Private Markets in Wealth Management

Delio

Executive Summary

Over the last four years, we have been privileged to discuss private markets with over 200 Wealth Managers and Private Banks across the globe. We've worked with over 50 institutions and provided them with the technology to digitise how they deliver private market offerings to High Net Worth (HNW) clients and Family Offices.

In 2019, we have noticed a seismic shift in these conversations. Wealth Managers no longer just understand that their clients are allocating heavily to private markets – they now, more than ever, want to be part of that conversation.

The insights gained from our experiences and discussions have been invaluable and have inspired us to create this Report to convey key themes to the broader market. The key findings of our research are summarised in four areas:

Client Demand

- Approximately a third of private client wealth is allocated to private markets;
- Despite perceptions, this has only modestly increased to date and is largely in line with the growth in private markets; and
- Structural industry changes are causing Wealth Managers to pay more attention to this space.

The Rise Of The Investment Club

- Private markets exposure was traditionally accessed via feeder fund programmes operated by Private Banks;
- Direct investment offerings are now almost as commonplace; and
- The proposition is typically structured as an Investment Club by larger institutions and is delivered through Third-Party Partners by smaller firms.

The Private Market (R)evolution

- Numerous organisations are creating private market propositions;
- Key areas of growth are in direct investments and impact investments;
- Innovative business models are increasingly emerging; and
- Technology is playing a key role as an enabler.

Obstacles Ahead

- It's well understood that regulation and governance are key considerations and unless fully considered they can impede the establishment or growth of the proposition;
- Internal capacity creation and Relationship Manager education are equally crucial; and
- Specialist technology is a key aid in overcoming hurdles to create and scale the propositions.

Overview

Delio is a strong believer in adding value beyond our technology. We provide our clients with access to our network and expertise and we share our private market perspectives.

A few years ago, many believed there was no need to allocate to private markets. Except for a few larger Private Banks, the vast majority of players within the market were unsure of the role a Wealth Manager should play. Too often, advisors were told to focus on traditional assets and to leave high net worth individuals to tap into private markets in their own time and at their own expense.

Now, in 2019, things are different. Firms with existing private market offerings are scaling these offerings, while those firms that were initially cautious in offering the proposition are becoming more proactive in designing and creating solutions.

We therefore felt it was an important juncture to take stock of the current market landscape through structured research, surveys and interviews to analyse the state of private markets in wealth management. We hope that our research is valuable to a broad array of parties – including those that are considering establishing a proposition as well as those assessing the strength of their current offerings. Whichever category you fall in to we hope the findings prove useful in understanding what is driving the market shift, how the market operates today, how it is evolving and the challenges to get there.

Our results supported the overwhelming trend that we have witnessed - the previous uncertainty over whether the wealth management industry should stand on the sidelines has long passed.

Wealth Managers with existing propositions can't allow complacency to set in as their peers are rapidly evolving their offerings – to maintain competitive advantage requires ongoing evolution. Furthermore, the consequences of the absence of a proposition are immediately evident. Nine out of every ten competitors already offer a solution, or are planning to, and 80% of the Wealth Managers surveyed have either gained or lost a client due to the existence or the absence of a private market proposition.

"1 in 4 Wealth Managers surveyed admit to losing a client because they did not offer illiquid investments, while 55% of respondents believe they gained clients by offering illiquid investments".

1 in 4

Wealth Managers surveyed admit to losing a client because they did not offer illiquid investments

While 55% of respondents believe they gained clients by offering illiquid investments.

1.

Setting The Scene: It Is All About The Client

To understand the current state and future evolution of private markets it's important to focus on what is causing the shift in the market – the client.

Private markets are a key component of a private clients' wealth. Our sources have noted that clients allocate between 30% and 50% of their wealth to private markets with 5 – 15% to direct investments **(See Figure 1.1)**.

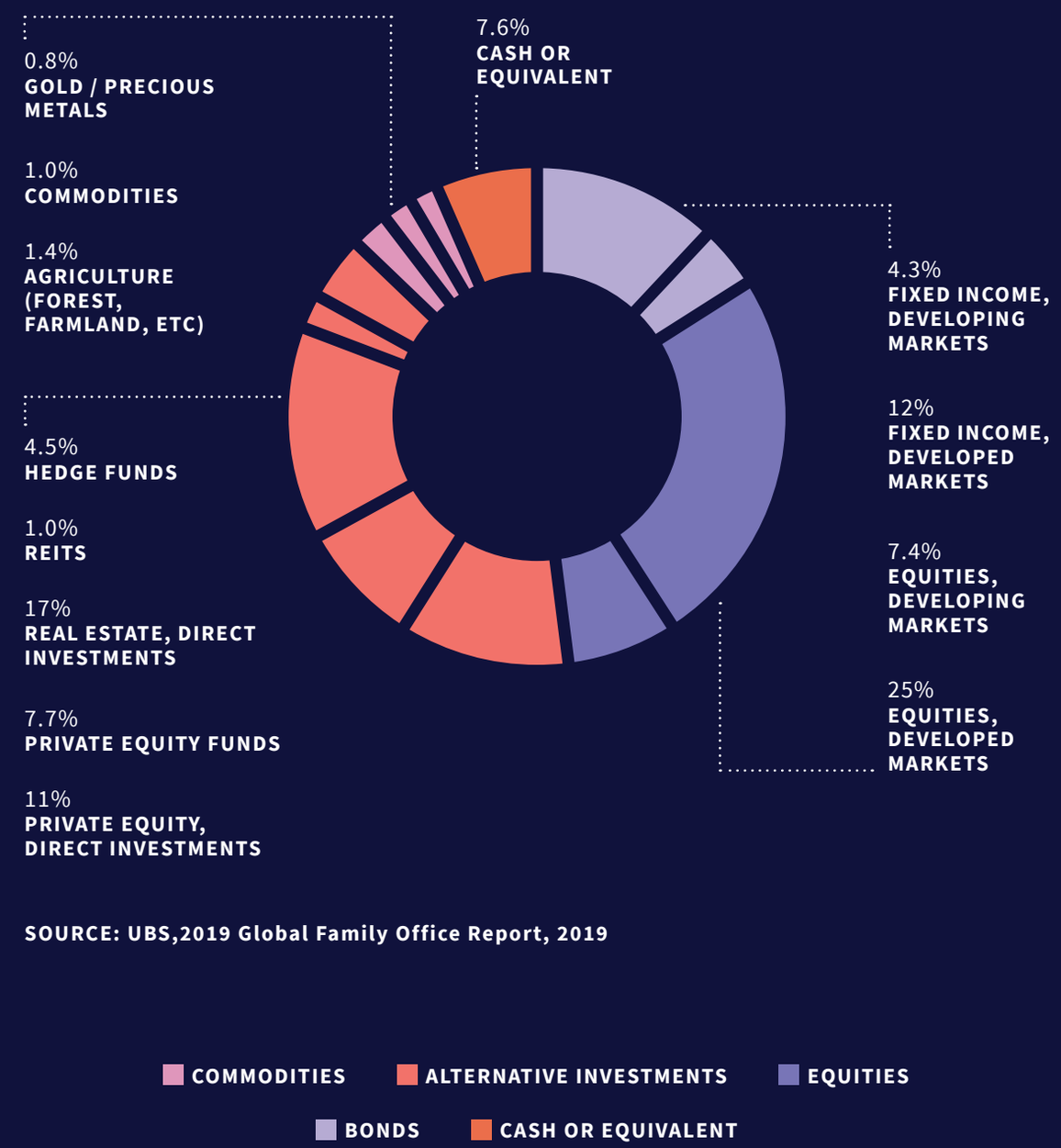
According to the Wealth Managers questioned, financial drivers are the key influences upon current allocations. Lower return expectations, excess liquidity, a greater understanding of the liquidity premium and the current interest rate environment, were all commonly cited as factors behind asset allocations.

There is however, an apparent disconnect when comparing this sentiment with historic allocation levels. Many Wealth Managers both overstate the importance of financial relative to emotional factors and perceive this to be a new phenomenon.

Allocations to private markets haven't significantly grown in recent years. In the space of five years, the 2019 UBS Global Family Office Report noted a modest increase in private markets and real estate (35% to 37%). This slight increase coincides with the general growth of HNW individuals - which has risen by 4% in the last decade, from 24% to 28% according to the Capgemini World Wealth Reports.

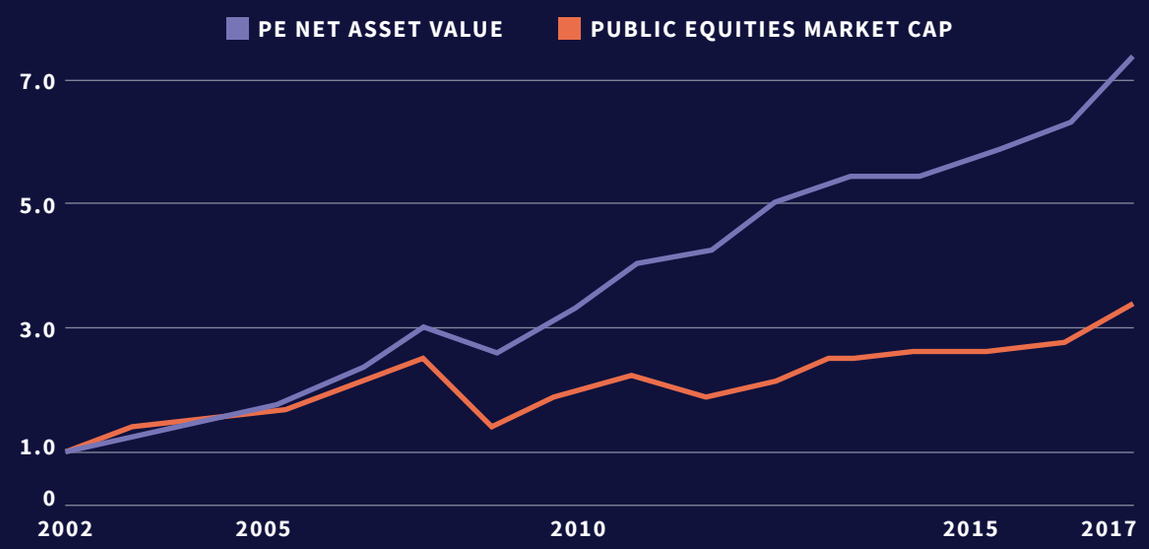
This is proportionate to growth in the value of private markets. According to McKinsey's Private Markets Review, global Private Equity net asset values have grown sevenfold since 2002 relative to a threefold growth in public equities. A modest increase in allocation is therefore no surprise, quite independently of investor sentiment **(See Figure 1.2)**.

FIGURE 1.1: UBS 2019 Global Family Office Report



SOURCE: UBS,2019 Global Family Office Report, 2019

FIGURE 1.2: GLOBAL PE NET ASSET VALUE HAS GROWN MORE THAN SEVENFOLD SINCE 2002, OUTPACING PUBLIC MARKET EQUITIES.



SOURCE: McKinsey, Global Private Markets Review 2019, 2019

What has changed the conversation however, are two entwined factors. Firstly, the increased commoditisation and democratisation of wealth management and secondly, Wealth Managers having a broader and deeper understanding of their clients' needs. It's therefore a logical progression to appreciate that clients are far more excited and passionate about private markets than they are about traditional investments.

This emotional motivation to invest is most evident in real estate, direct investments and impact investments, which, as we will see in the following chapters, are the biggest growth areas in the market. These investment areas are driven by two fast-growing client segments that want to be engaged and inspired: entrepreneurs and the next generation of HNW investors.

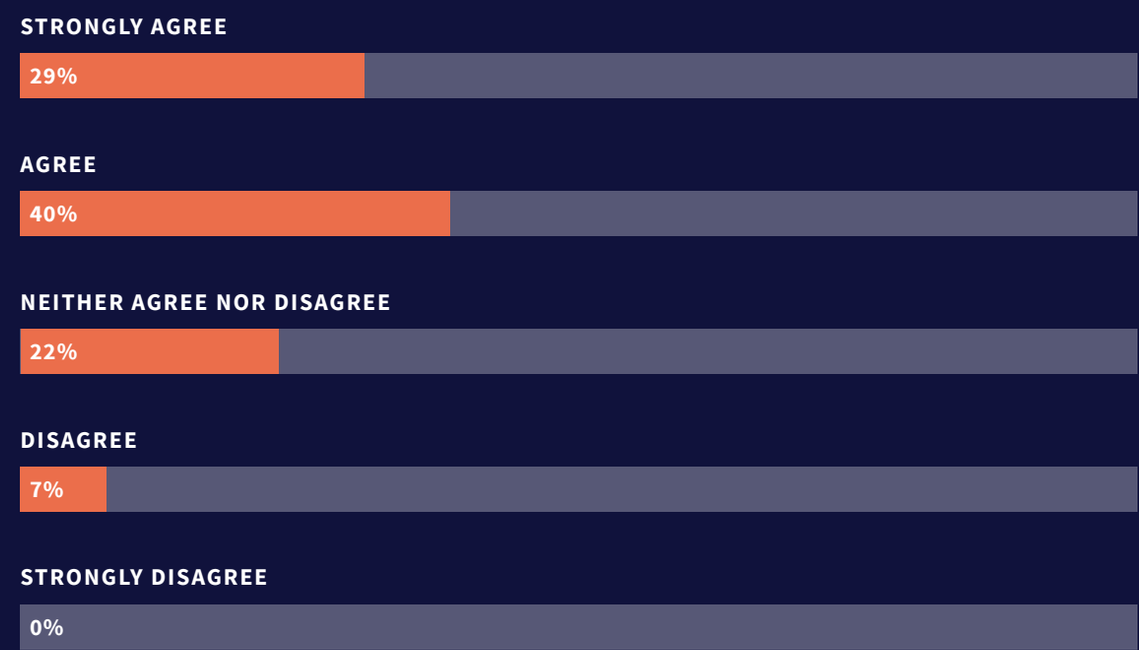
Our survey shows that entrepreneurs are now the most important client segment for Wealth Managers as they are the drivers of new liquidity. Simultaneously, the industry has become increasingly aware of the extent of assets at risk as part of the continuing great wealth transfer to the descendants of their current clients.

Both of these investor types are more involved in investment decision making, are more conscious about where their wealth is allocated and wish to be more engaged. These types of investors have a better understanding of private markets than public markets and they respond to the context and the emotional connection of direct investments and impact investments. For these clients, the efficient frontier is no longer just risk versus return; it is risk-adjusted return versus passion.

When considering this new type of investor, a low return environment, enhanced sophistication and an industry shift towards more holistic client engagement, it becomes immediately evident as to why 70.3% of those Wealth Managers that we surveyed believe their clients are increasingly seeking access to illiquid investments. More pertinently, Wealth Managers now believe that they should no longer sit on the sidelines – only 7.4% disagreed with the statement that Wealth Managers should offer private markets opportunities.

Having established this clear need we must ask ourselves - What is the industry doing about it?

FIGURE 1.3: WEALTH MANAGEMENT CLIENTS ARE INCREASINGLY SEEKING ACCESS TO ILLIQUID INVESTMENTS



2.

The Market Today: Rise Of The Investment Club

The current state of the market and how we've found ourselves where we are today should not be overlooked.

Looking back, even at the cusp of the crisis when broader private market interest was at its height, private markets played a relatively small role in the wealth management proposition. If you dealt with a large Private Bank, you may have had access to three or four feeder funds per year. If you were a large Family Office and were supported by one of the Universal US Banks, you may also have had access to a handful of club deals or a broader deal flow from the investment banking desks. Beyond this however, offerings were limited.

The feeder fund proposition and the corresponding challenge of complex fundraising and reporting processes has largely stayed the same. It remains the core offering for many institutions alongside semi-liquid permanent capital structures.

Yet, what has emerged over recent years is an evolution of wall-crossing deals to establish or raise the prominence of Investment Clubs and direct investment propositions.

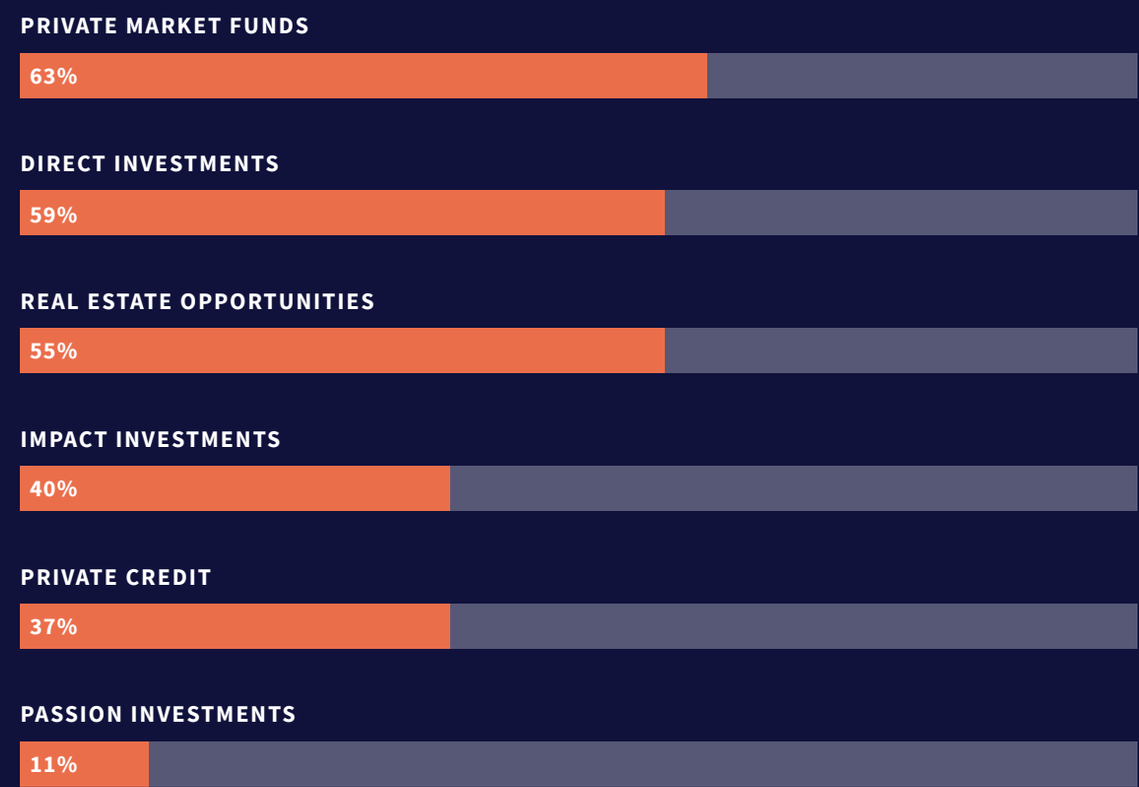
What started out as Equity Capital Market desks looking for a new pool of buyers for their pre-IPO deal flow paved the way for formalised propositions. Previously Investment Bankers played a significant part in this. As traction and turnover in the industry grew post-crisis, more and more advisers moved from investment banking to private banking. Their background knowledge within the industry ultimately helped accelerate the implementation of Investment Clubs in many Universal Banks.

Today, almost as many institutions offer direct investments as private market funds. Of the Wealth Managers we surveyed, 59% offer direct investments, slightly below the 63% offering private market funds and 55% offering real estate opportunities **(See Figure 2.1)**.

59%

Offer direct investments, just shy of the 63% who offer private market funds

FIGURE 2.1: WHICH OF THE FOLLOWING DOES YOUR FIRM CURRENTLY OFFER?



89%

Wealth Managers surveyed with AUM < $10bn now offer Direct Investments to their clients.

Not all Investment Clubs are the same. We see stark variations in terms of scale and focus – from a handful of part time staff working on direct investments alongside the broader alternatives offering through to a number of global banks who have dedicated teams of up to 30 people.

Often these teams sit within the wealth management arm. However, for the Universal Banks they often transverse the Investment Bank and the Wealth Manager, subject to careful wall-crossing compliance requirements.

The sources of deal flow are typically a combination of in-house deal flow from other service lines, third-party partners and from clients themselves. Our survey shows no clear trend in terms of origination source, given this is likely to be highly aligned to the organisation's strengths and networks.

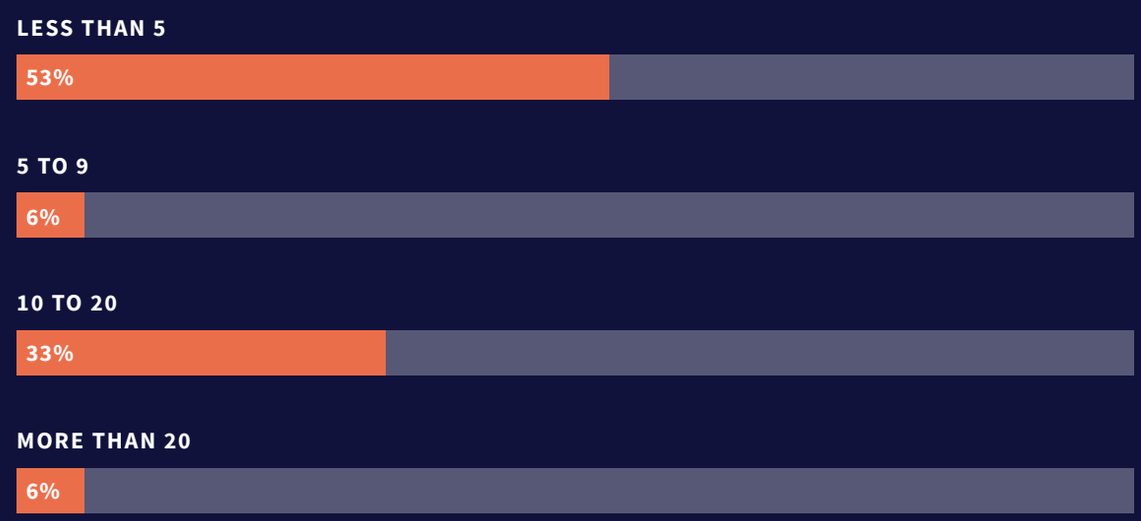
Taking one leading UK Private Bank as an example – they have a comparatively small Investment Bank but a significant number of entrepreneurial clients and their deal flow is almost exclusively sourced internally "all but one of our deals this year has come from members of our Investment Club." Contrast this to the Investment Club of a US bank with a leading ECM franchise who noted that ***"all our deal flow is from our Investment Banks pre-IPO pipeline and, as a result, is US and technology-focused."***

WE ARE THE "LEADING ARM TO DIFFERENTIATE THE BANK"

Investment Club of Top 3 Wealth Manager

What is common is a clear focus on quality and not quantity with over a half of the institutions we surveyed doing less than five transactions per annum **(See Figure 2.2)**.

FIGURE 2.2: NUMBER OF PRIVATE MARKET TRANSACTIONS OF PARTICIPANTS

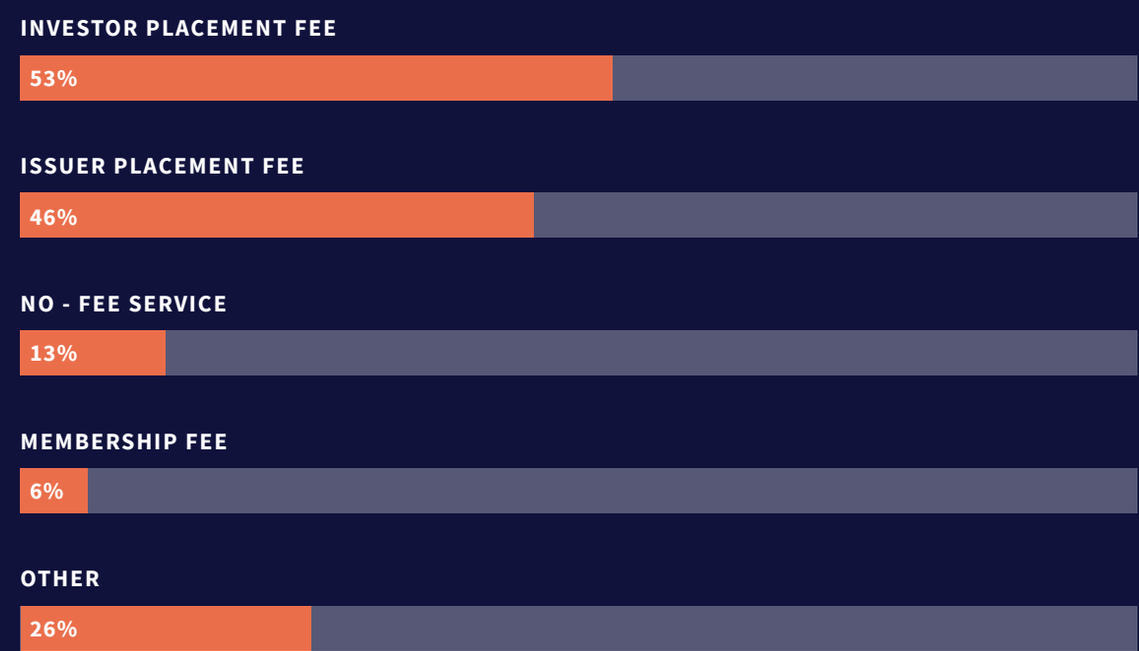


13%

Of institutions don't charge for the opportunities offered and focus on the 'value-add' service to clients

The variation in commercial models is also interesting: 13% of institutions don't charge for the opportunities offered and focus on the 'value-add' service to clients. Those that do charge are split almost equally between those who charge investors and those that charge issuers (where regulation allows). **(See Figure 2.3)**.

FIGURE 2.3: COMMERCIAL MODEL



The membership fee model is increasingly discussed as a future commercial model to balance the interplay of commerciality, risk and scope. One organisation that has already adopted this model is Hottinger. Their model is further detailed on p.15.

There are of course other ways of offering direct investments. Some institutions have retained the traditional referral to the Investment Bank. Most firms either offer an in-house Investment Club or, for those that lack the scale or resource, provide direct investments via third-party partners.

59%

Wealth Managers surveyed offer direct investments

Of those > $50bn AUM, 80% have built an in-house “Investment Club” team to manage it. This drops to 22% for those below $50bN.

Those working with partners today have either structured informal relationships or formal agreements where they receive a retrocession from the partner.

The evolution of the partner-led model is widely-discussed within the institutions this Report focuses upon. Establishing and growing a network, showcasing co-investments and “vetting the partner rather than the deal” type models are all approaches which have gained prominence.

HOTTINGER

Case Study: Hottinger

In addition to a rich history in the world of banking and capital markets, the Hottinger family has always been a pioneering force in the world of alternative investments.

Today, clients of Hottinger continue to recognise the role of alternative investments in their portfolios. Hottinger source and present a range of interesting private investment opportunities to their clients through Hottinger Investment Circle.

How does the Hottinger Investment Circle work and why was it created?

Hottinger Investment Circle members pay an annual retainer fee for access to a dedicated online platform showing direct investment opportunities. Investments will typically involve the purchase of shares or debt securities of unlisted entities or secured lending to such entities. In collaboration with Hottinger Art, access is also provided to works of art for purchase.

This deal flow is sourced from Hottinger’s clients, their own network and a range of third-party partners. The online platform is then used to showcase companies seeking capital by making available opportunity summaries and digital NDAs. Following this, members can request further information if they desire. Members can also view the composition and performance of their existing portfolio post investment and engage with their portfolio companies.

Members can set their preferences for attributes such as size, growth stage and sector. This, combined with digital analytics help Hottinger to understand their clients’ interests and better engage with them. The primary motive for launching Hottinger Investment Circle was building stronger client relationships and client acquisition.

3.

The Private Market (R)evolution: Business Model Innovation:

Our conversations with Wealth Managers have led us to believe that there is a structural evolution in how Wealth Managers take private assets to their clients. Our findings have highlighted three key themes, which, when combined, can lead to a private market revolution.

Firstly, private markets are going mainstream. Wealth Managers of all shapes and sizes are looking to offer private market opportunities, driven by direct and impact investments. This explosion of propositions will drive a second theme of business model evolution – the shift away from traditional transactional placement fee business. Lastly, technology will play a significant role. Propositions will need to be digitally delivered, enabling scalability, enhanced client experiences and timely uptake.

Going Mainstream

We have observed a point of inflection in the industry as an increasing number of firms consider launching new private market propositions and our findings corroborate this. 77.7% of Wealth Managers believe that the number of private market propositions will grow over the coming years.

FIGURE 3.1: THE NUMBER OF WEALTH MANAGERS OFFERING ILLIQUID INVESTMENTS WILL INCREASE IN THE NEXT THREE YEARS

While a small number of Wealth Managers consider their current proposition to be in a finalised state, most are looking to offer more. A top ten Wealth Manager highlighted: “We had taken our proposition as far as we could with the current risk appetite of the bank, but the mindset is shifting, and we are now looking at how we expand [our] offering.”

As firms seek to broaden their offering, the two key areas of proposition growth are impact investments (63%) and direct investments (55.6%).

55.6%

Wealth Managers that don’t yet offer direct investments are already planning to launch a proposition

63%

Wealth Managers that don't yet offer impact investments are planning an impact proposition

Despite this change of attitude, some remain cautious of private markets, particularly direct investments. This is primarily due to philosophical reasons, as some of our respondents explained that they only believe in passive management and traditional asset management, stating "nothing will change our mind."

Those organisations that neither offer nor plan to offer private market opportunities are exposed to the changing landscape. Of these firms, eight in ten believe that increased internal resources and private market expertise would increase the likelihood of building a proposition. Similarly, if they lose clients to competitors due to the absence of a private market proposition, they will be more likely to build an offering.

As the number of Wealth Managers developing their propositions grows, and the consequences of the absence of a proposition, both in terms of unfulfilled opportunities and lost clients becomes starker, this could encourage those shying away from private markets to change their minds.

Across the respondents, some had no intention to build a proposition, but admitted that they are often guilty of "focusing on where clients' needs meet our product set" or "not asking the right questions".

As the number of propositions expand, it will not just be "more of the same" though.

80%

Wealth Managers currently monetise via a transaction based fee.

Commercial Model Innovation

The second core area of future interest highlighted in our research and conversations is how commercial models and propositions will develop.

Today, close to 80% of Wealth Managers charge via a transaction fee, in particular placement fees - this is changing.

Driven by regulation and reputation, there is a rise of club membership fees. A large portion of the Wealth Managers interviewed are looking at how they play the role of a convener of an ecosystem in the absence of charging on a deal-by-deal basis. These include peer-to-peer exchanges with clients, as well as access to aggregated partner networks.

Some firms offer private market access as a free value-add service; focusing purely on the stronger client relationships and the broader share of wallet opportunities.

Combining these two approaches, e.g. waiving membership fees above an asset threshold, will support Wealth Managers in meeting their broader business goals.

Many institutions are exploring ways to build private markets into their discretionary offering. However, to date, the adaptation has only been evident in certain regulatory jurisdictions, such as in the Middle East, or by smaller Multi-Family Offices with larger clients (i.e. above $100m).

That is not to understate the number of firms who will continue to monetise through transactional placement fees. Given that this approach is largely framed around a low number of professional clients, the business model will need to evolve due to regulatory connotations.

Co-investment structures may prove to be a key response. Increasingly, Wealth Managers use co-investment rights accrued from their allocations to private market funds as part of a broader industry shift.

"PRIVATE MARKETS ARE QUICKLY BECOMING TABLE STAKES WHEN DEALING WITH UHNW CLIENTS. IT IS NO LONGER A NICE TO HAVE"

Head of Family Offices, Tier One Bank.

The Rise of Technology

The final notable shift, which will exponentially grow, is the use of technology.

Often, technology is the key enabler that unlocks the proposition. It helps to manage compliance and governance, as well as partner ecosystems that enable Wealth Managers to offer private market opportunities. Technology can also enable the proposition to scale, driving resource efficiencies to expand the proposition.

During the initial wave, the technology itself does not need to be revolutionary. While dedicated and specialist software is necessary to support the nuances of promoting private market opportunities in the wealth management industry, the innovation itself remains in the propositions that the technology enables. Technology is democratising access to alternatives. It allows lower minimum investment subscriptions, greater client access and builds communities among clients to collectively support club deals post-investment.

It is the second wave of technology enhancement that will be revolutionary. For the wealth industry, this could primarily be in the power of blockchain and what it enables and the private market industry at large is investigating how blockchain technology can be used to facilitate faster subscriptions and processing.

This powerful emerging technological opportunity will take some time to evolve and embed in the wealth industry. Where the industry may prove to be at the forefront, is in driving use cases around what this technology enables - secondary market liquidity. Retail investors demand liquidity more than institutional investors so the wealth market can play an important role in driving how technology plays a role in facilitating easier transfers of holdings. Technology alone, will not drive liquidity, so the industry should not get carried away yet and focus on walking before it can run.

Today's technological focus is on overcoming the obstacles to creating propositions.

4.

Overcoming Obstacles: The Path To The Future

While we are clear that the wealth industry is focused on responding to client demand through opening access to direct and impact investments, it isn't to say that there aren't challenges, many of which were laid bare in our survey. From the outset, designing the proposition is one of the key challenges in itself.

1 in 5

Wealth Managers that are planning to create a proposition are still unsure of their business model

"WE NEED TO REALLY FOCUS ON GETTING OUR TARGET AUDIENCE RIGHT"

We have seen proposition design as an interplay between scope, monetisation strategy and governance; a shifting approach to one has implications for the others. For instance, as we saw earlier, the most common approach in direct investments is charging an issuer placement fee and deals being distributed only to professional clients. However, if the firm wishes to engage retail clients, to satisfy their growing demand, this commercial model will no longer be appropriate in a post-MIFID world.

Similarly, intra group synergies are a key driver for new offerings but if you change the deal source from just third-party deals to deals originated from the Investment Bank or the Corporate Bank what impact might this have on how the proposition is papered from a governance perspective, for example how are conflicts of interest managed and what if the Bank ranks higher than their own clients in the capital structure?

These challenges can all be managed through a well governed and robust framework - careful consideration is essential from the outset, which is aided by a trusted partner.

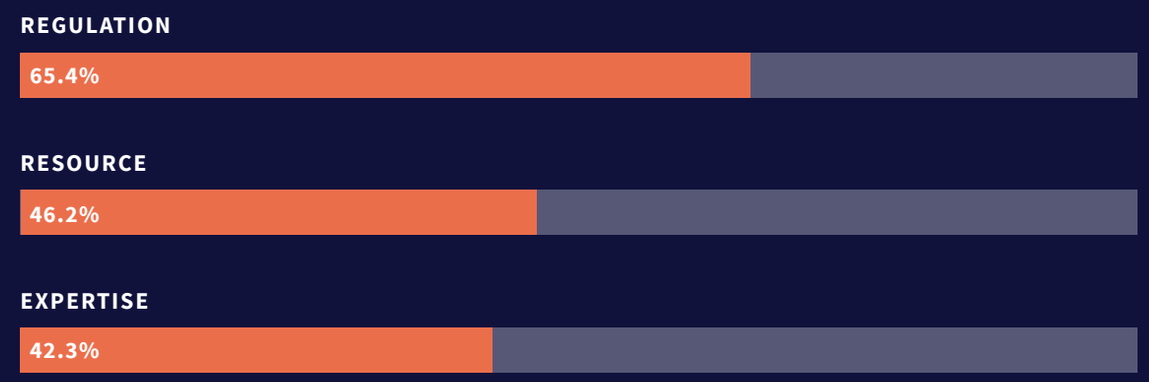
This challenge is echoed by our clients. 62% cite regulation as the key challenge to launching their proposition. This has two key component parts: suitability and reputational risk, both of which tie in to the broader question around proposition design.

Introduction-only or access-only type propositions are commonplace as they do not require suitability checks to be undertaken but do require appropriateness tests, or for the service to be confined to professional clients, and technology can play an important role in ensuring these are well documented.

From digital investor accreditations, to ingrained cross border restrictions and annual renewals, we are seeing these crucial processes being streamlined and automated, decreasing operational risk to remove blockers to launching or scaling private market activities.

Which clients and which deals remains a crucial thought process. As one Wealth Manager currently building a proposition for their Ultra-HNW clients described it, "we need to really focus on getting our target audience right". This echoes how existing offerings are managed with 44% of institutions restricting access to private markets based on the blanket regulatory status of their client, typically allowing professional clients only.

FIGURE 4.1: TOP THREE CHALLENGES TO LAUNCHING OR SCALING PRIVATE MARKETS



Beyond the expected element of regulation and governance it is internal expertise, internal resource and colleague education that were pinpointed as three of the five key challenges **(See Figure 4.1)**.

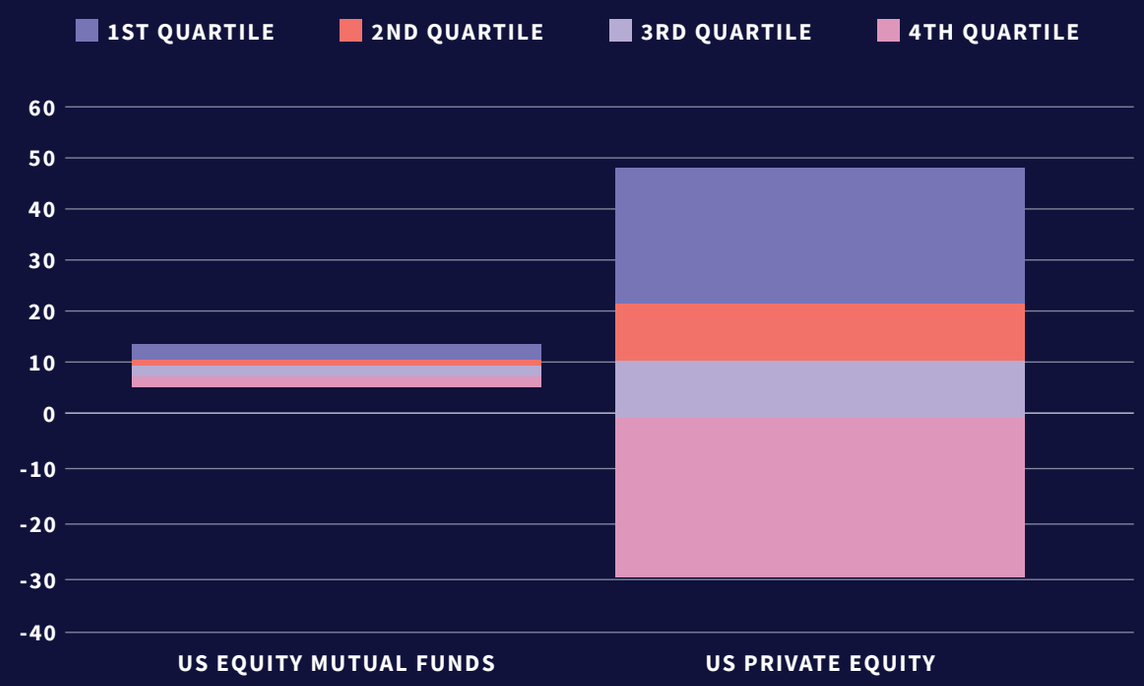
One large Bank remarked that "One of the most underappreciated challenges was educating our colleagues." In their case, like many others, the solution aligned the trust being built between product specialists and the front office and their advice was "communicate with bankers as much as you can." Again, technology plays an important role in providing client-facing staff with the crucial information, analytics and insights to empower them to fully support their clients.

Building that specialist product team in the right way is essential, more so in the private markets space than any other investment area due to the capabilities required, even when working with and selecting partners, given the wider variation of returns **(See Figure 4.2)**.

"COMMUNICATE WITH BANKERS AS MUCH AS YOU CAN"

FIGURE 4.2: RETURN DISPERSION IS MUCH GREATER IN PRIVATE EQUITY THAN IN PUBLIC MARKETS

5-year annual returns from US private equity funds & US mutual funds by performance percentile, 2013-18



SOURCE: McKinsey, Global Private Markets Review 2019, 2019

It is with interest therefore that not only do we see technology and partner collaboration driving this forward but the emergence of a small number of large direct investments groups who are focusing on providing an outsourced service to smaller institutions. This is a particularly interesting area to watch unfold against the backdrop of banks seeking an advantage in the competitive External Asset Manager (EAM) market.

Against the backdrop of client demand and industry appreciation of the essential role of private markets, these challenges will need to be addressed. Technology will continue to play an important role alongside working with trusted partners who can use their network and expertise.

We find ourselves in an exciting and innovative time and Delio is proud to be part of this journey.

Concluding Remarks

This report highlights the change in attitudes towards private markets. While five years ago, most financial institutions may have shied away from embracing private markets in wealth management, now, many are looking to expand their offering.

This is primarily due to the extent of the client-driven evolution of the Private Market Industry. Client demand is now considered the primary driver for this shift, emphasising that the client's demands remain at the core of the industry. This sentiment is echoed further in reality - some Wealth Managers now involve their clients in the proposition design to 'co-create' an offering that fully meets their needs.

From the research, we believe that direct and impact investments will increase in popularity for both financial and non-financial reasons. This has already led to a shift in propositions, given Investment Clubs are now as widespread as traditional fund offerings. As a result, it is vital Wealth Managers remain at the heart of this change. In order to remain relevant and necessary, it is crucial private market propositions are embraced. The risk of clients looking elsewhere if their increasing investment appetite in private markets is not met should not be underestimated.

Nevertheless, challenges along the lines of compliance, regulation and governance, are key considerations for Wealth Managers in scaling their offering. Additionally, there is a clear need for education, resource and capabilities, so more Wealth Mangers feel they have the capacity to adapt their offering.

Technology plays a key role in overcoming these industry challenges. As client demands continues to grow, technology supports Wealth Managers to meet this demand more efficiently and effectively. We find ourselves in an exciting and innovative time and Delio is proud to be part of this journey.

Want To Find Out More?

Delio is a private markets solutions provider specialising in wealth management. Our clients range from Top Tier Banks such as Barclays, Coutts, ING through to Boutique Wealth Managers and Multi-Family Offices. Our clients use our industry-leading white-labelled technology to streamline, scale and de-risk how they take private markets to their clients in a way that is right for them.

Beyond technology, we provide expertise to help design propositions, overcome regulatory and governance obstacles and open our network to help curate the right offering where needed.

We are always open to talk about what we are seeing in the market and where we can help firms, as they launch and scale their private market activities so please get in touch.

Contributors

This report was brought together by the global insights of our team on the ground speaking to banks, wealth managers & multi family offices day in day out but it would not have been possible without the input of all our clients, partners & contacts who have shared their views and insight along the way.

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