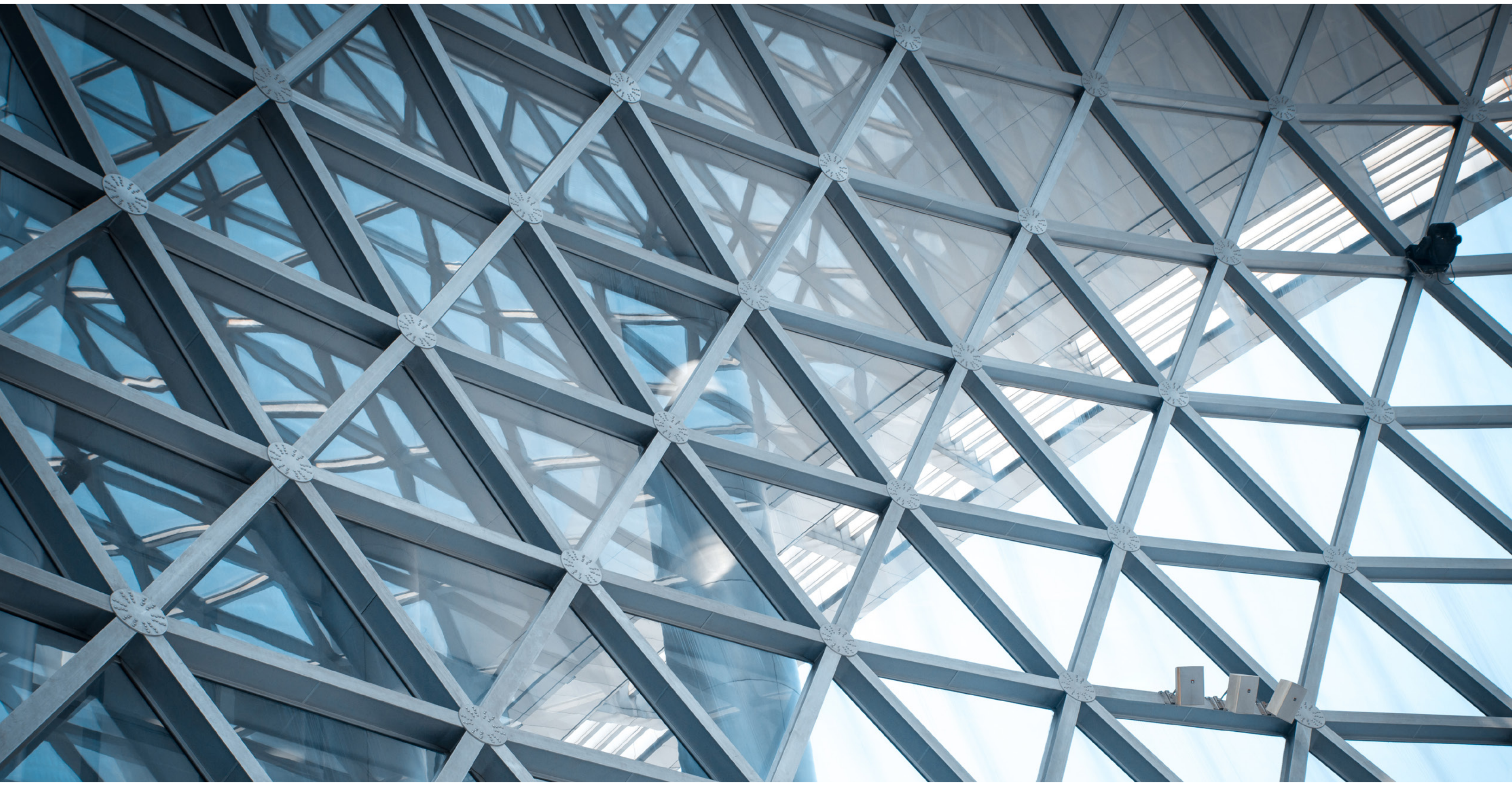
WHITE PAPER

Distributed ledger technology and private markets

Private market managers are improving core operational processes to satisfy investor demands. Is distributed ledger technology (DLT) part of the answer?



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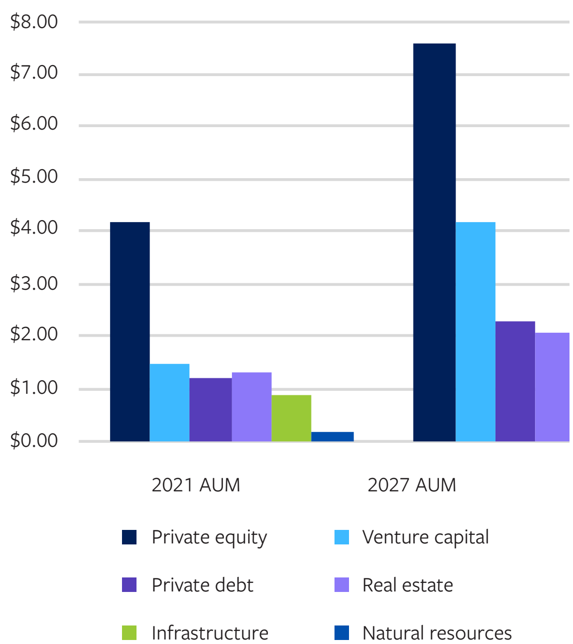
PRIVATE MARKETS' AUM BREAKS NEW GROUND

Until recently, private market strategies (i.e., private equity, private debt, etc.) were attracting record amounts of money. Despite fundraising slowing down due to the underlying macro conditions, data from Preqin still indicates that assets under management (AUM) controlled by private market funds could increase from $9.3 trillion to $18.3 trillion by 2027.



According to Bain & Company data, private capital's AUM increased by $1.3 trillion in 2022 to reach a five-year total of $6.4 trillion. These inflows come off the back of excellent historical performance.

For example, a study by Coller Capital found that 70% of investors said their private equity holdings had delivered superior returns relative to their public equity portfolios. In addition to outperforming public markets, private equity has also outclassed rival alternative investment strategies, including hedge funds. However, despite private equity's recent successes, the asset class faces some near-term challenges. Most notably, private equity fundraising appears to be tapering off.

So why has fundraising taken a slight knock? Firstly, the time period 2020 through early 2022 was unprecedented, with huge amounts of money being accumulated and invested off the back of pent-up client demand and ultra-loose monetary policy.

However, the rising interest rate environment means financing is more expensive for managers, while high inflation saddles their underlying portfolio companies with added costs. Compounding matters further is that technology companies – which comprise a large chunk of private equity holdings – have underperformed recently. Although challenging market conditions will probably result in a drop-off in the number of exits, demand for continuation vehicles and private equity secondaries is expected to grow.

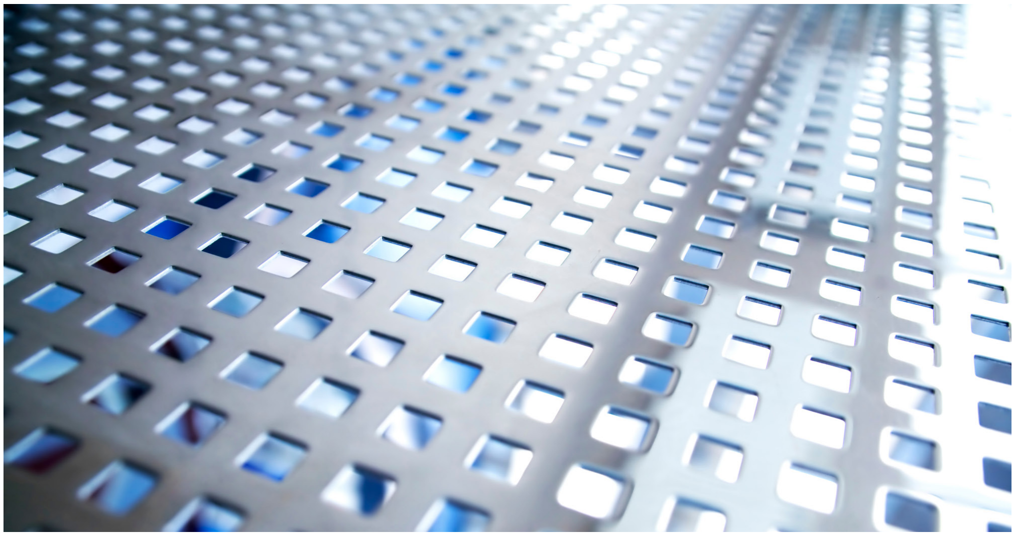
AN INDUSTRY WHOSE OPERATIONS REQUIRE A MODERNIZATION

While the industry looks after vast amounts of institutional money, its operating model remains highly inefficient. A large number of managers are reliant on manual processing, namely the ingestion of non-structured data and the ongoing use of Excel Spreadsheets and PDFs in critical business activities.

The situation is exacerbated by the fact that much of this data is held across multiple business silos – often in bespoke formats making interoperability all but impossible. This means private market managers often have limited visibility into the data being stored across different locations of their businesses or even at service providers, such as fund administrators, leading to duplication and errors, and with it, risk and costs. For instance, a spreadsheet error overstating the number of fully diluted shares led to one private equity firm overpaying for the acquisition of a software company by $100 million.

Reliance on legacy technology also makes it harder for managers to report seamlessly to investors and other stakeholders. In addition to quarterly reports, financial statements and notices, investors now want information about performance, risk and exposure shared with them on a regular, timely basis. Managers must acquiesce to customers' ever-increasing reporting demands if they want to win and retain client mandates.

The changing expectations from investors and regulators will require managers and fund administrators to update their technology and systems. So how is the industry responding?



THE GREAT TECHNOLOGY DRIVE

For an industry that has historically eschewed adopting new technologies, private market managers are starting to embrace change in greater numbers, according to Broadridge analysis. Broadridge's 2023 Digital Transformation and Next-Gen Tech Study found that 19% of private markets firms surveyed globally were classed as Digital Leaders in Broadridge's Digital Maturity Framework.

The same survey noted that 61% of the C-suite executives and direct reports surveyed from private markets firms said digital transformation is now their most important strategic initiative.

As a result, they plan to increase spending on next-gen technologies by an average of 16% over the next two years. Some firms are looking to DLT as an enabler. DLT is a decentralized, peer-to-peer digital system designed to record transactions between multiple counterparties simultaneously. Through its cutting-edge cryptography, the data recorded on a distributed ledger is immutable, meaning it cannot be altered.

DLT AS AN ENABLER FOR PRIVATE MARKETS FIRMS

A number of technologies exist today – such as software as a service – which can solve fund managers' problems in areas such as document management, but DLT – together with smart contracts, namely autonomous, self-executing agreements and eventually full tokenization – could take firms to another level in terms of operational efficiency.

CASE STUDY - PRIVATE MARKET HUB

- Performing highly manual and time-consuming legal and administration processes
- Managing costly and error-prone lifecycle activities
- Working with multiple stakeholders and value chain participants
- Complying with complex regulatory and investor reporting requirements
- Working across multiple disaggregated technology providers (no centralized view or a single source of truth)

If DLT is to become more widely leveraged by private market firms, the industry needs to overcome some of its perceptions about the technology. Firstly, managers need to disassociate DLT/Blockchain from crypto-currencies. While DLT/Blockchain is used to facilitate the trading and issuance of digital assets, it has multiple other applications, which have been trialed successfully by leading financial institutions.

Secondly, private market managers need to recognize that data stored on permissioned DLTs – as opposed to public blockchains – is protected and accessible only to those to whom it is shared. Given the sensitive nature of private market deals and transactions, managers need full assurances that the data they disseminate on a DLT is safe and secure so as to avoid risk of reputational damage.

HOW BLOCKCHAIN COULD RESHAPE PRIVATE MARKETS

So what are the operational benefits of DLT for the private markets?

Information stored on DLT cannot be tampered with or altered, meaning it is a golden source of truth. Whereas previously, managers would need to access duplicative data sets held in multiple locations by different counterparties, DLT gives firms a central reference point for critical business information with full provenance. Meanwhile, self-executing smart contracts will facilitate greater openness by enshrining in code the investment agreements between GPs and LPs, together with the managers' responsibilities.

The transparency benefits of these new technologies are massive for all parties in the investment chain. The provision of accurate information via DLT to managers can help them gain better insights into their operations and investments, allowing for improved decision-making and efficiencies to be realized. In turn, this will allow them to report more accurate and refined information to their own end investors and regulators.

Similarly, investors will also have instant access to key fund data across multiple managers and jurisdictions. At the fund administrator level, providers will be able to facilitate visibility, transparency and trust by collaborating directly with clients around an immutable single source of truth.

The technology – if used wisely – has the power to radically empower the private markets industry by breaking down many of the barriers that have historically precluded efficient information flows and Broadridge is actively engaged in this area.

Although DLT is showing a lot of promise, some issues with the technology need to be resolved before it can become more widely embedded across private markets.

The first challenge is that the financial services industry as a whole has yet to develop comprehensive standards around DLT's use. Without common standards, it is possible that multiple DLT protocols will emerge, which may not be able to interoperate with each other.

Some regulatory bodies, including the European Central Bank (ECB), have warned that the lack of standards, together with the diverse nature of DLT initiatives currently underway, risks causing market fragmentation in the DLT space. If progress on DLT is to be realized, the industry needs to collaborate and develop standards around the technology and its application to facilitate DLT interoperability.

Within private market firms specifically, there are concerns that a large number of legacy funds will be excluded from DLT initiatives. Again, the reality is that providers developing DLT solutions need to accommodate the needs of all clients, including those whose levels of digitalization may not be that advanced.

The industry's ability to digitalize should not be underestimated, however. Solutions are already being developed and sold using artificial intelligence (AI) and machine learning (ML) capabilities to capture and organize non-digitalized information from unstructured formats, such as PDFs. Such initiatives will help private market managers with their digital journey.

PRIVATE MARKETS IN A FULLY DIGITIZED WORLD

DLT is gradually being assimilated into the world of private markets, but what does its future hold within the industry?

As the adoption of DLT increases, it is possible that we could see full tokenization of private market funds and their underlying assets become more commonplace. By this, private DLT networks can be used to create smaller, tradeable digital representations of private market funds and their holdings, otherwise known as tokens. Smart contracts can also enable the tokenization of both funds and their underlying assets. Tokenizing funds and their holdings on a private DLT network will be vital to preventing data leakages.

Tokenization has the potential to facilitate moves towards greater democratization and, therefore, liquidity in an asset class that hitherto has been fundamentally illiquid.

Tokenization initiatives are already underway. For example, KKR is leveraging DLT to tokenize its $4 billion Health Care Strategic Growth Fund II, which will be available to individual investors with a minimum investment threshold of $100,000. This comes not long after Hamilton Lane made its global private assets fund available to individual investors through tokenization. As a result, the minimum investment threshold to gain exposure to Hamilton Lane's fund is $10,000, a significant reduction from the norm.

Tokenization offers a number of operational benefits as well, according to Bain & Company. For example, tokenization could help managers use their fund assets as collateral. "On the operations side, tokens could lower administration costs by automating manual processes and enabling structured secondary trading mechanisms, custody, margin lending, reporting and other features."

There are other benefits to DLT, namely the facilitation of multi-party consensus in private markets – a radical shift from the existing operating model. Such a transition would reduce intermediation and analog activities in manual processes, including fund administration, thereby reducing costs for the wider industry.

Although very exciting, these initiatives may take time to come to fruition. However, in the medium term DLT and fund life-cycle digitalization, will likely bring about unprecedented transparency and heightened efficiency to an asset class lacking both to date.

1 Preqin – Special Report: The Future of Alternatives in 2027

2 Bain & Company – Global Private Equity Report 2023

3 Pensions & Investments – June 7, 2022 – Private equity outperforms public equity – Coller survey finds

4 European Central Bank – April 2021 – The use of DLT in post-trade processes

5 Pitchbook – September 13, 2022 – KKR makes its PE fund accessible to individuals via a tokenised fund

6 Pitchbook – March 29, 2022 – Hamilton Lane token to give individuals access to private fund

7 Bain & Company – Global Private Equity Report 2023