Investment views

The rise of private markets

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Rothschild & Co
Wealth Management

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Cover: This partners desk of standard design is transformed by the role it played in one of the most significant pieces of business transacted at New Court. From this desk in 1875, Lionel de Rothschild (1808-1879) advanced funds to the British Government to enable it to acquire shares in the Suez Canal.

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Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Foreword

The Rothschild family has invested in private markets for generations, shaping the modern world.

The family's tangible track record stretches back to the opening of France's first passenger railway in 1837 and the development of its first mainline railway: *Chemin de fer du Nord* in 1846. Subsequent Rothschild generations built on the family's experience in private markets, helping to finance any number of iconic infrastructure projects including canals connecting the Rhine and Danube basins and later the Mediterranean and Red seas via the Suez Canal.

In the 20th century, the family's private market ventures helped build the New York Subway and London Underground in the 1920s and 30s whilst investing and developing formidable wine businesses from Château Mouton and Lafite estates in France and later in Chile.

The story of the Rothschild family and its experience in private markets is rich and varied and serves to illustrate our long term commitment to help you navigate and successfully manage your investments in this asset class.

Featuring an interview with our private markets specialists, this publication sets out the various opportunities which exist for investors within private markets. Our aim is to answer why you should invest in private markets and how we can help you achieve this goal at Rothschild & Co.

We look forward to working with you.

Dr. Carlos Mejía
CIO, Rothschild & Co Bank AG

The rise of private markets

Why private markets matter

Whether investing in private equity or private debt, it is important to understand **why** private markets matter. As illustrated by the history of the Rothschild family, investors have been acquiring or making minority investments (private equity) and lending to (private debt) privately held companies for centuries. Private markets are a well-established means of providing capital to businesses seeking to expand or manage new or existing services or operations.

As shown in **figure 1**, private markets are the channel by which private companies can obtain financing via equity or debt. This is equivalent to how listed companies obtain financing on the public markets via the issuance of stocks or bonds.

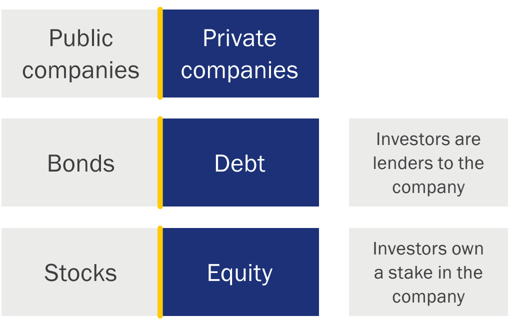
Private markets still have room to grow

As discussed in 'A brief history' on page 3, private markets have grown considerably in the developed world since the 1980s. This growth has been accompanied by a decline in the number of companies listed on public markets. In the US alone, the number of listed firms dropped by half between 1996 and 2012.[1]

Yet despite average growth of 10% per annum, popular private market strategies such as private equity still accounts for just one-tenth of global M&A transactions in a given year, indicating there is still considerable room for private markets to grow.

Figure 1: Financing channels

Private companies can obtain financing via equity or debt through private markets.



> **"Private equity still accounts for just one-tenth of global M&A market transactions in a given year."**
>
> **Mireille Klitting**
> Global Partner
> Rothschild & Co Merchant Banking

Shifting attitudes

Over the past 20 years, the growth of private markets has come hand in hand with a shift in attitudes. Becoming a publicly listed company used to be a symbol of measuring corporate success. Today, many companies avoid going public for strategic and financial reasons until absolutely necessary.

An example of this is household name and car-hailing app **Uber**, which has reached a potential IPO valuation of $120 billion, whilst remaining unlisted and sourcing capital from private markets.

As the nature of public market listings becomes older and more concentrated, private markets have benefited from the following **three trends**:

1. **Increased regulation**, which has made accessing public markets more burdensome for companies from a regulatory perspective,[2] channelling newer or medium-sized businesses towards financing solutions via the private markets;
2. **Newer business models** in turn are becoming less capital-intensive in post-industrialised economies and therefore require smaller capital investments which do not require nor warrant public market financing;
3. **The search for higher returns.** Driven by a decade of low interest rates, investors are attracted by the higher average returns available via private markets. This in turn has drawn more companies towards financing growth and development through private markets.

[1] 'Capital Formation: The Evolving Role of Public and Private Markets'. CFA Institute, Sviatoslav Rosov. 2018

[2] For example the median time to IPO for US companies has risen from 3.1 years in 1996 to 7.7 years in 2016. Idem.

Did you know?
Apple Inc., **FedEx**, **Cisco**, **Microsoft**, **Uber** and **Avis** are all companies which were able to grow thanks to private market investments.

Becoming a familiar asset class

With the rise of private markets, the asset class has become an increasingly familiar part of any wealth preservation strategy. In short, it now sits alongside other equity or fixed income investments within a multi-asset class portfolio.

Nevertheless, there are some important differences in the characteristics of private market investments such as liquidity, yield and time horizon which one needs to understand before investing.

To explain these differences, we interviewed our Merchant Banking team on pages 4 and 5 in order to take a closer look at the **principal trends and strategies** available to clients in private markets.

> **"10 to 15 years back, a company going public and becoming listed on the public markets was a symbol of measuring corporate success."**
>
> **Aurelien Bullot**
> Director
> Rothschild & Co Merchant Banking

A brief history

Post 1945: The birth of modern markets

Our story begins in the aftermath of World War II. The first modern-day private market firms, **American Research and Development Corporation** and **J.H Whitney & Company** were founded in order to invest venture capital in early-stage US companies. Fast forward to the **1980s** and the advent of large institutional investors transformed private markets as managers began allocating parts of their multi-billion dollar portfolios in **private equity** for **the leveraged buyouts of companies.**[3]

What began in the 1980s as a relatively radical form of financing, associated with highly leveraged hostile takeovers rapidly evolved in the 1990s. This happened as private markets started to focus on buyouts with an attractive value proposition for both management and shareholders and placed increased emphasis on the longer-term development of acquired companies.

Since the aftermath of the **2008 Great Financial Crisis**, private markets have again come to the fore as traditional bank lending has ceased for many medium-sized businesses. In Europe, the proportion of **private debt** lending carried out by banks shrunk from 80% to 25% during 2008 -2018.[4] Filling this void, private debt funds have seen assets under management triple in size in the decade after the Great Financial Crisis. Today, the breadth and depth of private markets extends beyond traditional private equity and debt investments to sectors such as **real estate**, **infrastructure** and **natural resources.**
In addition, an active secondary market has emerged in the last two decades for investors to sell and buy exposure to pre-existing private equity assets.

With secondary market transactions growing by more than 35% year-on-year to an estimated $70 billion in 2018[5], private markets have become an increasingly attractive option for investors and businesses looking for financing solutions in both the developed and developing worlds.

[3] Where a company is acquired using borrowed money to meet the cost of acquisition.

[4] https://www.ubp.com/de/newsroom/private-debt-financing-lbos-alongside-private-equity

[5] Pensions & Investments, Alternatives, 24th January 2019

Understanding private equity

An interview with Rothschild & Co Merchant Banking

Rothschild & Co's **Mireille Klitting** (Global Partner) and **Aurelien Bullot** (Director) of our Merchant Banking division, have multi-decade first-hand experience in investing in private markets.

In the following interview, they provide us with practical insights into the industry and how to invest in private markets' most popular asset class: **private equity.**

What are the main strategies deployed in private equity?

Mireille Klitting: The main ways to invest in private equity are through primary, secondary or multi-manager strategies.

A **primary** investment strategy allows clients to commit capital to a General Partner (investment manager) who in turn selects a portfolio of best-in class businesses. These businesses often offer strategic opportunities for the investment manager to make organisational or operational changes.

Examples of such strategies are our Merchant Banking funds, Five Arrows Principal Investments (**FAPI**) or Five Arrows Capital Partners (**FACP**). These are funds which look to invest in European or US mid-sized businesses to help them grow revenues, increase margins and maintain their competitive advantages vis-à-vis their peers.

In the case of both FAPI and FACP, the funds target a gross internal rate of return of 20%. The trade-off for such returns is that, as with most private equity funds, they are **illiquid.** This means that clients are liable to pay their full commitment during a fund's term and cannot sell their position. If clients wish to do the latter, they must get the approval from a fund's General Partner and find a buyer on the secondary market.

And what about co-investing?

Mireille Klitting: Clients can invest either directly as a **co-investor** or indirectly (via a primary strategy) as a participant or limited partner in a fund. Where a co-investment opportunity exists, a manager such as Rothschild & Co would hand pick market-leading companies for clients. These companies tend to have good management teams where there is a clear opportunity to directly invest and exit from an underlying business in a four- to five-year timeframe.

Turning to investing on the secondary market, how does this strategy differ?

Mireille Klitting: Secondary investment strategies allow clients to buy into an existing portfolio of private equity positions diversified across a number of underlying businesses. Key to this strategy is a manager's ability to:

- Thoroughly analyse and value an existing private equity portfolio of multiple businesses; and
- Deploy market and sectoral insights to help management teams strategically grow their assets.

Secondary market opportunities are generally fewer and harder to come-by and most clients invest via a dedicated secondary market fund such as our Five Arrows Secondary Opportunities (**FASO**) fund. FASO's diversification across a broad array of businesses at different stages of maturity in a wide variety of geographies often proves attractive for clients. Most importantly, clients like the fact that in secondary and multi-manager strategies, the investment period is shorter than in primary market strategies. This means that clients usually see returns distributed earlier than in the primary market, as illustrated in figure 2 on page 5.

Did you know?

The average 10-year cycle of a private equity fund is split into an investment and a divestment period. During the first five years of the fund's life (**the investment period**), the manager will call on your committed capital as and when businesses are identified to invest in. We call capital committed as and when investment opportunities arise. In the second five years (**the divestment period**), the manager will start to exit its investments, so as to realise profits and distribute returns to its investors.

"Investors have become increasingly attracted to the liquid profile of secondary and multi-manager strategies"

Mireille Klitting
Global Partner
Rothschild & Co Merchant Banking

You mentioned multi-manager strategies – what are these?

Aurelien Bullot: Multi-manager strategies extend the principle of diversification one step further by selecting a blend of primary, secondary and / or co-investment opportunities. Key to the multi-manager strategy is selecting fund managers with a proven business model and strong track record.

Our Five Arrows Private Equity Programme (**FAPEP**) fund is an example of this multi-manager strategy investing in top quartile mid-sized funds which are hard to access in Europe, the US and the rest of the world.

From the above strategies, have clients' preferences changed over the last 20 years?

Mireille Klitting: Clients have become increasingly attracted to the liquid profile of secondary and multi-manager strategies given that they offer high diversification and therefore a lower risk profile. At the same time, these strategies tend to give investors distributions within a shorter time frame than from the primary market, without much compromise on returns.

Aurelien Bullot: A separate trend we have seen in the primary market is increased specialisation by managers as the industry matures. Nowadays, a primary fund is likely to have dedicated sourcing teams looking for new investment opportunities whilst dedicated operating teams will create value from underlying companies by implementing new strategic initiatives.

Private equity has long been perceived as illiquid, is this changing?

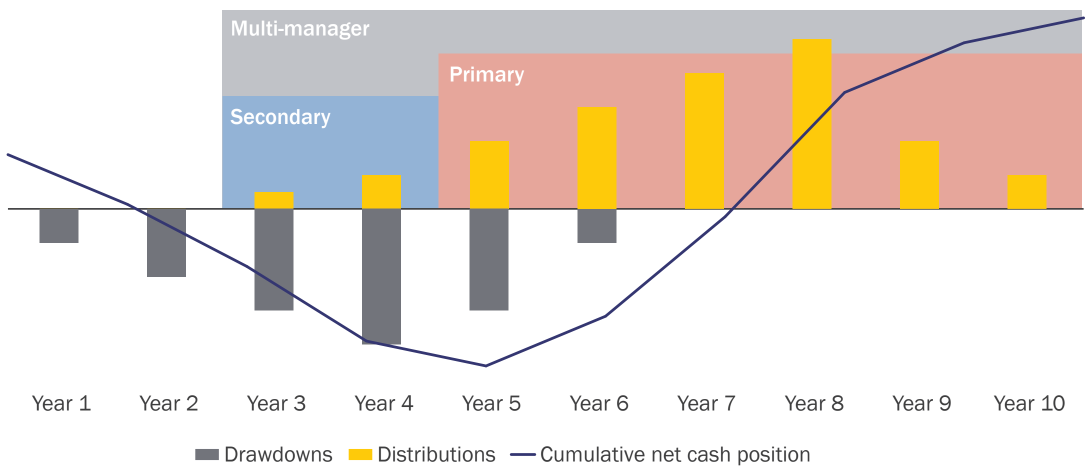
Mireille Klitting: The rise of the secondary market has changed the face of private equity and created a more liquid forum in which to sell existing holdings.

Increasing numbers of clients have therefore taken advantage of secondary markets to be more actively involved in the management of their portfolios. They now seek to shift their investments sectorally or regionally as opportunities arise, much like when managing a public markets portfolio.

Aurelien Bullot: Given increased levels of liquidity, we are also seeing clients become more comfortable with longer investment horizons. This is seen in some long hold funds which were recently launched with an investment cycle of up to 15 years.

Figure 2: Private equity

An illustrative example of how cash flows can be distributed across private equity strategies.



Note: Indicative information and illustrations. There can be no assurance that targeted returns will be realised. Nothing contained herein should be deemed to be a prediction or projection of future performance.

Source: Rothschild & Co

Understanding private debt

What are the benefits of investing in private debt?

Turning from private equity to private debt, private debt offers investors an attractive alternative to investing in traditional fixed income strategies and is inherently more conservative in terms of risk and return than private equity.

The most common ways to invest in private debt are either via **direct lending** or **syndicated loans.** In direct lending, as with most private equity strategies, funds tend to be closed ended, meaning that once monies are invested, the position is illiquid. Nevertheless, private debt's lower volatility and regular cash income are attractive to investors.

Examples of direct lending funds are our Five Arrows Credit Solutions (**FACS**) junior credit opportunities and Five Arrows Direct Lending (**FADL**) funds. The latter invests in senior-secured direct loans for mid-market companies seeking financing for buyouts, expansion opportunities or refinancing.

Examples of the types of companies which FACS or FADL have lent to (Figure 3) include Biogroup LCD, a leading network of French clinical laboratories, fast-food powerhouse Burger King, and Arachas, a leading Irish commercial insurance broker. The gross internal rate of return of direct lending funds such as FACS is around 12% and for FADL 8% to 10%. These returns tend to be higher than those obtained from lending via syndicated loans which are nearer 4% to 5%.

Syndicated loans have a lower rate of return given that they are issued by larger businesses (than DL) that have performed for longer and across cycles. The syndicated loans market also has the benefit of an active secondary market, making it more liquid in contrast to direct lending.

Did you know?

A private debt fund investing in senior-secured direct lending or syndicated loans will rank first in priority in case the underlying company defaults on its interest payments. This ensures a high recovery rate for the investor and greater price predictability on the underlying loans. This, added to the payment of regular cash income can make direct lending and leveraged loans attractive strategies for investors seeking a more defensive private markets strategy within their portfolios.

Rothschild & Co has considerable experience in participating in the syndicated loans market and currently offers three strategies: Oberon, Elsinore and CLOs. Our closed-ended (illiquid) Oberon funds invest in senior secured corporate loans in the European market.

Starting in 2018, we also launched our first open-ended fund in the US market which offers monthly liquidity. **Oberon USA** targets senior secured US corporate loans and a gross return of Libor +4% over credit cycles. With 192 new investments, 2018 was an active year for Oberon USA which lent to companies such as Cushman & Wakefield, and Energizer, the leading provider of batteries and torches in the US. Complementing Oberon, Elsinore is our actively managed multi-strategy credit portfolio investing in high-yielding sub-investment grade corporate debt. Because of its greater risk-return profile, it targets a higher net return of 8% to 10%.

Figure 3: FACS and FADL investments

Examples of the types of companies which FACS or FADL funds have lent to.

BIOGROUPLCD biologie médicale

Biogroup LCD

February 2018
Regional network of clinical laboratories in France

ARACHAS The Irish for Insurance

Arachas LCD

May and December 2018
Leading Irish commercial insurance broker

BURGER KING

Burger King

July 2018
Master franchise of fast-food restaurant chain in France

Source: Rothschild & Co

“Stability is a key characteristic of companies we lend to. They tend to have strong revenue visibility and regular cash flows.”

Edouard Veber
Co-Managing Partner Direct Lending Platform
Rothschild & Co Merchant Banking

Rothschild & Co’s Edouard Veber of our Merchant Banking division, has multi-decade experience in investing in private debt.

In the following interview, we ask Edouard to share some insights on managing a direct lending fund.

What are the key advantages of direct lending for investors in today’s market?

Edouard Veber: Firstly, in today’s market interest rates remain near to, or at record lows across the developed world. In an environment where the hunt for yield leads investors to increasingly risky assets, private debt and specifically direct lending offers clients a cash yielding product with regular payments at reasonable risk levels. Whilst potential returns may be lower than in private equity, private debt remains comparatively less risky as an asset class.

Secondly, private debt differs from private equity in that there is no initial drawdown period or J-Curve (Figure 2, page 5). In private debt, fees are generally not charged to the investor until monies are invested and lending is complete. This means clients’ returns are net positive from the beginning of the investment cycle.

In your first direct lending fund “FACS” you focused on Junior Debt. In the second vintage “FADL” your team focused on Senior Debt. What lies ahead?

Edouard Veber: Over recent years, the market continues to evolve towards senior lending (unitranche) investment opportunities. For our latest direct lending fund, FADP III, we have decided to optimise the risk/return of the portfolio by investing at least 70% in unitranche positions with the balance invested in junior credit.

For FADP III we will keep our focus on identifying direct lending opportunities in no more than 20 different companies. We limit our portfolio exposure to better understand the companies we lend to and prefer, where possible, to act as a sole lender.

What are some of the key characteristics you look for in the specific companies you lend to?

Edouard Veber: Stability is a key characteristic of companies we lend to. They tend to have strong revenue visibility and regular cash flows. Our goal as private debt lenders is to get our principal repaid and receive interest. As we do not have any equity upside, our focus is to limit risk. This means we tend to favour very stable businesses.

Given where we are in the business cycle, how does the issue of defaults compare to 10 years ago?

Edouard Veber: From the limited number of companies we lend to, we have so far not encountered any defaults. It is important to remember that compared with the 2008–2009 financial crisis, companies are generally less levered, interest rates are lower and the cost of debt remains reasonable. Meanwhile we should not forget recovery rates, even during the last downturn, were around 50% for junior debt and near to 80% for senior debt lending.

Insight into a direct lending company

BIOGROUP LCD (figure 3, page 6) is a leading French clinical laboratory business. We started lending to the business in 2014 when the company had EBITDA 30m Euros. The business comprised of 40 different laboratories with multiple lines of credit and a myriad of legal entities, restricting potential M&A activity.

After streamlining the business structure, Biogroup has grown to generate EBITDA 160m Euros. It is now able to provide critical blood test screening prior to surgery, via a network of laboratories financed in part through a single direct lending line. Over the past decade where bank lending has receded, private debt lending has stepped in to make a tangible impact on businesses and society.

Private markets for wealth management

Seeking returns with lower volatility

As we have illustrated, Rothschild & Co offers a broad range of private market strategies in keeping with the growing popularity of this asset class. With this in mind, we need to understand the benefits these strategies can bring private wealth clients within a standard multi-asset class portfolio.

Private market investments can diversify and lower volatility within portfolios
There are two key benefits private markets can bring to multi-asset class portfolios.

Firstly, private market investments allow for **broader diversification** of a multi-asset class portfolio as they access investment opportunities not typically available on the public markets. By being actively involved in key development stages of the companies they invest in, private equity and debt strategies can also give clients unique exposure to businesses as they grow. This in turn can add long-term positive returns to portfolios.

Secondly, private markets can **reduce the overall level of portfolio volatility** due to the fact they are generally less liquid in nature. This is due to the fact that managers need time to find the right companies to invest in, deploy capital and determine how to add value. As a result, they are not valued on a daily basis but rather on a quarterly basis. That being said, the rise of the secondary market has changed the face of private equity as the possibility to sell equity investments on the secondary market has increased.

Furthermore, even though private markets may be less liquid than public market investments, this does not mean private markets are *per se* less transparent. Regular account statements and communications by managers are issued to clients with comprehensive reporting.

To demonstrate these two positive effects, we have carried out a study to see how historically, private markets have added value within multi-asset class portfolios.

For this study, we tracked the performance of a USD multi-asset class portfolio, with (**blue**) and without (yellow) private markets exposure over the last five, 15 and 20 years.

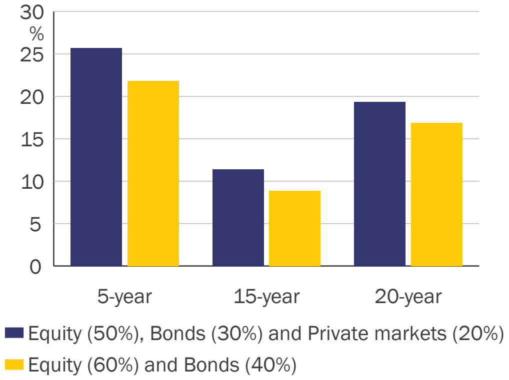
Figure 4 shows that the blue portfolio delivered a higher total return and figure 5 shows that it achieved this with a lower volatility. This was achieved with a mix of 50% global equities, 30% fixed income and, crucially, 20% private markets. This private market exposure was divided equally between private debt and private equity.

By contrast, the yellow portfolio which did not contain private markets exposure but merely 60% equities and 40% fixed income, had a lower return and higher volatility for the three periods studied.[6]

Another key feature of the study is that the blue portfolio outperformed the yellow portfolio both in periods of strong equity markets and in periods with deep market falls during the last 20 years. This includes during the 'dot-com crisis' in the early 2000s and the 2008 Global Financial Crisis.

Figure 4: Higher returns

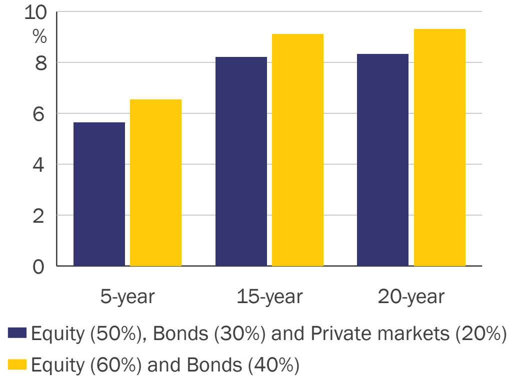
Total return performance of a USD multi-asset class portfolio, with (blue) and without (yellow) private market exposure.



Source: Rothschild & Co

Figure 5: Lower volatility

Annual volatility of a USD multi-asset class portfolio, with (blue) and without (yellow) private market exposure.



[6] The results are obtained with historical data based on 60% MSCI AC Index and 40% Fixed income (divided into 20% Government bonds; 16.8% Corporate bonds; 3.2% High yield). For private markets, we use the Cambridge Associates LLC US Private Equity Index and the CS Leveraged Loan Total Return Index.

Investing with Rothschild & Co

We are embracing sustainable investment approaches as part of our long-term commitment to growing wealth

We have shown in this publication that private markets can deliver higher returns and lower volatility to a client's well-diversified portfolio. Yet investing in private markets requires commercial insight into specific investment opportunities. As discussed in our introduction, the Rothschild family has been at the forefront of investing in these opportunities over the last 250 years. During this time it has been the Rothschild family's values and personal commitment that has allowed us to become a trusted partner in private markets.

Today, the Rothschild & Co Merchant Banking team works alongside our Rothschild & Co Global Advisory business in delivering this partnership. Our Merchant Banking team structures Rothschild & Co's Private Equity and Private Debt funds and receives monies to source and invest in the best deals across sectors and regions. Our Global Advisory business[7] in turn provides our Merchant Banking teams with unrivalled insights to the best opportunities available in private markets.

"By avoiding unethical trading and committing to ESG principles, we believe that we will create longer and more sustainable value for our clients when investing in private markets."

Investing responsibly

Since 2009, investors have been able to join the family in investing in Rothschild & Co Merchant Banking strategies. During this time we have been conscious of developing our investment strategies in a socially responsible manner. Nowhere is this felt more closely than in private markets where we offer and promote strategies which embrace Environmental, Social and corporate Governance (ESG) standards.

In order to fulfil ESG requirements, some managers embed ESG filters in their selection, due diligence and monitoring of private market opportunities. We are happy to say that Rothschild & Co Merchant Banking signed the UN Principles of Responsible Investment in 2012 and now has designated employees responsible for ESG affairs in each of its investment teams. By avoiding unethical trading and committing to ESG principles we believe that we will create longer and more sustainable value for our clients when investing in private markets.

Conclusion

This publication aims to highlight the important role of private market investments within a well-diversified investment strategy and to explain the various private markets strategies to consider when investing in private equity and private debt funds.

Should you have any questions on the current strategies open to invest in, our Client Advisers are available to discuss this at a time convenient for you.

[7] Rothschild & Co finished first globally in terms of number of corporate deals completed in 2018.

For more information

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