Private markets hold no secret

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Around the turn of the millennium, trying to talk about alternative investments and private markets to the managers responsible for asset allocation in their own books at German regional banks was difficult and often met with a lack of understanding or even principled objections. When our company was founded in 2000, record stock market highs had just triggered the first boom in equity investing in Germany. For a while, the stock exchange seemed to promise “prosperity for all”. Real interest rates were also reasonably sufficient – even by today’s standards.

Back then, many people thought that private equity and private debt were something for slick investment bankers in New York or London. In fact, private equity funds had been making successful investments in Germany for a long time, including in conservative sectors like public-private partnerships that had started to become fashionable.

Nevertheless: private equity did not generally seem to be a good fit for the rather conservative investment strategies of these regional banks. There was a lack of know-how, but also of transparency and an in-house track record in the asset class, which was not familiar at the time. At that time, generating income from holdings on one's own books was much less important for the banks’ overall financial performance than it is today. The motivation to experiment with new, seemingly risky investments was correspondingly low. There were also doubts about regulatory requirements, which added to the uncertainty and general reluctance.

This was soon to change, however. When the dotcom bubble burst, international stock markets crashed and after the shock of the terrorist attacks on 11 September 2001, the world entered a phase of slow economic growth and low interest rates, which continued for several years.

Suddenly the search was on for alternatives, and private markets – equity and debt products not traded on public exchanges – along with non-conventional debt, real estate and infrastructure investments, experienced a surge in demand, particularly from banks.

Private equity is now part of the canon

As globalisation accelerated from the middle of the decade, the world economy returned to a growth path. Banks were awash with investable liquidity – especially those “Landesbanken” whose debt had previously been backed by a state guarantee – and private markets of all kinds had now become an established part of the investment universe.

In some segments, bankers even started to overlook the risks involved, however, especially as far as the US subprime mortgage market was concerned. It should be said that corporate private equity and debt were not the root cause. But the stage was now set for the next big financial crisis.

With a few exceptions, local lenders were not among the banks most directly affected by the subprime crisis. It was more that they suffered indirectly from the losses incurred by the “Landesbanken” and related bank holdings.

For those banks the noughties were the decade in which they made their first forays into private equity and private debt products for their own books. It must have worked out well for them overall, because since then private market products have played an established role in the capital allocation process, at least for most of the larger banks in this market segment. Their importance is increasing too: a survey carried out by the CFIN Research

Center for Financial Services in Munich forecasts that alternative investments will account for 12 per cent of the assets held by domestic German banks in their own books by the year 2025, rising to 16 per cent in 2030. This would represent twice the figure for 2021, the year the survey was performed.1

Phase I in the 2000s: focus on funds of funds

In this initial discovery phase, the investment managers at regional and local banks tended to channel their commitments towards what are known as "funds of funds", i.e. collective investment vehicles that invest in private equity funds, which in turn invest in the share capital of privately held companies and similar illiquid assets. These are structured similarly to the funds of funds for retail investors.

The advantage of these vehicles is that they enable minor institutional investors such as regional banks to handle the complexity, illiquidity and demanding due-diligence requirements that characterise this asset class.

Successful corporate private equity investments also require specialist knowledge of the relevant industries. The best private equity fund managers are themselves specialists who focus on a particular segment, and often also only offer limited access to their fund portfolio. Funds of funds are one way for investors to tackle the vast range and diversity of private equity products, to identify the fund managers with the best track records in their respective specialist segment and to combine them to form a balanced, broadly diversified portfolio.

Diversification in this context not only refers to variables such as company, sector, country and region, but also means diversification over time: by combining funds with different inception dates (known as "vintage years") that invest through different phases of the economic cycle, it is possible to reduce what is known as the "J curve" effect. This refers to the fact that a private equity investment typically requires several capital calls before the return curve becomes positive and the investment reaches break-even on a net basis. By aligning many of these J-curves one after the other it is possible to smooth out this effect and thus stabilise the overall return profile. Investors obviously consider that the higher costs resulting from the dual fund structure are outweighed by the benefits. And for smaller investors in particular, the question is really; what is the alternative?

Private market allocations as part of regional banks' asset allocation in their own books quickly entered a second phase. The 2010s began with banks ridding themselves of legacy holdings from the subprime mortgage crisis and the euro debt crisis. This ushered in a long phase of declining interest rates, which ended with extremely low rates that were even nominally negative at times. Central banks flooded the markets with liquidity, at a time of relatively stable growth.

The result was asset price inflation: stocks and bonds, real estate and private market prices all rose rapidly. Conversely, returns generated from cash flows declined at the same time. Given the nominally negative interest rates in some cases, investors were finally even willing to accept negative real returns, in the hope that inflation would remain relatively low and valuations would rise.

Phase II in the 2010s: the emergence of secondaries

In this second phase the market liquidity and the dearth of attractive fixed-income investment opportunities caused transaction volumes in the private markets to increase enormously. All of a sudden, a relatively liquid secondary market emerged for private market investments. They are no longer only for use in an emergency, but now act as an efficient tool for portfolio strategy and liquidity management.

This development was in the interests of both buyers and sellers: why keep holding on to a position, when it is

[1] Whitepaper in German
https://www.bvai.de/fileadmin/Themenschwerpunkte/Investoren_und_AlternativeInvestments/Leitfaeden_Whitepapers_Studien/20210218_Summary.pdf

possible to exit early, bank the winnings and reinvest them elsewhere? And why not look for attractive entry opportunities with an existing track record? The yield compression at the time meant that every basis point of return was valuable. Almost all institutional investors joined this secondaries trend in the course of the 2010s. According to data from Preqin, assets under management by private equity funds grew by around 150 per cent to US$ 3.5 trillion between 2010 and 2020, whereas the volume of secondary transaction rose by some 250 per cent to US$ 300 billion. By 2022 the figure had even reached US$ 415 billion.

This trend was particularly useful for managers handling portfolios at smaller savings and cooperative banks. It enabled them to get into private markets segments that were previously hard to access; and to do so at a small discount that even made the initial yields seem halfway acceptable, at a time when in some cases nominal interest rates were negative.

Then there is another advantage: secondaries investments come with a track record. It may be that the negative early phase of the J-curve described above is already over, the due diligence by the initial investors is still available for inspection; in other words, one is no longer buying into a blind pool. This can also be a compelling argument for bank managers to use when presenting investment proposals to their own executive boards.

The secondaries trend is certainly not over yet either. But with the advent of the 2020s, the environment shifted again. The decade started with a global pandemic and the unprecedented reaction to it around the world. And this was followed directly by an escalation in Russia's war of aggression against Ukraine. The result was a sharp increase in inflation rates across all major currencies and a corresponding response by central banks that many had no longer thought possible and which turned out to be surprisingly clear-cut – suddenly interest rates were positive again!

Phase III in the 2020s: fund investors become direct co-investors

We are now observing a new trend in institutional investment activity in private markets: co-investments, which we expect to be the defining feature of this decade, also for regional banks. These are not fund vehicles, but rather a direct investment by the institutional investor in a portfolio company, alongside a private equity fund.

For the LP this has the advantage of being directly and so more closely involved in the development and performance of the portfolio company. They are no longer sitting back in the cabin, so to speak, but are up front in the cockpit, next to the pilot. The investor can also carry out their own independent due diligence and so manage their risks better and more actively. At the same time, they save on the costs of fund management. The advantage for the fund manager is that they avoid any excess concentration of risk in their fund portfolio and can also mobilise additional capital to complete larger deals.

A co-investment calls for competence and expertise on the part of investors, however, as well as the desire and the capacity to play an active role in managing the investments. For investment managers of larger banks with 25 years of experience in private equity, this is now increasingly the case. Then there is the partnership with the respective fund manager over many years and the mutual trust this has created, which is essential for close cooperation as co-investors. In those cases where the long-standing partnerships and expertise do not yet exist, the current market environment is a good time for proprietary traders to make a start – combined with the opportunity to make private markets products accessible for smaller institutional investors like the portfolios of regional and local banks.

Private markets and alternative investment markets have seen rapid growth in recent years; they have become even more professional, and their structures have diversified. They have come through all the challenges and crises during this period unscathed. Local and regional banks' managers responsible for asset allocation in their own books have been part of these developments and have profited from them. It will be exciting to see what changes lie ahead of us in the 2030s.