowledge that. Which by the way doesn't mean that we're not going to be launching new strategies. We are, because you're putting a stake in the ground. But we have to recognize that first time funds will be more... They're always difficult, but they are going to be more difficult in this environment. That's okay. We'll take a bit longer for these strategies.

Chris Hunt

And then finally the last question online, do you have any commentary around your geographic and sector exposures specifically? You mentioned we weren't in tech, but do you have any commentary around where our funds are exposed geographically and sectorally?

Benoît Durteste

Yeah, I mean it hasn't changed very much. I think we've mentioned that in the past, certainly during COVID, we are not exposed to tech at all. We don't do tech. We have significant exposure to healthcare, we have exposure to education, we have some exposure to software, but these are services like accounting software services. So we tend to have exposure to areas that are resilient. And it's not foresight, it's because structurally that's the nature of transactions that fit in well with levered deals. So infrastructure services also, we have significant exposure to infrastructure services, people who lay fiber in the ground. So that's very long term contract, long term visibility. Geographically, I mean most of our funds have a geographic focus. There are a few exceptions, but by and large, LPs prefer to have geographic focus for funds. So we have in sub debt and equity, we have a European fund, we have an Asian fund, we have a US fund, so they're exposed to their local markets.

Within that question, because we've had it from LPs, there's a question about exposure to the UK, by the way. We don't have significant... I mean we have some exposure to the UK within our European portfolios, but typically, for instance, France is a bigger market for US than the UK, has always been. Germany as well. So we have some, but it's not an overly significant exposure. But incidentally, where we are invested in the UK, I'm very confident. I mean we're invested in education, we've been investing on the staycation scene, which benefits from lower pound than potentially from Brexit. So actually the areas that we've invested in I'm quite confident are very attractive areas. I keep having this discussion with LPs, regardless of the up and downs of potentially politics here, there's still some really attractive opportunities in the UK market.

Chris Hunt

Perfect. Well there are no more questions online. If there are no more in the room. Thank you all very much for attending today.

Benoît Durteste

Thank you.