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Private equity: A(n) (asset) class of its own

The capital market has changed fundamentally in the last year and a half. After almost more than 15 years of low interest rates, access to cheap capital and steadily rising valuations, the market dynamics have shifted. Due to the current interest rate environment institutional investors have the opportunity to invest profitably in interest-bearing products again. This marks a new chapter for private equity. Many investors had been drawn to it over the last few years as a way to generate returns in low interest environment. Over the past few years, many investors have sought out this asset class primarily to benefit from higher and stable returns in the low interest rate environment. So now, when one of the key fundamentals of the private equity boom changes, the question is, how will investors react and what factors will gain increased importance when it comes to selecting providers and their respective products.

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Current environment

Institutional investors are subject to significant regulatory requirements in their investment policy. These include the quota restriction of private equity depending on the investor's capitalisation. The Dax 40 fell by more than ten percent in 2022, the S&P 500 by almost 20 percent (source: Bloomberg). The quota effect has thus reduced the funds available to institutional investors for investing in private equity – even if the percentage requirements remain the same. In addition, in an uncertain market environment, more liquid

investments are usually preferred in order to be able to react promptly. This is in contrast to the illiquidity of private equity.

The impact on private equity fundraising is clear: globally, fundraising volume fell by 15 percent in 2022, in Europe by as much as 32 percent (source: McKinsey). In parallel, deal volume also slowed. After record years in 2020 and 2021, the number of private equity transactions in Europe fell by 19 percent to 2,548, almost the same level as in 2018 (source: statista.com).

Investment behaviour is changing

The private equity market has become highly specialised in recent years, both in terms of the type of investments (e.g., venture capital, buyout, growth) and in terms of geographical and industry focus. In the current market environment, the trend is towards established funds with proven investment strategies and operationally stable set-ups. According to a study by Preqin, the top 25 largest fund managers account for 42 percent of fundraising volume in 2023, significantly higher than the average of 36 percent over the past ten years.

Structuring remains a central issue

It is precisely in times of change that it becomes apparent how suitably an investment and the associated investment structure serve the investment objectives. Whether direct or indirect, via funds of funds or special purpose vehicles: with private equity, there is no investment structure that fits every investor equally.

However, with a view to investment, tax and supervisory law, it is possible to derive the most suitable vehicle for each investor and adapt it individually.

A structure must take into account not only the investor's requirements, but also the regulatory, administrative and tax characteristics of the target asset class.

Practice shows that it is usually worthwhile to compare the various options intensively in order to develop a structure that meets the respective requirements of the investor and support the character of private equity investments optimally. Possible basic structures exist in Germany as well as in Luxembourg and Ireland. For many years, German institutional investors have set up their private equity platforms primarily in Luxembourg.

And for good reason: Luxembourg is central for European asset managers, because the familiarity of the structures from the world's second-largest fund market facilitates international distribution. Accordingly, many of the largest private equity funds in Europe are launched in Luxembourg. But the German market has now also developed itself for private equity investments. This is made possible by Investmentvermögen according to §§ 282 and 285 KAGB. For US asset managers, Irish fund structures are gaining in importance. Even if European regulation is basically harmonised, differences such as language and cultural proximity remain to influence a choice of structure.



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Keeping an eye on selection factors

The decision to venture into private equity investments is far-reaching. Motives vary and are influenced by market developments and the offerings of the active distribution units of domestic and international asset managers.

Besides deciding on the asset class itself, the dedicated analysis of the framework conditions and influencing factors is equally important. These include the investor's (prior) experience in an asset class, the internal resources, the motivation of the investment, but also the regulatory requirements, audit options and existing investment vehicles. With regard to the investment, the specific investment policy, legal form of the investment objects, regional distribution of the investments, investment volume, investment period and liquidity must also be taken into account. The more precise the analysis of the initial situation, the more sensibly possible structures can be developed.

Private equity investments are usually long-term investments and also less liquid than, e.g., shares or bonds. This places special demands on the launch process, which should be well-thought-out and individualised. Changes to the structures can usually only be implemented with great effort afterwards. At the same time, it is only logical to assume that changes may make sense during the term of the investment. Either because the market changes and the strategy has to be adapted or because regulatory changes lead to the need to create additional reports and thus to extended data requirements. In a positive sense, the structure requires a corresponding ongoing exchange over the entire life cycle of the private equity investment in order to be able to react adequately to the challenges and opportunities.

Success depends on many factors

Of practical relevance is the operational implementation of the requirements. For the administration, the valuation of the investments also plays a special role. Only in a few cases are there freely available comparative values and the valuation depends to a large extent on the underlying company valuations. The quality of the valuations thus also depends on the data material provided by the managers to validate and verify the valuations provided.

Optimised liquidity management is often useful in order to prevent cash holdings from becoming too high, but also to be able to react to potentially time-critical capital calls. When returns come, it must be clarified what is counted against the called capital and what is real income. This is reflected in the reporting requirements for the investments.

Here, too, the special features must be taken into account and as much information as possible must be provided on target investments, their structure, regulatory classification and (insofar as data is available) also on ESG qualities. Central to this is a functioning transaction management system that uses technical and organisational interfaces to enable the timely release of transactions, implement transaction processing,

including valuation and accounting, take over post-trade compliance and reporting to investors and supervisory authorities – and to continuously monitor the development of the portfolio from a risk perspective.

Private equity: an outlook

The figures on significant lower fundraising and transaction volumes do not allow for deception: private equity, along with other alternative asset classes, continues to be a significant component of many institutional investors' allocations. A tailor-made structuring of the investment remains key to supporting the investment's objectives and its controlling.

Whether an investor decides to set up a structure in Luxembourg, Germany or Ireland, we offer attractive, customised solutions. Private equity will continue to fulfil an important role as a financier and promoter of business models. In view of the necessary changes and innovations in our societies, there is a great need for precisely this.

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