Private markets: attractive return potential and risk diversification

Investors who focus purely on the markets are leaving an enormous amount of potential untapped. Under 2% of companies are listed on stock markets. The remaining 98% provide a huge range of opportunities to help investors achieve the returns that they need. That's why Kempen is highly active in private markets, which include not just private equity, but also farmland and infrastructure.

Marvin de Jong, Director of Private Markets at Kempen, believes that private markets represent an excellent addition to listed investments. Take private equity, for example. 'Our goal is to invest in companies and add value to them, make them more robust and ultimately sell them again. We don't target big companies but specifically the small and medium-sized businesses. which still often provide a great deal of potential for improvement.'

He cites the example of a company whose owner is planning to retire. The current management wants to take it over but doesn't have the required capital. Kempen enables the management buy-out and supports the new owners on aspects such as investment, digitisation and internationalisation. In doing so, the company acquires the capacity to grow. After a few years Kempen sells its interest, leaving the company in better shape than when it made its original investment.

Since the initial shock caused by the coronavirus crisis, most of the losses incurred by the listed equity market have already been recouped. But the coronavirus has not gone away, climate change has not been brought under control, the US and China continue to wage a trade war and the outcome of the US presidential elections remains uncertain. 'That's why it makes sense to look at investments outside the listed equity markets,' Marvin de Jong says.

VENTURE CAPITAL AND BUY-OUT CAPITAL

Private equity can be divided into two categories, Director of Private Markets Edzard Potgieser explains: venture capital and buy-out capital.

Venture capital focuses on start-ups, primarily in technology and life sciences. These are companies with a great deal of potential, but they also involve a relatively high level of risk. They aren't yet making a profit but expect to do so in future. A good example is biotech company Inflazome. Kempen participated in this firm via its partner Forbion. The company was sold to pharmaceutical company Roche in September 2020, yielding a great return in the process.

With venture capital a relatively small market in Europe, the private equity asset class is predominantly made up of buy-out capital. This involves stable, profitable companies, mostly with predictable cashflows and in many cases a long history. Buy-out investors either offer the vendor a potential exit or help them improve the company and accomplish their growth ambitions. Buyers usually acquire a majority interest and use their knowledge and experience to take the company to the next level.

Kempen invests in private equity in two ways: directly and via partnerships. 'In the case of direct investment, we take our seat at the table alongside the entrepreneur,' De Jong continues. 'We have a great deal of experience in this respect and are building on a long tradition within Kempen.'

PRIVATE EQUITY PARTNERS

Over 2,000 private equity general partners operate in Europe. Following a thorough screening process, Kempen has selected a handful to work with. 'We've worked with some of them for ten years now. They're often small, under-the-radar parties with strong networks in their respective regions. This enables them to add clear value when they're identifying investment opportunities.'

Opportunities to make direct investments often come to us via Kempen's own network, such as through private bank Van Lanschot. 'With branches throughout the Netherlands, Belgium and Switzerland we're firmly embedded in our home market. We mainly serve directors and major shareholders with family businesses. It's common for entrepreneurs to want to take a back seat and retire after a long career. That's often when we enter the picture with our private equity fund.'

Private equity can be an interesting addition to an investment portfolio. Returns are high on average, although there are significant differences between funds. This depends partly on the vintage year, the year the investment is made. We therefore diversify across several vintage years. Investors also need a relatively long investment horizon as they are allocating to closed-end funds with an average term of 10-12 years.

FARMLAND

Another alternative investment opportunity away from the listed markets is farmland, which generally provides a stable return with low risk. This asset class is receiving growing attention from pension funds, Potgieser says. 'Investing in farmland also enables you to make a difference in terms of sustainability. You can contribute directly to reducing carbon emissions, deforestation, soil depletion and many other issues. It's also a great alternative to investing in real estate. The future of shops and offices is uncertain due to the coronavirus crisis, but food will always be needed and there's been little impact from the virus on farmland investments.'

Although Kempen generally restricts itself to north-west Europe in its private equity investments, our investments in farmland cover a much bigger geographical range. While our emphasis is on the US, Australia and New Zealand, we also invest in countries such as Denmark and Portugal. 'We opt for broad diversification, both geographically and in terms of crops.'

Urbanisation and the ageing farmer population mean that more farmland is coming onto the market. Farmers who are about to retire often don't have anyone in their families willing to assume responsibility for the farm. A neighbour may want to take on the land but not have the money to do so. This is where investors can help. They can buy the land and lease it or hire a local partner to manage the land on their behalf.

'In addition to regular crops, we often opt for niche crops,' Potgieser explains. There's been a sharp increase in the consumption of crops such as kiwis, almonds and blueberries caused by a growing focus on health. These can generate relatively high cashflows. In Portugal, for instance, we're examining an irrigation project. Together with local partners we're buying farmland that used to be used for cultivating wheat. The land comes with water rights. We're planting olive and almond trees, that generate a higher return per hectare.

INFRASTRUCTURE

Infrastructure is a third private market that has considerable potential for investors with a longer horizon and who are looking for diversification. It involves investments such as toll roads, airports, ports, water companies, power stations and wind farms. Infrastructure investments are often not particularly liquid, but they can provide attractive risk-adjusted returns and generate predictable, inflation-proof cashflows.

'This market typically has high barriers to entry,' De Jong points out. 'It often involves companies with a monopoly that have concession agreements lasting decades, such as supplying drinking water or operating a toll road. Many of these amenities have been neglected by governments in recent years. A great deal of catching up is therefore required and private capital is needed to do that. This translates into opportunities for investors.'

Investment in infrastructure is usually carried out via collective partnerships. Only very large institutional investors invest directly. Both listed and non-listed infrastructure funds are available: Kempen Private Markets invests via non-listed funds, while Kempen's Real Assets team manages a fund that specialises in listed infrastructure companies. 'We obviously consult with our colleagues a lot,' De Jong confirms. Non-listed investments usually involve closed-end funds with an average term of 12 years. The return on the investment takes the form of what is known as a J curve. The return is negative over the first years, as this is when the capital is invested. Cashflow is then generated by managing the assets, before ultimately the investments are sold.

Infrastructure tends to be less sensitive to cyclical fluctuations than equities. Yet airports and ports have been hit hard by the coronavirus crisis. But while 'old' energy has also felt the effects, utility companies and wind farms have been largely unaffected. 'We participate in a wind farm that supplies energy to Amazon,' De Jong says. 'We know what it will yield over an extended period. The wind blows, the turbines turn, Amazon consumes the electricity. As long as Amazon doesn't fail, our investment is secure.'

SOUND OPPORTUNITIES

The prospects for private markets are good, according to Marvin de Jong and Edzard Potgieser, as long as you analyse individual cases thoroughly. For instance, Kempen is involved in the acquisition of a company that specialises in digital marketing. 'Research by the Chamber of Commerce shows that businesses are spending much less overall due to the coronavirus crisis. But it also says they're spending higher amounts on digital marketing. We want to capitalise on this trend.'

Another trend is that people are cycling more in order to avoid public transport, certainly while the risk of infection persists. 'We're conducting due diligence on a German distributor of electric bicycles and we hold a position in Amsterdam bicycle manufacturer Van Moof via one of our venture capital partners. Regardless of the pandemic, electric bikes are a growth market and that will continue for the time being. The coronavirus crisis is giving this market an additional boost.' De Jong and Potgieser also see opportunities for companies that are capitalising on the boom in working from home, such as suppliers of software for making calls via the internet. Laboratories that offer coronavirus tests also represent interesting opportunities as testing will be needed for some time to come, even once we have a vaccine.

There are also risks, of course. Partly because of low interest rates, there's a relatively large amount of money available for investment, with private equity firms sitting on a lot of capital. This is often referred to as dry powder; capital that has been committed but not yet invested. This can lead to higher entry valuations for companies, resulting in lower overall returns, although Potgieser and De Jong mostly see this as a risk for large companies rather than the small and medium-sized businesses that Kempen specialises in.

Infrastructure also provides plenty of opportunities thanks to its large amount of investments needed to maintain the existing infrastructure and the amount of catching up that needs to be done to bring infrastructure up to speed with the development of the global economy. 'Private investors' involvement is essential here,' De Jong explains. 'Take airports in the US. Some are in poor condition and need to be renovated. Then there's the money needed for rolling out fiber networks and to support the energy transition. More and more solar and wind energy is being generated, but electricity grids weren't designed to handle it. They need an enormous amount of investment.'

Farmland also remains an attractive investment. The global population is expected to reach about 10 billion by 2050, and there's a limited amount of farmland available to grow the food these people will need. What's more, there's growing demand for food to be produced more sustainably. Investors can easily combine financial and sustainability returns in this asset class and have a direct impact on both aspects. Climate change is a risk for farmland and a focus of our attention. That said, it may also be positive for certain regions, such as Denmark and Canada, due to the extended growing season and the option to cultivate different crops.

MAKING PRIVATE MARKETS ACCESSIBLE

Kempen offers its clients a range of options to invest in private markets. 'Private markets are normally the preserve of large pension funds,' Potgieser says. 'But our Kempen Private Markets Fund requires a minimum investment of just EUR 125,000. This means it could be of interest to wealthy private investors and family offices as well as certain pension funds and insurers that want to grasp the opportunities this market presents.' One major advantage is that it's an open-end fund: investors can allocate to it at any time and in so doing obtain direct exposure to an existing, well-diversified portfolio.

Kempen is also setting up a new farmland fund, working together with local partners in countries including Australia, the US, Denmark and Portugal. According to Potgieser, 'These parties are very strong in terms of local knowledge, but less good at raising and managing institutional funds, while they also lack the global overview in portfolio construction. That's where we come in.'

'We have broad-ranging capabilities and extensive experience in adding value to companies,' De Jong continues. 'We select our investments very carefully and take into account the environment, social aspects and governance. Investors with a longer horizon who wish to earn a sound return with a manageable level of risk should certainly consider investing in private markets.'

KEMPEN EUROPEAN PRIVATE EQUITY FUND

Kempen has set up a specific fund to open up private equity to wealthy private investors and family offices: the Kempen European Private Equity Fund. The minimum investment in this fund is EUR 250,000. 'Many investors feel that private equity complements their listed investments nicely,' De Jong says. 'They feel more involved in it. And we notice that the current low-interest-rate environment is prompting private investors to seek alternative destinations for their savings. Incidentally, the Kempen European Private Equity Fund could also be an interesting option for pension funds and insurers.'