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STATE OF THE MARKET 2024

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# Private individuals: The new “go to” LPs for private equity fund managers?

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The private equity market has experienced a significant evolution and growth in recent years. In early 2021 it came to an immediate halt. The reason behind this mirrored that which paused markets following the global financial crisis in 2008: a period of excessive investment activity prior to the crisis followed by one of great economic uncertainty. As a result, in both 2021 and after 2008, transaction activity stalled and investors’ cash flow profiles fell into disarray. Additionally, allocations were further limited by regulatory constraints. Altogether, these led to a substantial reduction in new commitments by institutional investors.

Private equity fund managers are now seeking “new” pools of capital. Private wealth investors, namely high-net-worth (“HNW”) and ultra-high-net-worth individuals (“UHNW”), have become increasingly attractive.

Why is that? HNWs and UHNWs are typically defined as individuals with substantial wealth, often exceeding $1 million in assets. In general, their cash flows mainly originate from entrepreneurial or labour income sources, and as such, they are less dependent on distributions from prior investments, affording them the “luxury” of allocating their capital more flexibly. They are in a better position to commit to new funds in this current market environment than other institutional investors. On paper, this makes them an interesting source of capital.

**The growing prominence of private wealth investors**

The private equity fundraising market has seen substantial growth in recent years, with total AUMs reaching record highs. This evolution has mainly been driven by the attractive returns. Historically, private equity has outperformed traditional asset classes like stocks and bonds. Moreover, with the sustained period of low interest rates, investors have ventured into asset classes with higher risk profiles in order to generate decent returns.

Private investors have been largely left out of this trend, up until recently. In the Global Private Equity Report 2023, Bain & Company estimates that 50% of the total global AUM, representing $275-295 trillion, is owned by private wealth investors. Across alternative investment funds, this investor group only represents 16% of AUM. What’s more, these allocations mainly come from a relatively small number of UHNW investors and family offices. This is set to change. Bain projects strong growth in the private wealth investor base, which could see their allocations to alternatives more than triple from $4 trillion in 2022 to $13 trillion by 2032.[1]

The increasing prominence of private wealth investors in the private equity fundraising market follows their growing appetite for the asset class. It is mainly driven by:

- **Pursuit of higher returns**: Private wealth investors’ appetite for returns surpasses what traditional investments offer, as they understand private equity’s potential to provide substantial profits over the long term, especially when managed by experienced fund managers;
- **Risk tolerance**: Given their higher levels of wealth, HNW and UHNW investors are often able to take on more risk in their investment portfolios, and recognise that private equity can be an attractive option for those willing to endure some volatility in exchange for the prospect of significant gains; and
- **Growing need for diversification**: HNW and UHNW investors recognise the importance of diversification to manage risk across their portfolios. Private equity investments are less correlated to traditional asset classes, thereby adding a layer of protection during market volatility.

**The challenges faced by private wealth investors**

While private wealth investors’ interest in private equity is significantly increasing, they face certain challenges and complexities which need to be addressed in order to unleash the full might of the private wealth capital pool:

- **Regulatory complexity**: The private equity industry is subject to a variety of regulations with various jurisdictional idiosyncrasies. Ensuring compliance with these regulations is often complex and requires expertise, with added costs;
- **Illiquidity**: Private equity investments are illiquid, and private wealth investors must be comfortable with longer investment periods and the inability to sell their stakes in a regulated market;
- **Cashflow profiles**: Private wealth investors are typically accustomed to more predictable cash flow patterns whereby they have to transfer money at one or more clearly defined dates and, likewise, receive their returns on a specified date. Contrarily, private equity drawdowns and distributions do not always follow a set schedule;
- **High minimum commitments**: Often, private equity funds call for minimum commitments of €5-10 million, and therefore require a significant portion of a private individual’s wealth;
- **Due diligence**: Selecting the right private equity fund manager is critical to reaching return targets. Considering that private equity investments are regularly blind pooled, there needs to be a high degree of conviction in the manager’s investment acumen. Proper and thorough due diligence prior to committing to a fund is crucial, but it is also intensive from a time and cost basis, and requires relevant experience; and
- **Access to closed fund managers**: The best performing fund managers can be very selective about who they accept commitments from. Private investors need an “in”, and in some cases, they need to convince a GP to be included in its investor base.

The first three challenges can be overcome with education, but the last three require a different approach as well as innovative investment solutions.

**Capturing private wealth through feeder funds and funds of funds**

For many years, private banks have been a means through which to access private equity funds by providing their HNW and UHNW clients with feeder fund solutions, with tickets starting from c. €100,000. Given the ease of marketing, these feeder funds could often provide access to well-known large-cap private equity funds, with additional fees for the private bank's efforts.

In Europe, these investment models weren't as widespread. In 2013, a new regulatory framework was introduced in Europe with the advent of the Alternative Investment Fund Manager Directive ("AIFMD"), which itself was recently supplemented by improved regulation on fund structures, such as European Long-Term Investment Funds. These new rules and regulations have afforded greater protections and/or enabled smaller investors to access private equity investments within the context of a diversified investment approach.

Following this, new trends emerged in Europe such as digital investment platform models, feeder funds (as described above) and funds of funds structures targeting HNW and UHNW investors. Most recently, large private equity fund managers have started to open their core flagship funds to small retail investors via their own digital investment platforms. As a result, private wealth investors are enjoying a greater array of investment opportunities to choose from.

Feeder funds normally start with relatively low minimum commitments of €100,000 to €200,000 and provide private wealth investors with access to specific private equity funds with a second fee layer. However, there are some important considerations to bear in mind. Firstly, the responsibility of due diligence typically lies with the investor, not the feeder funds. Often, several feeder funds provide access to the same private equity fund, which investors need to consider when trying to build up diversified investment portfolios. If an investor wants to invest in a specific fund and to perform their own due diligence, they should use relatively low investment tickets and the most cost-effective feeder fund approach.

Because of these considerations, historically, funds of funds have been the investment solution for smaller institutional investors who lack the financial means and experience to build a diversified portfolio on their own. Whilst they have a second fee layer, funds of funds are mandated to find private equity funds generating alpha and have to perform due diligence on such managers. Moreover, they have to build and monitor private equity portfolios.

In the last ten years, new funds of funds serving private wealth investors have entered the private equity market, enabling private individuals to invest with minimum commitments as low as €200,000. Managers of funds of funds also act as advisers to their underlying investors, providing them with guidance on cash flow requirements as well as addressing their regulatory questions. As such, these funds of funds can provide a one-stop solution for smaller investors looking for a diversified private equity investment product with higher returns than feeder funds.

Given the increased interest in private equity investments, the feeder funds and funds of funds will likely play an important role in increasing private investors' allocation to private equity in the coming years.

**Private investors may become a stable source of funding for private equity fund managers**

In summary, the market is responding to the increasing demand from private wealth investors for alternative assets, with lower minimum commitments, enhanced transparency and greater access to top-quality fund managers. With the growing regulatory complexities and the inherent risks associated with private equity investments, private wealth investors should be ever-so diligent and/or use trusted advisers before entering the private equity arena. Private wealth investors are poised to become an important pool of capital for fund managers, who, in tumultuous fundraising markets of the kind we are witnessing today, stand to benefit from this investor base with predictable cash flows, flexible deployment habits and inherent stability.

*1. Bain & Company, Global Private Equity Report 2023*

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*Immediately after completing his business studies in 1997, Thomas started working in leverage finance at Dresdner Kleinwort, where he was jointly responsible for a number of deals including the structuring of the first German large-cap transaction in 1999. Between 2000 and 2012, he worked at BC Partners as an investment professional and partner in the direct investment business. He was largely responsible for several investments including public-to-private transactions and IPOs. In 2012, he founded the fund of funds provider Astorius, where he was CEO and Co-Due Diligence Partner until his exit in 2022.*

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