INVESTING IN PRIVATE MARKETS – WHY AND HOW

White Paper

Marketing Communication

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws.

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UNION BANCAIRE PRIVÉE

Key points

- *Historically low interest rates and high stock market valuations have triggered unprecedented investment flows into private markets.*
- *Private market investments provide exposure to asset classes, such as private equity, private debt, infrastructure, private real estate and real assets.*
- *They have demonstrated their ability to offer further diversification in a portfolio by lowering volatility while generating superior returns.*
- *Private markets can potentially provide investors with attractive recurring returns and capital gains.*
- *UBP's approach to private markets is to select niche, under-the-radar strategies with compelling performances.*
- *Due diligence and understanding of the risks are paramount in the investment process.*

What are the main benefits of private market investing?

"Private markets" refers to assets that are not traded on public equity exchanges; they are illiquid, and are spread across different market segments, such as real estate, private equity, private debt, and investments in tangible assets and infrastructure. Private market investments represent a much broader investment universe than public markets, and therefore offer a wider net to capture opportunities over the long term.

"Institutional investors, including pension funds, endowments and family offices, have been allocating aggressively to private market investments. Individual investors have been lagging behind with only 5% of their portfolios allocated to private market investments, due to them generally only being open to institutional investors. At UBP we pride ourselves on providing access with a lower minimum investment," says Brice Thionnet, Head of Private Markets Group, UBP.

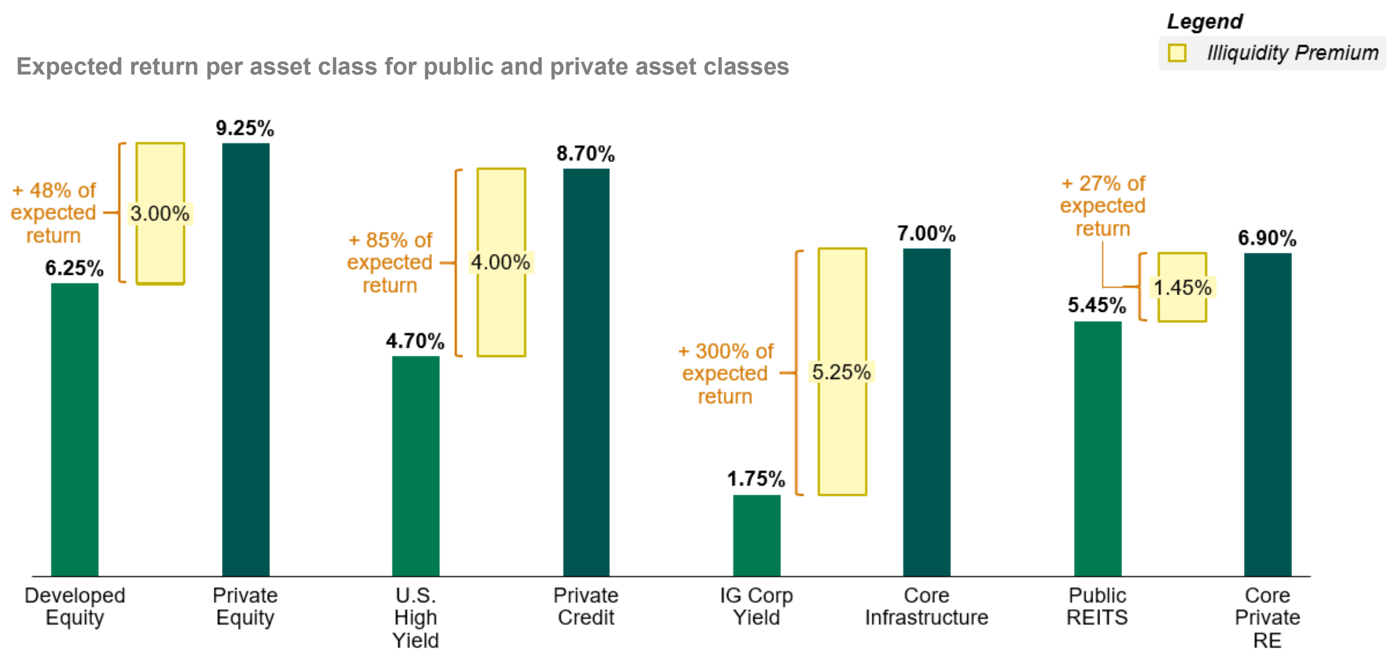
With investors seeing historical return drivers – falling bond yields, tightening credit spreads, and accelerating profit growth – beginning to come under pressure, investors will need to seek out alternative return drivers to compensate, and private markets provide just such an alternative, as they improve the risk and return profiles of a portfolio.

Private market assets offer additional drivers to augment the total returns available to investors across the risk spectrum. Key amongst these drivers is the significant illiquidity premium they offer relative to public markets' expected returns. This illiquidity premium, which is the excess return investors earn for committing capital over the medium-to-long term, can reach 3–5% depending on the private asset class.

In absolute terms, private markets generate higher returns than public markets. For example, between 2000 and 2021, the average yearly performance in private equity reached 12.1% (CAGR) compared with 7.7% for the S&P 500. This outperformance is linked to the robustness of private markets across multiple market cycles. In particular, private markets have demonstrated increased resiliency during market downturns. One reason for this is the fact that private market investments focus on long-term value creation, which is why they avoid cyclical industries.

Private market investments play an important role in portfolio diversification. They are unaffected by market noise and the correlation between private assets and public market assets is low. As a result, private assets help reduce the volatility of an overall portfolio. This is an important consideration given the prospect of heightened uncertainty ahead in financial markets.

Expected return per asset class for public and private asset classes



Source: Carlyle Analysis; Cliffwater 2021 Long Term Capital Markets Assumptions as of 19/01/2021; There is no guarantee these trends will continue

What are private markets composed of?

Private equity

Investing in private equity means taking stakes in non-listed companies to finance their growth and then exiting at a later stage through a trade sale, a buyout, or an initial public offering (IPO). UBP's Private Markets Group (PMG) team provides access to exclusive private equity strategies implemented either through strategic partnerships with experienced managers or through co-investments. Private equity investors take an active ownership interest in their investments, allowing them to influence strategy with an objective of proactively seeking to increase the value of the investment over its lifecycle. This may be achieved by recruiting talent, entering into partnerships to accelerate business growth and development, identifying operational improvements and synergies, providing access to new geographies or markets, or even changing the mix of capital deployed in a business. The long-term approach usually fits with impact investment, and most private equity firms now insist on environmental, social and governance matters.

Infrastructure

Infrastructure assets are the backbone of an economy: they provide essential services for our modern daily life, for example, toll roads, renewable energy facilities, utilities, such as water and waste management, and even data centres. Core infrastructure investments can serve as a source of steady income supported by regulated pricing and long-term contracted revenues from governments. These essential assets are inflation-linked and have high barriers to entry. Governments and corporates are seeking out capital to address new secular trends, such as decarbonisation, digitalisation and new means of mobility, as well as population growth and ageing. With the pandemic and the increasing incidence of extreme weather around the world, growing infrastructure spending should present investment opportunities in the post-pandemic era.

Private debt

One consequence of the increased regulatory oversight for the financial system following the global financial crisis has been the growth and maturing of the private credit market. As banks were discouraged from lending, companies needed to find alternatives. In many cases, the private credit market offers floating-rate exposures that may benefit from rising interest rate environments. Indeed, private debt investors should benefit from higher short-term rates that will probably accompany rising inflation.

Venture capital

This provides the opportunity to finance innovation. The median age of tech companies that went public in 2020 was roughly 12 years versus 4.5 years in 1999. Most of a start-up's value is generated while it is still private. Venture capital investments through funds or pre-IPO direct investments enable investors to gain some exposure to that value creation.

Private real estate

Government real estate is another of the PMG team's favoured thematics. In this category, the PMG targets net yields of 7–8%[1] in USD and a wide spread over government bonds. In addition to attractive yields, the appeal of government real estate lies in the low counterparty risk: investments are backed by the "full faith and credit" of a government, and government spending tends to be countercyclical to economic trends. The focus on mission-critical assets goes hand in hand with a high probability of renewal.

Real assets

Real assets are tangible assets which focus on niche sectors. Each category of real asset has its own properties and requires specific expertise. Music royalties are one particular area of interest according to the PMG team, as they give investors access to the recurring cash flows associated with the music catalogues of popular artists. Royalties come from many sources, such as CD sales, radio broadcasts and film soundtracks, but it is streaming that leads the way. Streaming generates resilient cashflows, as people listen to music irrespective of the economic cycle or financial market conditions. Another aspect is that fund managers manage their song catalogues with the aim of growing their value through active marketing; this opens up the possibility of an investor benefiting from significant capital gains upon the conversion of the fund into a publicly traded company.

The PMG team has built a competitive advantage in private markets

Building and maintaining a well-diversified private market portfolio is a dynamic process that requires highly specialised technical and investment expertise, as well as strong legal, compliance, structuring and accounting skills. The PMG team's offering is guided by the economic environment and favourable macroeconomic trends. The first step in the investment process consists of identifying the most promising long-term investment trends and themes. The search for ideas is carried out by UBP's PMG team through banking relationships and a proactive approach.

Second, the PMG team conducts in-depth screening to select best-in-class managers to implement the investment strategy. A typical PMG deal has the following characteristics: exclusive access, easy-to-understand business models, visibility into underlying assets, and strong teams and governance.

The PMG team's competitive advantages

Proprietary origination: proactive, off-market origination by the senior management team.

Structuring expertise: this enables transactions to be executed across jurisdictions and borders.

Geographic reach: a broad scope across Western Europe and North America.

Sector expertise: active in build-to-rent, social/affordable housing and student housing, where there is substantial demand.

Strong manager-selection team: the dispersion of returns between top-performing and lower-performing managers is 10 times wider in private markets than in public markets, where investors can seek to eliminate the risks of underperformance associated with active management by increasing allocations to passive strategies. Given the structure of private markets, the investor cannot take a passive approach; instead, manager selection requires expertise, but it is paramount to secure illiquidity premiums in the private market space.

[1] Target returns are targets only and may not be achieved. The potential for profit is accompanied by the possibility of loss.

The PMG team's monitoring activities, which cover the entire lifespan of the investments, aim to ensure that investments remain in line with the initial business plan, that distributions are paid to investors on time, and that investors are provided with material information in a timely manner, with strategies being adapted as necessary.

Risks

As with any investment strategy, certain risks must be considered when investing in private markets, such as the risk of loss of capital (the value of a private market investment may rise or fall) and the performance risk (there can be no assurance that the performance will equal or exceed the target).

Private market inflows tend to go into illiquid investments, making them harder to exit from or price regularly. They also have more complex structures than traditional investments. Further, as there are more and more investors chasing opportunities in the private market space, there is a risk of stretched valuations and poor-quality deals in some segments. It is therefore crucial to work with specialists when investing in private markets.

Case study

In March 2019, UBP clients invested in the existing portfolio of Cambridge Innovation Capital (CIC), a holding company set up by the University of Cambridge in 2013 to bring private capital to rapidly growing intellectual-property-rich businesses in Cambridge. The target return was three times the equity invested, and the investment horizon was 5–7 years.

Contrary to a "blind pool" investment, which involves allocating capital to a strategy without knowing exactly how it will be deployed, these companies were identified as being some of the most rapidly growing technology and healthcare businesses emerging from the Cambridge ecosystem.

By June 2021, the portfolio consisted of 25 companies and the share price had increased by 45% since UBP clients first invested.

The added value of investing alongside the University of Cambridge stems from its unique environment: it is the most successful university innovation ecosystem in Europe, with more than 4,700 knowledge-intensive companies employing over 60,000 people. Over 85% of research groups are classified as world-leading or internationally excellent, and 107 Nobel Prize winners are associated with the university. Particular strengths include artificial intelligence, big data, next-generation biologics, genomics and epigenetics.

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