Joint interview with Markus Benzler and Jochen Mende on private equity and secondaries

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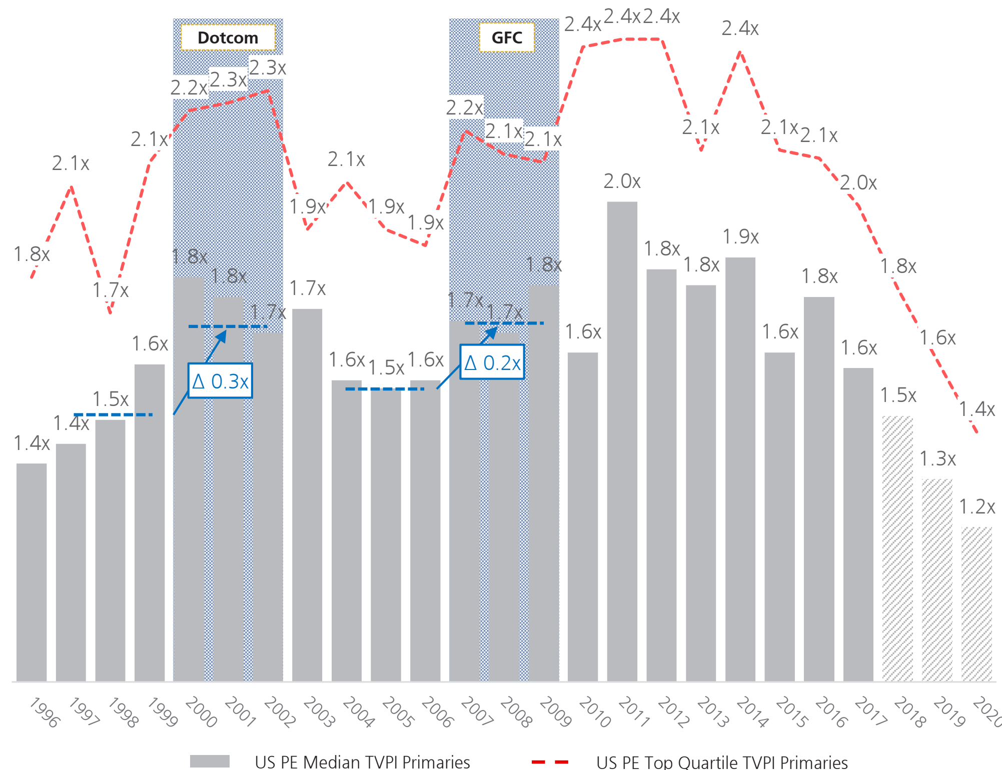
Why consider investing in private equity (PE) now?

MB: We believe private equity to be a very exciting asset class to invest in, especially in current times. For a start, PE has been growing steadily for years, providing on average higher returns than other asset classes[1] in the long term, and rewarding investors with an illiquidity premium for their long-term commitment. Over the past years we've witnessed a very strong fundraising environment of more than USD 600 billion p.a.,[2] with an equally strong investor demand.

Further, diversification is another benefit of PE, which not only can improve returns but also decrease volatility. Market volatility and uncertain economic scenarios usually pave the way for investors to enter this asset class, as well as favor higher returns. This has been the case historically (see Figure 1; these are vintage years since inception returns; vintage years younger than 2020 are not yet meaningful), as volatile vintage years marked by economic uncertainty represented entry points to PE, along with strong relative returns. We saw this both during the dot-com bubble in 2000 and the GFC some years later, where PE opportunistically took advantage of cheaper entry-level valuations.

Figure 1: US PE returns before and after recent crisis



Source: Pitchbook 2022, UBS Asset Management, Real Estate & Private Markets (REPM); January 2023. Note: vintage year since inception return multiple. **Past performance is not indicative for future results.**

What kind of diversification should investors expect within PE?

MB: Private equity allows investors to access a broader investment universe of unlisted companies, which is not the case for public markets. These companies are often young and innovative and operating in high growth markets. Another key argument for investing in PE is the active value creation. Most of PE returns are derived from increasing revenue, increasing profit margin or strategic repositioning - which is typically achieved through the actions of fund and company management that are properly aligned on that outcome. That skill-based element adds to any large, diversified portfolio an additional return creation level.

Typically investors diversify by region and investment stage. Investment stage typically comprises of venture capital, growth capital, buyout and special situations. Each of the stages then is subdivided, (e.g. for buyout into small, mid, large and mega). Each of these subcategories have different risk/return characteristics and return drivers. Another diversification angle is by investment type (i.e. primaries, secondaries or co-investments). Secondaries for example are a great solution for those investors wanting to mitigate the J-curve, have lower risk and a more diversified portfolio early on.

Why choose a fund-of-funds?

MB: There are broader and focused fund-of-funds (FoFs). Focused FoFs typically provide access to a specific region or strategy that are hard to access for investors, because they are lacking the skill, team capacity or capital for that niche. Broader FoFs typically cover a couple of regions or strategies and often investors can pick and choose from an "investor menu" according to their taste. The latter typically are invested by smaller and mid-sized investors who can't afford a dedicated PE investment team at all. So both FoF types fulfill a need for certain investors.

FoFs today are also very different compared to 10 or 20 years ago. Today most FoFs invest across a range of primaries, secondaries and co-investments. To embrace those changes today many FoF-Managers refer to themselves as multi-managers.

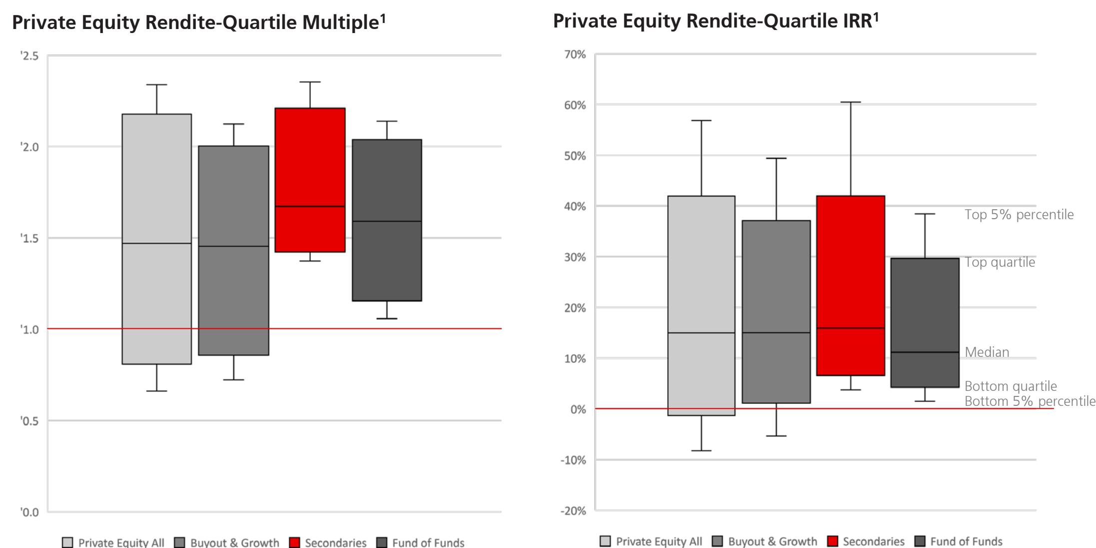
Secondaries help to accelerate portfolio build-up, boost early returns and diversify the portfolio early on. They are also a great tool to round out the portfolio and exploit market opportunities.

Co-investments help to quickly deploy capital and significantly reduce the total expense ratio. Both secondaries and co-investments allow to finetune the risk-return-profile and allocation to specific investor preferences.

A good primary business is essential to have access to good secondary and co-investment deal flow (especially for deals on a no fee / no carry basis).

This results in FoFs that are comparable on a net return level and total expense ratio to single funds but typically with a better risk position. Typically, FoFs

Figure 2: PE Rendite-Quartile Multiple & IRR



Source: UBS Asset Management, Real Estate & Private Markets (REPM); February 2023, **1** ThomsonOne/Cambridge Associates, Vintages 2001-2020, Private Equity all includes Buyout, Venture und Growth Capital; 3714 funds in total. **Past performance is not an indicator for future results.**

have 10x more assets and the historic probability of losing money with FoFs is close to zero when looking into industry data. Single funds, on the other hand, have a higher risk of losing money, especially when you are in the bottom performance quartile. In all fairness however, the top quartile of single funds typically still outperforms the top quartile FoFs but with a much lower margin than in the past. Another advantage of FoFs is the higher reliability of the cashflow profile, especially for the distributions of broader FoFs.

How can secondaries boost a PE portfolio?

JM: To provide some more context, there are two approaches to multi-manager investing: either via participating in funds when they are raised in the form of making a so-called primary commitment, or via acquiring private equity assets on the secondary market later on. In our view, both styles are highly complementary to each other. Generally speaking, secondary buyers tend to focus on acquiring mature portfolios of assets. This allows to build diversified exposure to the asset class much faster, and in a more diversified way. Also, holding periods of assets are much shorter than in primary investments. And, since secondary buyers underwrite an existing pool of assets, certain risks inherent in primary-focused investment strategies such as the so-called 'blind pool risk' are significantly reduced. For these reasons, we think every PE portfolio should include a healthy allocation to secondary transactions. However, from a return perspective, we note that secondaries historically have exhibited higher IRRs vs. primary focused investment strategies, but – on average – smaller absolute return multiples.

How can secondaries be advantageous in the current macroeconomic scenario?

JM: Secondary-focused investment strategies tend to perform best in difficult macroeconomic scenarios, as pricing and overall conditions for buyers are generally speaking much more attractive. And right now, we do find ourselves in such a situation. In fact, in many ways, the current investment environment for secondaries is the best we have seen in a very, very long time. The sustained and simultaneous declines of equity and bond markets in 2022 means that many investors are currently overexposed to private equity. At the same time, exit and thus distribution activity has slowed down on one hand, while managers who have been fortunate enough to build a war chest by end of 2021 have started to invest and call capital from their investor base. In addition, many managers are coming back to raise additional capital much quicker than anticipated. Keep in mind the massive inflow of capital into private equity over the last years – Preqin most recently estimated AUM at over USD 9 trillion - and it's not hard to see why secondary buyers such us ourselves are expecting record transaction volumes and very attractive investment opportunities in the years to come. Especially as secondary-focused investment strategies relative to other approaches are in our view vastly undercapitalised.

Can you talk about your strategy for secondaries?

JM: Generally speaking, I would characterise us as disciplined, conservative, value-oriented investors across all of our private equity investment strategies. When looking at transactions currently, we focus on opportunities where we perceive strong alignment of interest between us and the fund managers who are ultimately in charge of managing our and our investors' money. When thinking about the secondary investment environment at the moment, we focus more on the so-called GP-led segment of the market. In these transactions, fund managers typically approach the secondary market to raise additional capital and gain extra time to acquire select companies they already manage. We currently prefer these deal types as we are able to assess the rationale for a transaction, as well as value-creation levers, valuations and alignment of interest on a very granular level. However, we expect that we will turn our focus towards the LP-led transaction side later this year – that is transactions in which an investor in private equity funds is looking to generate liquidity, e.g. for portfolio management reasons - once we have developed more comfort and clarity on the underlying valuations.

What trends should we expect for PE in the near future?

MB: To start with: capital supply. Right now, allocations to PE are reducing globally, especially for those allocators struggling with the denominator effect.

This should lead to more attractive investments in the next one to two years with advantageous returns a few years later. The situation is similar just as we have seen for example after the GFC (see Figure 1).

Then, the democratisation of private markets and private equity in particular: there is an ongoing secular trend which enables more and more investors to participate in private markets. I see that trend to continue as more suitable offerings are hitting the market. This starts with dedicated suppliers (often labelled as Fintechs) to innovative fund offerings (i.e. more and more semi-liquid strategies) but also supported by the regulator (e.g. the ELTIF is currently being reformed leading to a much wider application range).

Another major trend (applying across all asset classes within private markets) is ESG/impact investing. While Europe is leading with the recent SFDR regulation, I am confident North America and parts of APAC are following from a regulatory side. Investors are also demanding more innovation and progress on the not purely-financial return measures. Hopefully the regulators around the world will provide a consistent framework across countries and regions that allows global investors to integrate their efforts.

Last but not least (and one for the long run) is technology, with blockchain and Artificial Intelligence (AI) specifically.

More and more GPs are looking at the tokenisation of fund shares. This means issuing the fund shares on a blockchain to make them more easily tradeable. Another reason to do this is to bring down the minimum investment of funds. For example, a USD 5m commitment could be divided into 100 tokens worth USD 50k each. Another benefit of making private equity fund shares available on the blockchain is the ability to easily sell shares on the secondary market, further increasing the liquidity of private equity investments.

AI will more and more augment and help the way we approach and solve problems. So, I believe that in five years from now our investment analysts will have new tools that will allow them to make investment analysis faster and more holistically. However, I still believe that investment decisions for investments will continue to be the domain of humans.

Beside the two technology topics above, there are probably many more developments that will become more visible in five years from now. It's certainly exciting for us, as a technology investor, to observe what developments and discoveries will happen around technology in the future.

FOOTNOTE

1 CAPE Global Private Equity Index, CliffwaterDirect Lending Index, Cambridge Real Estate Index, Global Real Estate Fund Index, MSCI AC World, Barclays Global Aggregate. Data covers period between 1 January 2001 and 31 December 2021.

2 Source: UBS Asset Management, Real Estate & Private Markets (REPM); January 2023; Preqin extract of fundraising in private equity markets for strategies buyout, growth, venture, secondaries, turnaround, mezzanine, data extracted per 03.01.2023.

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