Offering broad diversification and generating growth

The private equity industry is growing not just in size, but also through diversification of the types of investments. Markus Benzler, Head Multi-Managers Private Equity (MM-PE) explains to us how the business continues to expand its global investment horizon to achieve growth for clients in the midst of a changing and evolving private equity landscape.
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What does MM-PE offer to clients?

MM-PE offers extensive private equity expertise to institutional investors such as pension funds, family offices, insurances and sovereigns. The product offering comprises both individually tailored and managed accounts as well as private equity fund vehicles following our high conviction strategy. Thereby, we closely support our clients during the build-up and maintenance of their private equity allocation. Through operating in core markets globally, our business has developed into a core capability of the Real Estate & Private Markets (REPM) business.

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How do you differ from your competitors?

Firstly, by European standards, MM-PE is highly experienced and tested through many cycles having been active in the industry for over 20 years. Only a few of our US peers have been active longer than us. We have a long-standing heritage of exclusively managing the captive portfolio of a pension fund. This combined with our alternative approach to risk consideration and ultimately selection, differentiates us from other asset gathering peers in the market. Finally, we are a mid-sized player. We've found this to boost our capacity to deploy capital in comparison to our larger peers who have to deploy billions more per year. In addition, MM-PE is able to leverage the significant resources of the broader UBS business. This has especially impacted magnitude of deal flow, as well as how we select and deploy money.

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Private equity has reached record capital inflows. Why do think this is?

Although the popular view simplistically attributes this trend to the record low yield environment, the reasons behind this dynamic is much more complex and differs from investor to investor. For example, looking more closely into defined benefit pension plans, it becomes clear that the higher allocations to private equity are driven by the large and growing funding gaps that these schemes are facing. Whilst we agree that the low yield environment has rather aggravated this situation, we believe that the main driver behind it is the reduced risk appetite that these players put in place in response to the global financial crisis (GFC).

Indeed, having experienced poor results in the wake of the GFC, these actors missed the opportunity to benefit from the subsequent correction in the equity market by maintaining a lacking risk appetite for an extended period. This diminished exposure to an asset class which typically contributes heavily to returns has led to disappointing results. Furthermore, a number of defined benefit pension plans adjusted the return expectations for their assets downwards, which simultaneously increased the discounted value of their liabilities. In combination with required adjustments to mortality expectations, the quest to find higher returns is hastily increasing the will to add additional risk to their portfolios. Private equity – and private markets overall – seem to be perceived as the “secret sauce” to solve the structural issues that have arisen in the pension plan world over the last decade.

Another actor in the market that has heavily increased allocations to private equity is sovereign wealth funds (SWF). These players were mainly driven by their strong dependence on the energy sector and its intrinsic volatility. However, their exposure to privately held companies has mainly grown through either co-investments or through direct investment, placing them in full competition with General Partners (GP).

Looking closely at the overall public market dynamics and as a derivative the tools that central banks still can use in order to achieve their goals, we don’t expect a significant change in this overall trend.
What are the benefits of a multi-manager private equity platform?

There are basically three ways to access private equity. One could think that the simplest approach is to invest directly into privately held companies. However, this requires a strong level of sectorial expertise and especially for non-institutionalized investors increases the concentration and headline risk around single companies. Therefore, a lot of investors try to invest via fund managers into the space. The fund managers bring along the expertise and a certain level of diversification.

Historically, we have seen that only the best fund managers (usually in the top quartile) are capable of delivering consistently an outperformance to the typical equity benchmarks. The issue with these types of managers is that they are usually not in need for additional capital as their strategies are only scalable to a certain extent (in comparison to more liquid strategies). Multi-manager platforms can solve the riddles arising from the aforementioned dynamics: a good multi-manager set-up can provide access to top-notch fund managers either via primaries or secondaries and can participate into direct deals as co-investor. This provides a solid diversification but also ensures quality and execution capacities that only professional private equity investors can deliver.

What will be the key themes to drive industry growth over the next five years?

From 2019 onwards, we expect the private equity industry to be much more insulated from economic and political volatility in comparison to other asset classes. Both current trends and investor sentiment are indicative of increased appeal into the asset class. According to Preqin, 2018 saw around USD 432bn³ worth of commitments flow into private equity. We expect larger fundraisings as seen in 2016-2018 to continue over the coming years as fund managers are hungry to lock capital in during this expanded period of economic expansion. The increased appetite from investors means that capital will continue to flow into funds. The record level of dry powder will afford more cash to be spent than at any other time in history. Private equity firms are, as a result developing the resources to take on strategic buyers head-to-head. We also expect to see new strategies and firms widening their scope in regions such as Africa.

Selection and diversification will play an even more significant role in investors’ portfolio construction process as a means for increased downside protection. For our flagship products, this has been instrumental in order to avoid cycle-related concentration and return dependence risks. In general, we aim to have not less than 4-5 fund positions of equal size per year. This translates to roughly 40 to 100 companies per vintage year given a fund usually invests in 10-20 companies. Appropriate sector diversification in order to avoid region specific concentration and return dependence, will also be a key driver of growth. In general, we take a top-down approach regarding the regional allocation of the under-lying assets. This general strategic allocation is overlaid with tactical considerations influenced by the concrete investment opportunities available.
What are the main benefits of pursuing a growth strategy?

We have strong evidence that such strategies bode well over-time, having successfully launched our fourth private equity fund-of-fund growth strategy since 2000. We’ve achieved this through the careful fund selection carried out by our highly experienced team which has deployed more than USD 1.5bn across this strategy with over 120 fund investments since it was launched. Our ability to continue to attract commitments from largely repeat investors is also testament to our expertise in sourcing some of the best investment opportunities for clients in the fund-of-funds market.

We target funds actively investing in the growth, small buyout and mid-market buyout spaces. These tend to be more conservatively valued, and have a history of strong strategic and operational involvement in their portfolio to boost company revenues and profits. We target top-down themes which shape the economic environment, and create opportunities for managers to exploit growth and generate strong returns. Some of these growth investing themes include company builders and scalers, undermanaged situations, industry roll-ups, new technologies etc., including assessing the business models of particular firms. For MM-PE it’s also about value-adders such as our strong strategic and operational involvement to boost revenue and profits. Being able to rapidly evaluate the changing dynamics within our portfolio is important to successfully operate private equity portfolios in a changing economic environment.
The private equity industry continues to grow and is becoming an integral part of the capital market. The low interest rate environment has been a catalyst for global buyout activity. Global economic growth has also supported cheaper deal financing. Tech venture investing is highly in demand. And, fundraising activity has been a main driver as to why dry powder is currently at its current record levels. Today’s market is clearly a sellers’ market and investors are still being drawn to this asset class. Deployed capital stands at over USD 1tn, which is the highest it’s been in the last 13 years⁴. In today’s low yield environment, we are seeing more investors put additional capital into private funds while at the same time the abundance of dry powder is one of the major causes driving competition in the market – largely impacting fund managers’ buying power managers have and further need to adjust their strategies. This all has led the industry to be much more complex than 10 or 20 years ago. In our view, the fundamentals of the private equity market, however, are still very much the same and intact. The current record levels of dry powder, coupled with investors’ requisite for exposure means that funds are both equipped and geared-up to swiftly execute.
What do you see as the biggest challenges in the industry, and how are you responding?

The surge in competition in the private equity industry will prove to be challenging for many players. Both dry powder and the number of players mean that there is increased competition in the market for the best opportunities. Another important point to note is that once capital has been raised, deals also have to be made without firms appearing as if they’re not able to deploy capital. With increased competition, comes the need for speed in order to get to the best deals first. This will require from us that we continue to improve our processes but also increase our search for talent in the industry in order to be ready for these industry shifts. Furthermore, we will likely continue to remain very disciplined and diligent in how we manage capital for our investors. Further, we are enhancing our skills on the secondary and co-investment side.

Will private equity continue to outperform in the next few years?

History has shown private equity can consistently deliver strong risk-adjusted returns, ahead of the public market. Tough economic times such as the 2008 GFC have not swayed private equity’s capacity to perform well. A majority of funds with 2008-09 vintages delivered strong returns in spite of market volatility and outperformed the public market. This prompted the number of players active in the market and existing investors to increase their allocations. We expect the private equity market to remain strong in the event of future cyclical changes, not just in terms of absolute returns but also as a diversifier to the public market. As an asset class, private equity is highly important both as an investment vehicle and a catalyst for economic growth.

How can investors search for value in a crowded market?

Today’s crowded market means that fund managers have to think more carefully about how they deploy capital. Over the last five years, investors have allocated more capital to the private equity industry than at any other time in history. There is a disparity between value and the number of deals. Increased competition and an unclear macroeconomic outlook are contributing to the difficulties in calculating future values. This competitive market is causing firms to re-examine their strategies, focusing on those that can deliver the most returns. MM-PE for example, invests in proven managers and strategies which has worked well for our business in the past. At the same time, it’s important for investors to stay in close touch with managers and markets to assess the relative attractiveness of the strategy in light of macro or strategy-specific developments.

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