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# Private Equity 2022

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**Norway: Trends & Developments**

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# Trends and Developments

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## Norway: A Haven for Private Equity

### *Introduction*

Although a small country, Norway has an affluent economy. In part, this can be attributed to income from extensive oil and gas extraction in the North Sea, but another contributing factor is likely the traditional openness of the Norwegian economy with few barriers to foreign investment. The "buy side" of private equity is a relatively young phenomenon in Norway, with the first "true" private equity funds by Norwegian sponsors having been established around 20 years ago.

The Norwegian sovereign "Petroleum Fund" (funded by tax income from the oil and gas extraction) is barred from investing in Norway, however, the government-owned investment company for private equity, Argentum, established in 2001, has assisted several Norwegian and Nordic private equity sponsors in achieving a track record and critical size.

The private equity industry in Norway has seen steadily increasing levels of fund raising with larger funds being closed as years progress. There may, however, be large variations from year to year due to the relatively limited number of sponsors in Norway, leading to a marked vintage effect.

Regulation of private equity is "light touch" in Norway: Norway is a member state of the European Economic Area, and as such is required to implement all EU legislation relating to the single market, including financial regulatory legislation. With the exception of general contractual, corporate and marketing law, private equity is regulated only at the level of managers. The Norwegian Alternative Investment Fund Managers Act implements the EU AIFM directive. A private equity fund (outside the scope of the EuVECA and EuSEF regulations) is not regulated.

In the past, Norwegian private equity sponsors relied heavily on use of offshore fund structures, with Guernsey and Jersey being the two most popular jurisdictions. The trend towards onshoring began with the AIFM directive, which has intensified since BREXIT took effect. Today, fund structures are usually established in Norway or another EEA-jurisdiction, primarily Luxembourg.

### *The "green shift" – market and government initiatives*

A major component of the Norwegian economy is extraction of oil and natural gas, and the oil services industry. This has also been the focus of several private equity sponsors, and also the largest Norwegian private equity manager to date, HitecVision.

While investors' focus shifted from general ESG concerns to sustainability in 2021, 2022 presents a more complex picture due to rising energy costs, including natural gas. As the oil and gas industries were initially not perceived as "sustainable", institutional investors allocations to private equity shifted further away from this, affecting both private equity managers active in this segment, as well as the Norwegian oil and gas industry's funding situation. In 2022, the EU Commission has proposed to include specific gas energy activities in the list of environmen-

tally sustainable economic activities covered by the so-called EU Taxonomy. This will doubtless affect investor appetite for gas-related assets and businesses.

Although the government has been vocal in calling for implementation of EU rules on sustainability-related disclosures in the financial services sector (the SFDR regulation), applicable to private equity fund managers, these rules have not yet been implemented. It has also established investment initiatives to fund sustainability-related projects, such as Nysnø, a sovereign climate investment company.

In Norway, this has chiefly been represented by investments into land and sea wind power farms. According to the Norwegian Water Resources and Energy Directorate (NVE), approximately 90% of all energy production is generated through hydropower. However, tax rules and specific investment rules have kept private investments in hydropower (currently 11%) at a low level. There have been initiatives to change this as the hydropower generator park, which is mostly old, requires capital investment for modernisation. A strained energy situation in the south of Norway, with substantially higher energy prices compared to 2021, could spur additional activity in this sector.

This green shift has led to a high level of activity both among mutual funds and private equity funds to source "sustainable" investment objects. All else being equal, this should inflate pricing of sustainable investment objects, and depress prices of non-sustainable investment objects. It remains to be seen how this will affect deal activity going forward.

### *COVID-19 and private equity*

The "green shift" has been concurrent with the COVID-19 pandemic. In terms of economics, Norway has not generally suffered much from the pandemic. However, this hides the fact that certain sectors have done well, while others have been devastated by it. Additionally, the substantial financial resources of the Norwegian government through its sovereign fund also provides a level of "implicit guarantee" for large parts of the Norwegian economy. The Norwegian government withdrew more from the fund than is agreed by the "budgetary rule" (Norwegian: "*handlingsregelen*"), which states that no more than 3% (previously 4%) of the fund should be withdrawn and used in any one year in order to prevent macroeconomic stress (and fund depletion).

According to the Norwegian Venture Capital Association (NVCA), Norwegian private equity funds are primarily invested in IT, oil and gas, and consumer goods retail. The IT and oil and gas industries have been largely unaffected by COVID-19 – indeed, IT has generally performed well with the increased demand for IT solutions and the expansion of work from home policies.

The non-sectoral funds with reasonably diversified portfolios should therefore not be adversely affected, whereas sectors such as gyms, food service and travel have experienced significant losses. An immediate effect of COVID-19 on private equity may seem to be volatility, and uncertainty in valuation models. Volatility may well be weathered by funds that are in their investment phase. However, late stage funds will likely need to extend their term in order to avoid non-optimal exits, and during the last few years more than one sponsor has restructured investments at the requests of GPs, offering existing investors certain liquidity options.

*Real estate funds and COVID-19*

Among the Norwegian alternatives sector, real estate funds, and single asset real estate funds, account for over double the AuM of Norwegian private equity funds, according to statistics from the Financial Supervisory Authority of Norway. In the infrastructure sector, however, real estate funds border on private equity.

As a result of COVID-19 and lockdowns, significant have introduced large – and likely to a large extent – lasting changes have been introduced in office use, retail and distribution. Due to the fact that real estate funds are typically sector-specific, and single asset funds are by their very nature undiversified, such funds are at increased risk of greater volatility and restructurings.

*Legislative bottlenecks*

Norway is required to implement the main body of EU-legislation pertaining to the single market as a party to the EEA-Agreement, including legislation relating to the financial sector and asset management.

The establishment of the EU system of financial supervision in 2011, with the EU supervisory organisations, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and the Occupational Pensions Authority (EIOPA) conferred supranational authority, was contrary to one of the principles of the EEA Agreement, which prohibits member states from relinquishing sovereignty. In 2016, the Norwegian Parliament approved an agreement concerning Norwegian integration into the EU system of financial supervision. It should be noted, however, that each and every legal instrument must be amended before incorporation into the EEA-agreement.

It is evident that the high level of rule production and changes in EU financial regulatory legislation since the financial crisis in 2008 has outpaced Norwegian authorities' ability to implement the legislation, indicating a consistent "lag" between Norwegian legislation and the EU legislation in general. This resulted in Norwegian insurance brokers being instructed to cease activities in Denmark in June 2021 because the Insurance Distribution Directive had not been implemented in Norway (which has since been implemented on an expedited basis).

Relevant to private equity, the PRIIPS regulation has not yet been implemented more than five years after it entered into effect in the EU. It is likely that the amended AIFM directive provisions on pre-marketing of fund interest will enter into force in the third or fourth quarter of 2022 – a year after the EU. Legislation implementing the EuVECA and EuSEF regulations entered into force on 1 August 2022.

The Norwegian authorities do not appear to have any policy in place regarding how to address this issue. Instead, the current policy involves "fast tracking" certain pieces of legislation deemed to be of greater importance than others.

*Pensions and private equity*

Norway's private equity sponsors rely heavily on institutional investors as investors. Insurance companies in Norway are subject to legislation implementing the EU Solvency II directive, which combines freedom of investment with a risk-based capital requirement based on the assets invested in.

Under previous Solvency I-legislation, Norwegian insurers were severely restricted in their investments in private equity, and "habits" have kept investment levels relatively low even though

the EU consistently stressed the importance of private equity as an appropriate asset class for the long-term obligations of life insurers and pension providers. This understanding – which has been outlined in the EU Capital Markets Union initiative – has been largely lost on Norwegian authorities who have made no effort to encourage such investment.

One new development in 2021 was a letter from the Norwegian regulator stating that Norwegian insurers were required to include management fees in underlying fund investments – hereunder carried interest and performance fees – as costs in their own scales of premiums (instead of being subtracted from the return on investment). This view has been challenged, given that it would be very difficult to comply with the requirements and yet make private equity investments. Several insurers have attempted to sell off such investments as a measure to avoid the issue.

The Norwegian supervisory authority has had less of a focus on private equity sponsors outside of the consumer sphere. This is likely based on a risk based approach due to the fact that institutional and professional investors have a lesser need for enforced investor protection rules from the regulator. There are both positives and negatives to this.

It is surely positive for Norwegian fund sponsors to be “left alone” by the regulator and to conduct their business as agreed with investors. The relative lack of focus will, however, mean that the regulator will not have acquired much experience in the field.

This lack of regulator presence may lull some sponsors into a false sense of complacency. There have been recent regulatory actions in the asset management space that may well be applicable to private equity in the professional and institutional markets as well.

The regulator has focused primarily on mutual funds advertised as being actively managed but which are actually so-called “closet indexers”. It is possible that the regulator will expand its review to include other types of funds in order to confirm that managers are achieving their stated management goals and not charging investors undue fees. We also expect to see greater scrutiny directed towards products marketed as “sustainable”, an area of existing focus for consumer authorities.

The regulator’s letter regarding management fees and premium scales was prompted by the observation that many life insurers within a group had large sums allocated to “in house” private equity funds with a very small “external” investor base. Additionally, the regulator has publicly addressed the issue of certain large life insurers that are part of financial groups who have “steered” their pensions customers to investment funds managed by affiliates, which often carry higher fee options. Ultimately, this would lead to regulatory action to ensure that private equity fund costs are correctly allocated and disclosed.

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## Authors

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