UWEALTH

GUIDE TO UNDERSTANDING ASSET CLASSES :

PRIVATE EQUITY

U Wealth : Your partner in mastering financial instruments.

We want you to feel comfortable making suitable investment decisions based on knowledge of the opportunities and risks of given financial instruments.

September 2026

FINANCIAL INSTRUMENTS: OPPORTUNITIES AND RISKS

The higher the complexity of a financial instrument, the higher its potential risk –but the higher, too, the opportunities for returns.

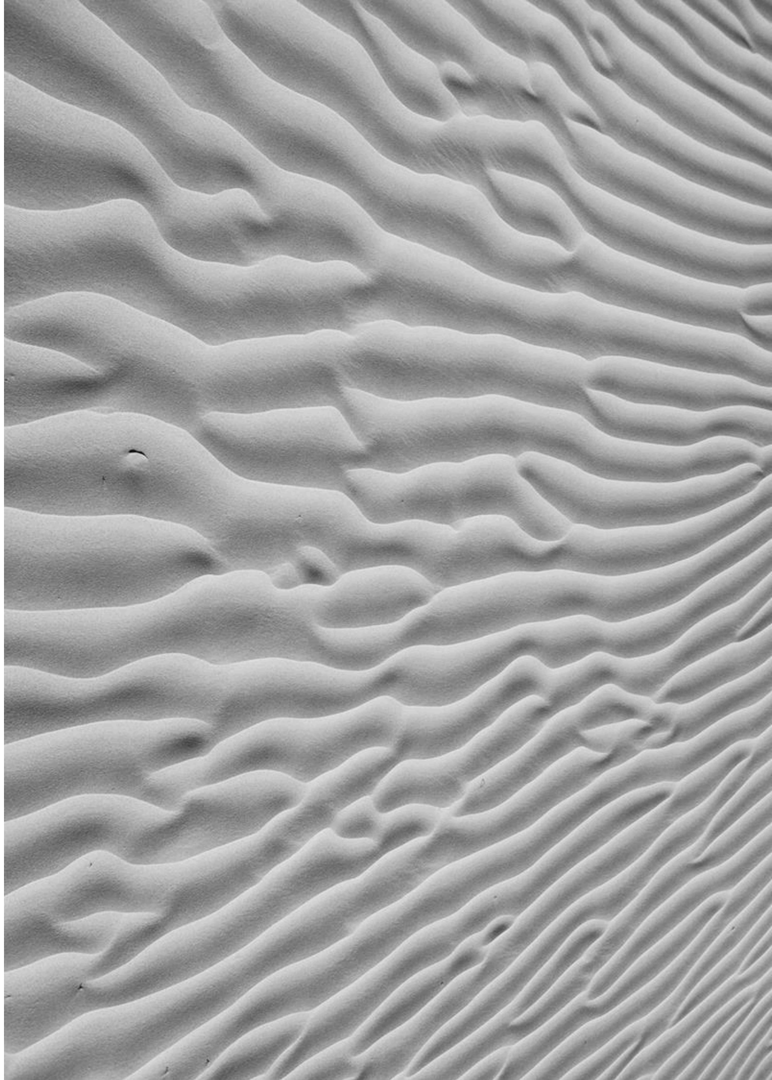
WHAT IS PRIVATE EQUITY?

Private equity is an individual asset class.

Private equity is participation capital in companies that are generally not listed on the stock market (hence 'private', not public). Participation ranges from early stage financing to management buyouts.

Private equity is an alternative investment that does not correlate closely with traditional investments. Apart from providing returns, it can contribute to the diversification of a portfolio.

Private equity funds are investment partnerships that only accept professional, institutional, or qualified investors.



ADVANTAGES/DISADVANTAGES

Advantages

Participation in markets not available through traditional financial instruments

Participation in market environments where traditional instruments offer few opportunities

Professional management with performance incentive

Reduced portfolio volatility

Opportunities for high returns at the expense of long-term investments

Disadvantages

Liquidity constraints

- minimum investment period (lock-up periods)
- not usually listed; illiquid participation

Predictability: capital drawdowns on the investment amount (i.e. requests for a payment by the investor to the fund) and the cash flow of the return are not determinable beforehand.

Only accessible to professional, institutional, accredited, or qualified investors

Lack of control: the quality of fund management is crucial to the success of the fund.

IMPORTANT RISKS TO CONSIDER

Private equity and private equity funds

Accessibility

Only accessible to professional, institutional, accredited, qualified investors

Liquidity risks

Private equity cannot usually be sold, and so, if at all, can only be liquidated.

Market risks

Private equity is a market as other return investments dependent on the market environment. However, some dependencies remain: the economic success of a company also depends on the general economic environment. With investments, and the timing of the investments, a favorable economic condition on the public market influences the cash flow with investors.

Predictability

Cash flows (drawdowns) as well as payouts are not predictable. Conditions are not, at the time of investment, fully dependent on the quality of the management.

Valuation

When investing directly in private equity, the valuation of the investment may be difficult.

Operational risks

The quality and expertise of the fund management and staff are crucial to the success of the fund investment.

Long-term investment

The capital is tied down for an average period of four-to-six years.

Legal and regulatory risks

The participation in this type of investment vehicles may be restricted by local legislation and may influence the taxation of the investment.

WHAT TO EXPECT FROM PRIVATE EQUITY

Investment horizon

- Long term

Income expectation

- Capital gain
- Irregular dividends

Market expectation

- Independent

IMPORTANT TO KNOW BEFORE INVESTING IN PRIVATE EQUITY

Maximum gain

No strict preconditions
– fund managers aim at maximum return

Maximum loss

Total loss of capital invested

Profit/loss

- Possible profits cannot be predicted; the fund strives to return objective.
- A longer-term investment horizon is required; possibly with the option of earlier termination or sale.
- Profit/loss and risks involved also depend on the quality of the management.
- Private equity investments can take place in different phases of company development.
- Due to their investment strategies, private equity instruments are more independent, i.e. less exposed to individual movements on stock and bond markets.
- They are an alternative investment used for diversification and income optimisation.

A CLOSER LOOK AT PRIVATE EQUITY

TYPES OF PRIVATE EQUITY INVESTMENTS (1/3)

Three potential investment types

Direct investment

- Open to holding through a direct equity stake in a company by an individual investor.
- May not be feasible or interesting for an individual investor due to the high associated effort, substantial minimum capital investment, specialist knowledge required, as well as the risk of default.

Private equity fund investment

- Aims for substantial control or even company ownership.
- Collect capital from investors and invest in a small number of companies (usually 10-20).
- Companies are optimised in value by restructuring and/or organisational improvements.
- While earning ensuring ownership, the returns achieved by public listing or resale of the company.

Private equity fund of funds investment

- Investment in a small number of individual private equity funds.
- Enables diversification of the risks across a larger number of companies, sectors, and countries.

TYPES OF PRIVATE EQUITY INVESTMENTS (2/3)

Subdivisions of private equity

Private equity can be subdivided into four broad categories according to the development phase of the company the investment is targeted at.

Venture capital

- Investment in young growth companies, supporting development of business ideas and products, the marketing and sale of new products, as well as the expansion of business and growth of the market share.
- The companies profit from financing as well as from the know-how the investors provide.

Growth Capital

- Growth capital typically involves minority investment in mature companies that are looking for capital to expand or restructure operations, finance a major acquisition, or enter new markets.
- Companies involved in growth capital typically can generate revenue and operating profits but cannot generate enough cash to fund major expansions, acquisitions, or other investments.

Buyout Capital

- Investment in mature companies with the aim of taking them over, supporting their expansion and growth, or facilitating a turnaround for positive performance.
- Less risky than venture capital.

Distress & special situations

- This is a broad category that refers to investments in the equity or debt securities of financially stressed companies.
- This sector has grown in importance over recent years, as banks have pulled back from such rescue lending situations, mainly due to regulatory changes.

TYPES OF PRIVATE EQUITY INVESTMENTS (3/3)

The risk to individual investments in the fund also depends on the development stage.

- **Private equity**
  - **Venture Capital**
    - **Incubator or seed**: Development of a business idea, product, and research and development
    - **Start-up**: Development of a business plan, starting sales and marketing, finalising a product
    - **Expansion**: Break-even point, conquering market share
  - **Buyout Capital**
    - **Management buyout/buy-in**: Takeover/ control of a company by an internal or external management team
    - **Expansion**: Capital investment in a company to expand market share
    - **Turnaround**: Financing to support fundamental change towards positive performance

PROPERTIES OF PRIVATE EQUITY FUNDS

Private equity funds are long-term investments with special characteristics

- The term of a fund is usually restricted to about 10-12 years.
- The fund is **closed after an initial subscription** period of 3-18 months.
- Investments are characterised by **high minimum amounts** of EUR 5-25 million for medium- to large-scale funds.
- Capital is invested from three to six years and **withdrawn in tranches.** The full amount is not usually drawn at any one time.
- Repayment and **returns commence** at about four-to-seven years into the investment.
- Investment objectives vary, but the goal is to obtain a maximum return on the investment.
- It is **not usually possible to liquidate or terminate the investment early.**
- Fund **managers** are generally investment partners themselves whose major incentive is sharing the profits.

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FOR FURTHER INFORMATION ON RISKS OR ON OTHER AVAILABLE FINANCIAL INSTRUMENTS, PLEASE REQUEST TO YOUR RELATIONSHIP MANAGER ON U WEALTH EDUCATIONAL MATERIAL.

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