A new decade for private markets

McKinsey Global Private Markets Review 2020
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Executive summary

Welcome to the 2020 edition of McKinsey’s annual review of private investing. Our ongoing research on the industry’s dynamics and performance has revealed several critical insights, including the following trends.

**Private markets complete an impressive decade of growth.** Private market assets under management (AUM) grew by 10 percent in 2019, and $4 trillion in the past decade, an increase of 170 percent, while the number of active private equity (PE) firms has more than doubled and the number of US sponsor-backed companies has increased by 60 percent. Over that same period, global public market AUM has grown by roughly 100 percent, while the number of US publicly traded companies has stayed roughly flat (but is down nearly 40 percent since 2000).

**The fundraising outlook remains favorable.** The early prognosis for 2020 is for continued strength: by the end of 2019, large firms had announced targets collectively approaching $350 billion, more than at year-end 2018. Further, limited partners (LPs) continue to raise their target allocations to private markets. Even at current levels, LPs appear to be underallocated versus target levels by more than $500 billion in PE alone—as much as the global amount raised for PE in 2019.

**Industry performance has been strong, but manager selection remains paramount.** PE outperformed its public market equivalents (PME) by most measures over the past decade. Variability in performance remains substantial, however, so the challenge—and the potential—of manager selection remains paramount for institutional investors. Although persistency of outperformance by PE firms has declined over time, making it harder to predict winners consistently, new academic research suggests that greater persistency may be found at the level of individual deal partners. In buyouts, the deal decision maker is about four times as predictive as the PE firm in explaining differences in
performance. This finding is intuitive to many in the industry but remains tough for many LPs to act on.

**The more things change...** The shape of the industry has evolved as it has grown: buyout’s share of PE AUM dropped by a third in the past decade, while venture capital (VC) and growth have taken off, led by Asian funds. Today, Asia accounts for more than twice as much growth capital as North America does, and about the same amount of VC.

**... the more they stay the same.** Megafunds of $5 billion or more increasingly dominate buyout fund-raising, making up more than half of the total in 2019. The share of funds below $1 billion has fallen to a 15-year low. Yet, paradoxically, there is little evidence of any consolidation at the top of the industry. And even as the number of active PE firms continues to grow (it’s now nearly 7,000), more managers are calling it quits than ever. Most of those raised just one fund, suggesting that attrition is mainly a result of one-and-done managers.

**Technology in every sector.** Deal volume declined in every region except North America, where the amount of capital invested rose 7 percent to $837 billion, a new high. Tech deals, up almost 40 percent, powered this growth. In parallel, the number of tech-focused private market firms has grown rapidly, while many others have tilted in that direction. Increasingly, we see general partners (GPs) that once had a technology “vertical” team now starting to view technology as a horizontal theme cutting across many of their deals.

**Signs of a peak?** US buyout multiples climbed yet again in 2019, continuing a decade-long trend, to reach nearly 12x. Leverage surpassed levels last seen in 2007. Dry powder rose further due to record fundraising and stagnant deal volume. It now stands at a record $2.3 trillion. PE accounts for most of this total, though PE dry powder is still less than two “turns” of annual deal volume, within the range of historical norms.

**The industry finds new opportunities in ESG.** Public interest and limited-partner pressure to take environmental, social, and governance (ESG) factors into account in investing have soared, prompting greater transparency on ESG policies and performance as well as a rise in dedicated “impact funds.” Nine of the ten largest GPs now publish annual sustainability reports. Perhaps more significant, our survey data show a clear uptick in the value that managers attribute to ESG—in other words, they increasingly find that these factors are positive (or neutral at worst) in achieving strong performance. Still, the private markets are only in the early stages of materially incorporating ESG factors into investment and portfolio-management processes.

**Diversity remains a challenge.** Private market firms have made only limited progress in improving diversity and inclusion. Women represent just 20 percent of employees across the private markets and less than 10 percent in investment-team leadership positions. The industry’s performance on other forms of diversity is also poor—recent McKinsey survey data places combined black and Hispanic/Latino PE representation at just 13 percent for entry-level positions and less than 5 percent for senior roles. Private markets firms may be missing an opportunity: increasing evidence shows that greater representation may meaningfully enhance performance.

**Many firms are thinking about how to digitize the investment process—and a handful are moving ahead.** The largest GPs have taken the lead, especially in sectors such as real estate, where investors can draw upon larger, more accurate data sets. In these areas, machine-learning algorithms using a combination of traditional and nontraditional data have demonstrated the ability to estimate target variables (such as rents) with accuracies that can exceed 90 percent.

**Many firms have predicted a downturn, but fairly few have adapted their operating model to prepare.** New McKinsey research shows that while most fund managers consider cyclical risk as part of their due-diligence and portfolio-management processes, only a third have adjusted their portfolio strategy to prepare for a potential recession. GPs can take several steps to build resiliency and improve performance through a downturn.
One example: GPs with dedicated value creation teams outperformed those without them by an average of five percentage points during the latest recession.

**About this report**

McKinsey is the leading adviser to private markets firms, including private equity, real estate, and infrastructure firms, as well as to the institutional investors that allocate capital to private markets, such as pensions, sovereign-wealth funds, endowments, and family offices.

This is the 2020 edition of our annual review of private markets.¹ To produce it, we have developed new analyses drawn from our long-running research on private markets, based on the industry’s leading sources of data.² We have also gathered insights from our colleagues around the world who work closely with the world’s leading GPs and LPs.

This report is divided into four chapters. In the first, we review capital inflows in 2019 and the rise in AUM. In the second, we discuss the deployment of capital, the outlook for dry powder, and recent changes in the industry’s structure. In the third, we consider the implications of three material challenges to the industry’s growth and stature: the growing prominence of ESG issues, the industry’s lack of diversity, and the promise and perils of digital and analytics. The final chapter discusses resiliency in a downturn, and the steps firms can take during the remainder of the current cycle to lay the groundwork.

We welcome your questions and suggestions at Investing@McKinsey.com.

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¹ We define private markets as closed-end funds investing in private equity, real estate, private debt, infrastructure, or natural resources, as well as related secondaries and funds of funds. We exclude hedge funds and, except where otherwise noted, publicly traded or open-end funds.

1 Onward and upward

Fundraising in 2019 nearly matched 2018’s record haul, but as always, the devil is in the details. North American buyout had its best fundraising year ever. Private market managers in Europe also experienced strong growth, while Asia fundraising declined for the second straight year. Megafunds still flourish, though the industry continues to defy predictions by not consolidating toward the larger firms. Meanwhile, fundraising for infrastructure and natural resources slowed, as did private debt, which declined for the second consecutive year.

Total AUM across private markets hit another all-time high at $6.5 trillion, as investors continue to shift capital from public asset classes in search of upside. Performance across vintages since the global financial crisis has been remarkably strong and consistent. Still, the broad range of performance among funds permits even more meaningful upside for those LPs capable of picking winners (and threatens some measure of downside for those less fortunate).
Fundraising stays strong
In 2019, the industry raised $919 billion, roughly in line with 2018’s record clip (Exhibit 1). At the time of publication, year-over-year fundraising was down approximately 3 percent, with some firms yet to report 12-month totals. Despite the small dip, 2019 was the second-strongest fundraising year ever, trailing only 2018. And the early prognosis for 2020 is more of the same: by the end of 2019, large firms had announced targets collectively approaching $350 billion, exceeding the $300 billion target at this point last year.\(^3\)

Drawing definitive conclusions based on year-over-year comparisons is challenging, given imperfect, late-breaking data and the uneven pattern of large raises. With that in mind, the longer-term trajectory demonstrates steady growth. Cumulative trailing five-year fundraising, a reasonable proxy for fee-bearing assets, suggests that the industry’s assets are at an all-time high. By that measure, fundraising in private markets has grown at 14 percent annually since 2014. Private debt, private equity, and infrastructure have grown faster than private markets as a whole, though there

Exhibit 1
2019 was the second-strongest fundraising year ever.
Private markets in-year fundraising,\(^1\) 2019

<table>
<thead>
<tr>
<th>Region</th>
<th>Private equity</th>
<th>Closed-end real estate(^2)</th>
<th>Private debt</th>
<th>Natural resources and infrastructure</th>
<th>Private markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>$350 billion</td>
<td>103</td>
<td>46</td>
<td>58</td>
<td>$556 billion</td>
</tr>
<tr>
<td>2018–19, $ billion</td>
<td>9.4</td>
<td>19.9</td>
<td>−27.0</td>
<td>−8.7</td>
<td>−6.4 billion</td>
</tr>
<tr>
<td>YoY change, %</td>
<td>2.8%</td>
<td>24.1%</td>
<td>(36.8%)</td>
<td>(13.1%)</td>
<td>(1.1%)</td>
</tr>
<tr>
<td>Europe</td>
<td>$99 billion</td>
<td>32</td>
<td>47</td>
<td>40</td>
<td>$218 billion</td>
</tr>
<tr>
<td>2018–19, $ billion</td>
<td>0.6</td>
<td>0.1</td>
<td>9.3</td>
<td>6.2</td>
<td>16.1 billion</td>
</tr>
<tr>
<td>YoY change, %</td>
<td>0.6%</td>
<td>0.2%</td>
<td>24.5%</td>
<td>18.5%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Asia</td>
<td>$94 billion</td>
<td>13</td>
<td>8</td>
<td>2</td>
<td>$117 billion</td>
</tr>
<tr>
<td>2018–19, $ billion</td>
<td>−27.3</td>
<td>−8.4</td>
<td>1.6</td>
<td>−4.9</td>
<td>−39.1 billion</td>
</tr>
<tr>
<td>YoY change, %</td>
<td>(22.5%)</td>
<td>(39.3%)</td>
<td>23.2%</td>
<td>(71.7%)</td>
<td>(25.0%)</td>
</tr>
<tr>
<td>Rest of world</td>
<td>$12 billion</td>
<td>3</td>
<td>4</td>
<td>8</td>
<td>$27 billion</td>
</tr>
<tr>
<td>2018–19, $ billion</td>
<td>−5.9%</td>
<td>−0.7</td>
<td>2.5</td>
<td>2.4</td>
<td>−1.7 billion</td>
</tr>
<tr>
<td>YoY change, %</td>
<td>(32.5%)</td>
<td>(17.8%)</td>
<td>194.6%</td>
<td>44.4%</td>
<td>(5.7%)</td>
</tr>
<tr>
<td>Global</td>
<td>$555 billion</td>
<td>$151</td>
<td>$106</td>
<td>$108</td>
<td>$919 billion</td>
</tr>
<tr>
<td>2018–19, $ billion</td>
<td>−23.2</td>
<td>10.8</td>
<td>−13.6</td>
<td>−4.9</td>
<td>−31.0 billion</td>
</tr>
<tr>
<td>YoY change, %</td>
<td>(4.0%)</td>
<td>7.7%</td>
<td>(11.4%)</td>
<td>(4.4%)</td>
<td>(3.3%)</td>
</tr>
</tbody>
</table>

\(^1\)Excludes secondaries and funds of funds.
\(^2\)Closed-end funds that invest in property. Includes core, core-plus, distressed, opportunistic, and value-added real estate, as well as real estate debt funds.

Data source: Preqin

\(^3\)Includes funds with a target of more than $1 billion that have had at least one close but not a final close by end of 2019. Excludes one large fund with a target that has been publicly revised downwards, and three state-backed funds.
are signs that growth in private debt may be slowing (see page 12). While real estate has grown at 9 percent, the data reflect only a partial picture of the asset class, as it is limited to closed-end funds; real estate assets have grown faster in open-ended vehicles.

Regional fundraising

North America and Europe: Fundraising in 2019 remained healthy on both sides of the Atlantic. In North America, managers raised $556 billion on the back of record PE fundraising, while in Europe, managers raised a record $218 billion, driven by growth across all private market asset classes.

In North America, PE fundraising reached $350 billion for the first time, driven by a bounce-back in the buyout segment, which increased by 85 percent to a record $240 billion after a down 2018 (Exhibit 2). The reported slowdown in 2018 may simply reflect “lumpiness” in the timing of large raises, an inherent issue in assessing the asset

Exhibit 2

North American PE fundraising reached an all-time high in 2019.

North American buyout funds greater than $10 billion by year of close

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
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<tr>
<td>Number of funds</td>
<td>1</td>
<td>1</td>
<td>4</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Collective fundraising, $ billion</td>
<td>18.0</td>
<td>10.5</td>
<td>63.0</td>
<td>34.5</td>
<td>95.3</td>
</tr>
</tbody>
</table>

1 Excludes secondaries and funds-of-funds.

Data source: Preqin
class annually. While four funds larger than $10 billion closed in 2017 and six in 2019, 2018 saw only two such funds close.

Closed-end real estate fundraising in the region had another strong year, propelled by the raise of three megafunds ($5 billion or more), including the largest and third-largest opportunistic funds ever. Other real assets fared less well in 2019, as fundraising for natural resources and infrastructure fell by 13 percent in North America. Concerns about this decline may be premature, however, as approxi-mately $55 billion in additional fundraising was pending at year-end in North America for the asset class, including an infrastructure fund that closed in early 2020 and became the second largest infrastructure fund ever raised.

European private market fundraising increased by 8 percent overall. The growth was fueled by increases in private debt as well as natural resources and infrastructure. Infrastructure's growth has been particularly impressive, as fundraising has more than tripled in the past five years. Driven partly by the expectation of continued privatization of government-owned infrastructure assets, as well as the divestment of noncore assets by opera-tors, infrastructure fundraising has increased at 27 percent annually over the last five years. PE and closed-end real estate fundraising in the region held steady at $99 billion and $32 billion, respectively.

Asia: Fundraising in Asia slowed again in 2019, falling by almost $40 billion, or 25 percent year on year. All asset classes (with the exception of private debt) declined, notably PE, which fell by $27 billion. Within PE, venture and growth had a particularly poor year, both falling by nearly 50 percent.

This year’s decline is the second straight for Asia fundraising, which dropped 25 percent from 2017 to 2018. That year saw a steep drop in fundraising by Asia-based managers, while foreign managers—that is, those based elsewhere, raising capital to invest in Asia—had a record year driven by the closing of three large Asia-focused flagships. In 2019, foreign fundraising reverted to levels in line with historical averages, whereas Asia-based managers declined a second year in a row. Of course, this follows the two best fundraising years ever for Asia-based managers, in 2016 and 2017, so this may simply reflect fundraising cyclical-ity, but it is a trend to watch in 2020.

How to explain the slowdown in Asia fundraising? The simplest rationale starts with the mountain of dry powder focused on the region, which reached a new high of $419 billion in 2019. Considered alongside the region’s slowing deal volumes (down 35 percent in 2019), managers may have eased fundraising in order to work through already committed capital. Further, in recent years, Asia’s exit environment appears to have become more challenging; 2019 marked the third year in a row that exit volume and count decreased, partly driven by higher requirements for local companies to be effectively sold or listed on the stock exchange. Concerns over illiquidity may have tempered investors’ enthusiasm. Softening LP appetite for private markets exposure may also have been driven partly by region-specific concerns. In China, trade tensions with the US have been a drag on economic growth. In addition, tighter asset management regulations, first rolled out in 2018, have continued to slow Chinese fundraising. In an effort to curb debt and reduce systemic risks, the Chinese government has placed restrictions on banks’ and insurers’ ability to invest in alternative asset classes, including PE. As a result, renminbi-based fundraising has plummeted, and though there are signs suggesting that PE limitations may soon be lifted, uncertainty surrounding the regulatory environment may have helped suppress 2019 fundraising.

The decline in venture and growth fundraising over the past two years in Asia reflects a shift in fundraising from growth toward buyouts. From 2017 to 2019, venture and growth’s share of PE fund-raising has decreased from 75 percent to 60 percent, while buyout’s share has increased from 21 percent.

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6 Excludes large state-backed growth and venture funds raised between 2014 and 2019 for a total of $110 billion.
to 37 percent. In part, this is a manifestation of maturing regional economies; GPs are beginning to see more opportunities to pursue buyout investment theses as well as growth deals.

Asia’s lone bright spot in 2019 fundraising was private debt, which rose 23 percent on the year. Although less than 10 percent of the regional total, private debt has garnered more attention from investors in recent years, as the search for new sources of yield in a low-rate environment continues and traditional lenders struggle to keep up with rising demand for credit, particularly from midmarket borrowers.

**Fundraising by asset class**

*Private equity:* Megafunds (≥5 billion or more) continued to drive buyout fundraising growth, making up more than half of total fundraising in 2019 (Exhibit 3). Funds greater than $10 billion accounted for 35 percent of buyout fundraising in 2019, up from 23 percent in 2018 and nearly equal to 2008’s all-time peak. At the same time, the share of small funds (less than $1 billion) fell to a 15-year low.

The sustained fundraising growth for PE reflects widespread LP conviction in the asset class’s ongoing potential for outperformance.

PE funds have outperformed public markets, even during one of the longest-ever bull markets. PE vintages from 2009–16 outperformed public market equivalent (PME) benchmarks, according to data from both Burgiss and Cambridge Associates (Exhibit 4). A passive investor in PE would have performed quite well over the past decade.

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Exhibit 3

**The largest buyout funds account for a growing share of PE capital.**

**Global buyout fundraising,** %

![Graph showing buyout fundraising by fund size](chart)

1 Excludes secondaries and funds-of-funds. By fund size and year of close.
Data source: Preqin

Onward and upward
Of course, passive investment in PE isn’t yet feasible for most investors—there is no ETF equivalent for the asset class. Manager selection presents both risk and opportunity; the consistency of outperformance by the asset class as measured in pooled returns belies substantial variation in performance among individual funds. In both VC and buyout, stars have outshone laggards by a wide margin, but it remains hard to predict the winners (and perhaps even harder to gain access to the predictable winners). In buyout vintages from 2000 to 2016, median performance is comparable across funds of various sizes. On the other hand, variance in performance is inversely correlated with fund size: the spread between the top five percent and bottom five percent is particularly noticeable in small-cap funds (Exhibit 5) and smallest among the larger funds. Simply put, smaller funds have higher highs and lower lows.

The picture is somewhat different in VC. For vintages from 2000 to 2016, not only is manager selection risk between funds small and large equally pronounced, but fund size is, unlike in buyouts, positively correlated with performance—that is, the largest funds tend to outperform (Exhibit 6). It has long been recognized that strong reputations and unique networks provide top VCs preferential access to the next generation of leading entrepreneurs, enabling persistent outperformance. The recent period indicates a slight twist: in VC bigger has generally (though not in every case) meant better for several years now. But interestingly, this does not appear to have affected VC fundraising strategies very much. As we noted last year, venture-capital GPs (with a couple of noteworthy exceptions) have remained fairly disciplined with respect to flagship fund size, whereas their PE cousins have rapidly expanded fund size.

Investors in private markets have limited options for avoiding active-management risk. Manager selection is simply part of the game, and it is clear from the data that considerable outperformance can result from being better than average at picking managers. The wrinkle is that most LPs seem to

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Exhibit 4

**PE has topped public market returns since 2009.**

PME\(^1\) and mPME (S&P 500) by vintage, PME/mPME = 1

\[^1\] Public market equivalent.

Data source: Burgiss; Cambridge Associates
Exhibit 5

In buyout, while there were similar median returns across fund sizes, there was a larger spread in returns for small-cap funds.

**Net IRR**<sup>1</sup> 2000–19 for global buyout vintages, 2000–16, %

![Graph showing Net IRR for different fund sizes](image)

<sup>1</sup>Internal rate of return.
Data source: Burgiss

Exhibit 6

In venture capital, larger funds outperformed smaller funds over the past decade.

**Net IRR**<sup>1</sup> 2000–19 for global venture capital vintages, 2000–16, %

![Graph showing Net IRR for different fund sizes](image)

<sup>1</sup>Internal rate of return.
Data source: Burgiss
believe they’re better than average, even while manager selection has only grown more challenging. As we first noted in 2010, and as recent academic research has since confirmed, the persistence of performance by PE firms has declined considerably.⁷

Other research on the topic provides some additional nuance. This research finds performance persistence for both buyout and VC, but for individual decision-makers—such as a deal partner—rather than for firms or funds.⁸ One study finds that in buyout, the individual is about four times as important as the PE firm in explaining differences in performance. Individual investors’ repeatable investment skills explain this persistence. For example, in VC, human capital and networks are the most important predictors—personal networks can help with sourcing attractive deals, building the right equity syndicate, and bringing the most helpful capabilities and expertise to portfolio companies.

Still other research highlights factors that do not appear to affect persistency of performance. According to a 2017 study, for instance, there is no significant relationship between change in fund size and performance. In other words, despite anecdotal accounts to the contrary, a successful manager that increases fund size in a subsequent vehicle is no less likely to succeed at the new level than before.⁹

Despite the challenges posed by manager selection and performance persistence, most investors maintain conviction with the PE asset class and show no signs of easing back on allocations.

Private debt: For the second straight year, private debt fundraising softened. After 2017’s record haul, fundraising decreased by 9 percent in 2018 and, against the expectation of many in the industry, by a further 11 percent in 2019 (Exhibit 7). Nonetheless, fundraising for the asset class still surpassed $100 billion for the fifth year in a row, finishing off the decade at a level more than twice as high as in 2010.

Exhibit 7

After sustained growth, private debt fundraising cooled off in the past two years.

Private debt fundraising, $ billion

<table>
<thead>
<tr>
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<tr>
<td></td>
<td>23</td>
<td>42</td>
<td>40</td>
<td>68</td>
<td>72</td>
<td>69</td>
<td>103</td>
<td>116</td>
<td>131</td>
<td>119</td>
<td>106</td>
</tr>
</tbody>
</table>

¹ Excludes secondaries and funds-of-funds.
Data source: Preqin

Private debt’s growth began in the wake of the financial crisis, when tighter capital requirements curtailed banks’ lending, even as demand for credit quickly recovered. Often offering higher yields than public debt, private credit became an attractive option for investors looking for yield in a low-rate environment, leading to a fundraising boom in North America and Europe.

Several factors may have contributed to the slight pullback since 2017. First, following several years of record fundraising, private debt dry powder climbed to a record $297 billion in 2019. Managers may be easing fundraising while they work through committed capital, which has increased by 50 percent in just the last three years. Second, amid concern about the potential end of the current economic cycle, some investors are cautious about private debt’s performance in a recession. These concerns are exacerbated by a rebound in “covenant-lite” loans, which have again become commonplace as deal competition has intensified. As we saw in the global financial crisis, lack of covenants can limit lenders’ ability to manage risk and minimize loss in times of market stress. Finally, red-hot markets make equity an attractive source of capital, even in a record-low rate environment.

**Natural resources and infrastructure.** Global fundraising for vehicles targeted at natural resources and infrastructure held steady at just over $100 billion in 2019. While natural resources fundraising slowed globally in 2019, infrastructure fundraising—some of it targeting natural resources—continued to climb. Infrastructure saw a handful of successful large raises in Europe and North America, and the 2019 uptick continues a multiyear growth trend for the asset class.

In the past five years, infrastructure has grown by 17 percent annually, making it the fastest-growing private asset class. In a yield-starved world, investors continue to seek infrastructure opportunities, which many believe offer government bond-like risk coupled with higher yields than sovereign debt. For institutional investors with perpetual or multigenerational time horizons, infrastructure provides stable, long-term, inflation-protected returns. Fundamentals appear to be strong: populations are growing stably, and infrastructure in developed markets is aging. The world has more infrastructure needs than dollars to finance them, a gap that is particularly acute in emerging markets.

Somewhat surprisingly, Asian fundraising for natural resources and infrastructure dropped by 70 percent in 2019, continuing a recent slide. In our view, this is partly attributable to the slowing rate of infrastructure development in China over the last few years, which has limited the need for private market capital.

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In buyout, the individual is about four times as important as the firm in explaining differences in performance.
Real estate: Closed-end real estate fundraising grew 8 percent year over year. Closed-end strategy fundraising is more typically measured on an annual basis than open-ended strategies, as the latter does not return capital at the same velocity (that is, the funds can stay invested in perpetuity). Within closed-end funds specifically, opportunistic fundraising grew 38 percent year over year, reaching a new post-crisis high. That record included two very large funds—representing the largest and third-largest opportunistic funds ever raised—which together accounted for more than half of total opportunistic fundraising in 2019.

While closed-end vehicles have steadily grown, open-end funds have grown faster (Exhibit 8). Three factors may help explain this shift in investor preferences. First, the overlap between risk preference and vehicle type has created a tailwind—at this point in the cycle, investors have rotated into lower-risk strategies, which tend to be open-ended (as we discuss below). Second, investors prefer control over the timing of their cash flows, and open-end funds allow LPs to add dollars and take distributions at their discretion, an option that includes hold periods well beyond the duration of a traditional closed-end vehicle. For investors trying to maintain long-term exposure to a less-correlated asset class, open-end vehicles are a more efficient way to do so. Finally, open-end funds offer investors the opportunity to know what they are buying, particularly for mature vehicles. As such, open-end vehicles offer a level of transparency that closed-ended funds, which typically feature blind-pool investing, cannot match.

Across both types of vehicles, the needs of LPs have been evolving in three noteworthy ways. First, as a share of their real estate allocations, LPs have traded down the risk spectrum in the years since the global financial crisis (Exhibit 9). Allocations to core, core-plus, and debt strategies have grown more quickly than value-add, opportunistic, and distressed strategies. One likely reason is a search
for yield, as many investors have rotated away from sustained low yields in traditional fixed income. This influx of capital has compressed cap rates and thus forward-looking returns at the safest end of the risk spectrum, prompting growth in core-plus and likely supporting the recent surge in opportunistic fundraising, which could presage a reversal of the recent trend (not yet factored into the included chart).

Second, more LPs are going direct. Many larger, at-scale LPs have built in-house capabilities, increasing control and discretion through separate accounts, discretionary sidecars, coinvestments, and direct investment through large-scale joint ventures (JVs). Others are tying up with operating companies, either by buying them outright or by investing through exclusive agreements. By increasing allocations to more-direct strategies, LPs both lower their costs and retain greater control over decision making and cash-flow timing—both attractive attributes.

Third, LPs are looking for ways to get exposure to real estate but will only pay for higher cost structures if they deliver consistent alpha. This push for lower costs has led to rapid AUM growth for several very large investment managers—most notably, funds sponsored by insurance companies and traditional asset managers, both of which often benefit from balance-sheet capital and in-house distribution networks. These embedded advantages provide scale economics to these players, allowing them to compete with relatively low fee structures (typically without carried interest). As these investors grow larger, and as the institutional investment landscape grows increasingly fee-averse, managers with higher cost structures will be further pressed to justify their fees through differentiated value propositions and proven ability to outperform through cycles.

LPs’ needs are changing—and so are the sources of capital, as retail dollars enter the market.

Exhibit 9

**Fund flows are shifting to lower-risk strategies.**

**Real estate gross AUM contribution, by strategy, %**

<table>
<thead>
<tr>
<th>100% = $2.656 trillion</th>
<th>$3.779 trillion</th>
<th>$ CAGR, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>17</td>
<td>7</td>
</tr>
<tr>
<td>Debt</td>
<td>17</td>
<td>14</td>
</tr>
<tr>
<td>Opportunistic</td>
<td>25</td>
<td>2</td>
</tr>
<tr>
<td>Value-added</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Core/core-plus</td>
<td>40</td>
<td>11</td>
</tr>
</tbody>
</table>

1 Figures might not sum to 100%, because of rounding.

Data source: IREI for open-ended separate accounts; IPD Global Quarterly Property Index for open-ended core commingled funds; Preqin for all closed-ended funds data (value-add, opportunistic, debt); eVestment for institutional securities; Simfund for retail securities.
Whether through wirehouses or even direct distribution, retail investment in private real estate has grown substantially, providing a new source of capital for managers traditionally focused on institutional and institutional-like pools. Managers building products for retail and the distribution capabilities to access these investors will be advantaged, as retail investors hold pent-up demand for this asset class.

**AUM: another year, another all-time high**

In 2019, private market AUM grew by 10 percent, reaching $6.5 trillion, another all-time high (Exhibit 10). AUM increased for all asset classes, but it was PE that drove most of the increase. PE grew 12.2 percent to $3.9 trillion, about 60 percent of the total.

2019 capped an impressive decade for private markets, during which AUM grew by some $4 trillion (169 percent). Approximately 60 percent of net new capital came from PE, which increased by $2.3 trillion.

PE has changed as it has grown. Buyout funds comprised nearly 75 percent of the total in 2010 but represent just over half today, as VC and growth AUM have taken off. Buyout has grown quickly, but a tremendous rise in Asian VC and growth funds has tilted the balance. While Asia represented only

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**Exhibit 10**

**AUM now totals $6.5 trillion, almost 2.7× more than in 2010.**

**Private market assets under management, H1 2019**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Rest of world</th>
<th>Asia</th>
<th>Europe</th>
<th>North America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyout</td>
<td>$2,067</td>
<td>$63</td>
<td>$50</td>
<td>$1,240</td>
</tr>
<tr>
<td>Venture capital</td>
<td>$988</td>
<td>$238</td>
<td>$41</td>
<td>$423</td>
</tr>
<tr>
<td>Growth</td>
<td>$691</td>
<td>$41</td>
<td>$417</td>
<td>$1,799</td>
</tr>
<tr>
<td>Other</td>
<td>$107</td>
<td>$23</td>
<td>$417</td>
<td>$4,924</td>
</tr>
<tr>
<td>Private debt</td>
<td>$813</td>
<td>$23</td>
<td>$242</td>
<td>$5,795</td>
</tr>
<tr>
<td>Real estate</td>
<td>$992</td>
<td>$57</td>
<td>$272</td>
<td>$4,524</td>
</tr>
<tr>
<td>Infrastructure and natural resources</td>
<td>$813</td>
<td>$44</td>
<td>$204</td>
<td>$4,524</td>
</tr>
</tbody>
</table>

1 Figures might not sum to 100%, because of rounding.

Data source: Preqin
12 percent of global venture-capital AUM in 2010, it now constitutes over 40 percent, about the same size as North America. In growth capital, Asia has already overtaken North America, accounting for 60 percent of the market compared with North America’s 26 percent.

Global PE net asset value has multiplied eight times since 2000, almost three times as fast as public market capitalization, which has grown approximately 2.8 times over the same period (Exhibit 11). Yet it is important to keep in mind that even after two decades of torrid growth, private market AUM remains miniscule next to public markets, coming in at less than 8 percent of total public equity market capitalization and 3 percent of public debt.

The outlook for continued growth in private market AUM, from both traditional and new sources of capital, remains strong. For all the attention they receive, LP allocations to private markets still tend to account for only 5 to 15 percent of portfolios. And according to Preqin, LPs are underweight relative to their target allocations for PE (Exhibit 12). Closing that gap would require more than $500 billion in additional capital commitments—as much as the global amount raised for PE in 2019. Further, the gap does not account for the continued growth in LP target allocations, which increased by an average of one to two percentage points for most LP types over the last decade. All the evidence suggests that despite the record amount of capital committed to PE over the last several years, there’s likely more to come.

Exhibit 11

The value of PE companies has grown more than eightfold since 2000, outpacing public market equities.

Global private equity net asset value¹ and public equities market capitalization, indexed to 2000

¹ Net asset value is defined as AUM less dry powder.

Data source: World Bank; Preqin
In addition, new sources of capital are finding their way into the private markets. Some of the largest private markets GPs are ramping up fundraising from nontraditional sources, including individual investors. Through feeder vehicles into classic buyout funds, as well as newer products designed for sale via financial advisors, the largest players in the industry are finding ways to raise capital from the retail and high-net-worth markets. Meanwhile, US regulators have started considering ways to roll back restrictions on individuals’ ability to invest in PE and VC funds, which may provide another tailwind. Though this trend is still in the early innings, retail investors are beginning to represent a meaningful source of capital for private market managers.
Private equity deal volume was stable in 2019, and deal count fell substantially. Managers were not shy when they came to the table, however: the earnings multiples they paid rose to a new record of nearly 12x, partly fueled by record leverage. With fundraising strong and deal volume flat, dry powder rose, increasing to nearly two times annual PE deal volumes. As the industry has amassed capital, its structure has evolved in some ways. The ranks of managers are seeing greater churn, as new firms are formed and others fade away. In other ways, however, the structure remains the same. We see little evidence of consolidation among the largest firms.
**PE deal activity plateaued in 2019**
Capital deployment was essentially flat in 2019. PE deal volume plateaued at $1.47 trillion versus $1.49 trillion in 2018 (Exhibit 13). Before 2019, deal volume had grown 12 percent annually, from 2013 to 2018.

Deal volume declined in every region except North America, where capital invested rose 7 percent to $837 billion, a new high (Exhibit 14). Investments in technology companies were critical to the rise, up 37 percent in 2019 on the back of three very large public-to-private tech buyouts, and consistent with the multiyear growth in technology investments (see page 23). European deal activity pulled back, with $505 billion invested in 2019, down 8 percent from the previous year. Still, European deal volume is up 4 percent annually since 2014.

In Asia, on the other hand, deal volume fell 35 percent, from $87 billion in 2018 to $56 billion in 2019. “Lumpiness” in the technology sector accounted for most of the decline. In particular, two large 2018 tech deals totaled $30 billion, but 2019’s largest investment was less than $5 billion. Ongoing geopolitical tensions may have also caused a bit of a pullback in capital deployment in the region.

Meanwhile, global deal count fell 13 percent to about 9,300 deals, the first drop since 2009 (Exhibit 15). (Note that the figure is preliminary and may be adjusted upward later in 2020.) Taken together with record levels of dry powder and rising multiples, softening deal count may suggest that GPs are having a harder time finding the same number of attractive investment opportunities as in previous years. All regions saw declines, with Asia witnessing the largest drop (roughly 30 percent). North America, the largest market with 55 percent of all deals, experienced a decline of 11 percent.

With deal count softening but deal volume flat, the average PE transaction in 2019 rose to $157 million, up 14 percent from the prior year. This continues a multiyear growth trend in average PE deal size, which has risen 25 percent since 2014. Two

---

**Exhibit 13**

PE deal volume was flat in 2019 after growing 12 percent annually from 2013–18.

**PE deal volume, $ trillion**

<table>
<thead>
<tr>
<th>Year</th>
<th>Deal Volume, $ trillion</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>0.72</td>
</tr>
<tr>
<td>2009</td>
<td>0.30</td>
</tr>
<tr>
<td>2010</td>
<td>0.59</td>
</tr>
<tr>
<td>2011</td>
<td>0.72</td>
</tr>
<tr>
<td>2012</td>
<td>0.74</td>
</tr>
<tr>
<td>2013</td>
<td>0.85</td>
</tr>
<tr>
<td>2014</td>
<td>1.13</td>
</tr>
<tr>
<td>2015</td>
<td>1.23</td>
</tr>
<tr>
<td>2016</td>
<td>1.19</td>
</tr>
<tr>
<td>2017</td>
<td>1.33</td>
</tr>
<tr>
<td>2018</td>
<td>1.49</td>
</tr>
<tr>
<td>2019</td>
<td>1.47</td>
</tr>
</tbody>
</table>

Data source: PitchBook

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Exhibit 14

PE deal volume rose only in North America, while deal count fell in all regions.

**Deal volume by region, $ billion**

**Deal count by region, thousands of deals**

Data source: PitchBook

Exhibit 15

PE global deal count declined 13 percent in 2019 but grew 8 percent annually from 2013–18.

**PE deals, thousands**

Data source: PitchBook
shifts may explain this increase. First, as noted above, megafunds are proliferating. In 2014, $72.5 billion in PE capital was raised by megafunds, comprising 20 percent of that year’s total. In 2019, the figure was three times larger, $219 billion, 39 percent of the total.

Larger funds tend to pursue larger deals. This is true both for buyout funds as well as for VC and growth vehicles. We first noted this trend last year in VC, which saw a record number of “supersize” rounds (25) exceeding $1 billion. In 2019, VCs placed 14 rounds of more than $1 billion as young companies continued to eschew traditional public market financing in favor of large private investments. (The value of PE-backed IPOs dropped by roughly one-third in 2019, from $163 billion to $110 billion, according to data from PitchBook.)

### Multiples and leverage continue to rise

A second factor in the growth of deal size has been the steady upward march of purchase multiples, which increased every year of the past decade. After an incremental creep from 9x to 11x EBITDA, US buyout multiples increased markedly last year, reaching the highest level of the past 15 years (Exhibit 16). An investor in 2019 would have to pay 35 percent more than in 2010 to acquire the same company. It has become vanishingly rare to see a private market firm write multiple expansion into its investment case. To the contrary, we see more firms underwriting deals that assume some degree of multiple contraction—putting more pressure on themselves to enhance portfolio company earnings.

Meanwhile, GPs used more leverage to finance these ever-pricier purchases: pro forma leverage for US buyouts increased to 6.6x, up from 6.45x in 2018 and even higher than 2007’s precrisis peak of 6.5x. The share of all buyouts with a gearing of less than 5x, furthermore, declined to a multiyear low, at just 7 percent.

Private and public market earnings multiples are highly correlated, of course, and public market multiples remain near a multidecade high. But in the
past five years, US buyouts have gradually closed a historical valuation gap to US small-cap equities, which traded at only a 1.5x premium to buyout transactions in 2019, the lowest since 2013.

When it comes to multiples, of course, sector matters. PE has grown increasingly tech heavy, driven by meaningful growth in tech-focused firms and funds but also more broadly by a recognition among traditional firms that technology is a growing factor in most transactions. Last year, tech-focused GPs accounted for nearly 20 percent of capital raised by PE funds in Europe and North America, according to data from PitchBook. A decade ago, none of the ten largest PE firms were explicitly tech-focused; by 2019, two invest solely in technology companies. (The two are among five new entrants to the top ten.) More than one name-brand firm has begun reconceptualizing its tech/software “vertical,” or sector, team in favor of a view of technology as a horizontal theme that cuts across every vertical. Tech returns have been strong—according to Burgiss data, tech-focused PE funds have generated internal rates of return (IRRs) six percentage points higher than those of nontech funds in the last decade. Of course, some big tech plays have done poorly. But the larger trend is intact. This growth in tech and tech-related deals is putting upward pressure on average multiples, given that the margin and growth profiles of technology companies typically merit higher valuations. All else being equal, that shift should stay on track.

**Dry powder: No signs of slowing down**

Once again, private managers’ dry powder rose last year, hitting a record high of $2.3 trillion in H1 2019, up from $2.1 trillion at the end of 2018 (Exhibit 17). Dry powder has grown at a rate of almost 14 percent annually since 2014, in part because of the rise of megafunds, particularly in PE. At $1.4 trillion, PE dry powder accounts for 60 percent of the total. The largest alternative asset class has also been the fastest-growing, adding 16 percent in dry powder annually since 2014.

Viewed as a multiple of average annual equity investments over the prior three years, dry powder inventories have crept higher, growing 31 percent

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**Exhibit 17**

**Stocks of dry powder reached a new high.**

**Global capital committed and not deployed, 2000–H1 19, $ billion**

<table>
<thead>
<tr>
<th>2014–H1 19</th>
<th>2018–H1 19</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAGR, %</td>
<td>growth, %</td>
</tr>
<tr>
<td>Total</td>
<td>13.9</td>
</tr>
<tr>
<td>Private equity</td>
<td>15.8</td>
</tr>
<tr>
<td>Real estate</td>
<td>12.0</td>
</tr>
<tr>
<td>Private debt</td>
<td>12.3</td>
</tr>
<tr>
<td>Infrastructure and natural resources</td>
<td>9.9</td>
</tr>
</tbody>
</table>

Data source: Preqin

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**Running hotter**
since 2016, though these levels are not far from historical norms (Exhibit 18). In North America, dry-powder inventories grew 19 percent over the same time range, suggesting that GPs there are deploying a greater share of available capital than their counterparts elsewhere.

Industry structure: Rapid turnover, but little consolidation
Despite the rise of large funds in recent years, relative market concentration in PE has remained remarkably steady: since 2011, the top five fundraisers have consistently accounted for 8 to 9 percent of all fundraising, and the top 250 have accounted for around 65 percent (Exhibit 19).

Nonetheless, the industry has evolved in a few noteworthy ways. First, membership in the top ten club has changed. Only half of the largest ten PE firms from 2010 remained in the top ten in 2019. It’s hard to stay on top. As noted, two of the five new firms are tech-focused, and all five have strong tech investing capabilities—consistent with technology becoming a particular area of focus for PE investors.

Second, the number of active PE firms has continued to increase every year, nearly matching the number of hedge funds (Exhibit 20). In 2019, nearly 6,700 PE firms had raised at least one fund in the previous seven years, up from 4,100 five years earlier.

Third, while many new PE firms form every year, the rate of attrition has been increasing. Prior to 2010, 2 percent of firms became inactive each year—that is, they had gone seven years without a fundraise. Since 2010, that rate has doubled to 4 percent. Nearly 60 percent of inactive firms...
Market concentration has remained remarkably steady.

**Trailing 5-year cumulative fundraising, % of total**

![Bar chart showing market concentration from 2011 to 2019.](chart)

*Data source: Preqin*

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The number of PE firms has continued to grow while hedge funds remained steady.

**PE firms and hedge funds 2005–19, number**

![Graph showing the number of PE firms and hedge funds from 2005 to 2019.](graph)

*Data source: HFR Global Hedge Fund Industry Report Year End 2019; Preqin*
today only raised a single fund, supporting the conventional wisdom that new funds have a higher failure rate than funds with at least two raises. So, even with more new managers forming and more folding than ever, it remains true that those that prove themselves early tend to stick around for the long term.

In other private markets, some degree of consolidation is undeniable. The larger players have actively deployed their institutional (and retail) platforms across more capital by adding new strategies organically, lifting teams out of other organizations, or acquiring other large players outright.
3 Looking ahead to the new decade

Consider the figures for 2019: $900 billion in funds raised; $6.5 trillion in assets under management; $2.3 trillion in dry powder. These numbers may seem remarkable in isolation but are merely the culmination of a decade of steady growth—an era when private markets have become more relevant than ever.

Since 2010, both private markets AUM and the number of private equity GPs have more than doubled, while the number of US sponsor-backed companies has increased by 60 percent. Over that same period, global public market AUM has grown by roughly 100 percent, and the number of US publicly traded firms is roughly flat (but is down nearly 40 percent since 2000).
As private markets settle in to their newfound status, three strategic issues for the next decade have come to the fore. First, growing pressure from LPs and from the public is pushing environmental, social, and governance (ESG) considerations to center stage. In light of the sharp focus on ESG, GPs are reevaluating some of their diligence processes and portfolio choices.

A second strategic issue is diversity and inclusion. While GP performance on these measures has improved modestly in recent years, it is still low by any objective measure. Private markets are immersed in a war for talent and cannot win by excluding whole categories of people from due consideration.

Third, digital approaches and advanced analytics are another transformative force that will shape private investing in the 2020s. New analytical tools will likely have more influence on investment decisions in some asset classes, as firms seek distinctive sources of insight. Adoption of these techniques remains fairly limited for now. Some managers, in some asset classes, have begun to embrace new techniques, while most are still figuring out how to incorporate these new tools and approaches into their investment processes.

The coming decade will also present unforeseen challenges. But firms that get their house in order on the strategic issues of the day will be better situated when the next set of problems arrives.

ESG comes to private markets
An approach to investing that accounts for ESG factors has been perhaps the most talked about development of the past several years. As public awareness of and activism relating to ESG-driven investing have soared, many prominent allocators to PE have taken up the cause. They now require GPs to pass an ESG screen as part of their vetting process and demand more transparency into ESG policies, procedures, and performance of portfolio assets. Collective action among LPs has increased in recent years; see, for example, the Investor Leadership Network, which was formed in 2018 to coordinate ESG efforts among institutional investors, and now represents more than $6 trillion in capital. In some regions, furthermore, regulations have become a forcing mechanism. Europe recently adopted a sustainable finance action plan that requires asset managers to disclose how they account for ESG factors. Finally, an increasing body of evidence indicates that the inclusion of ESG criteria is positively related to corporate financial performance. A meta-analysis of more than 2,000 primary studies found that 63 percent show positive results, while only 8 percent reported negative impact.

The positive relation between ESG and financial performance is typically attributed to reduced levels of risk: though there is not yet consensus, several studies estimate that the presence of ESG concerns can increase an asset’s cost of capital by

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An increasing body of evidence indicates that the inclusion of ESG criteria is positively related to investment performance.

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Among respondents who say ESG programs create value, the share seeing short- and long-term value has grown.

Share of respondents who say given program creates value, %

<table>
<thead>
<tr>
<th>Environmental programs</th>
<th>Social programs</th>
<th>Governance programs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Long-term value</strong></td>
<td><strong>Long-term value</strong></td>
<td><strong>Long-term value</strong></td>
</tr>
<tr>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>80</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>60</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>40</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Exhibit 21

Looking ahead to the new decade up to 1.5 percent. Capital costs may therefore be lower in the absence of ESG risks, which should translate to higher valuations. This may help explain why a new McKinsey survey found that a sample of investment professionals and C-level executives would be willing to pay 10 percent more for a company with a positive ESG record than for a similar company with a negative one. Further, the share of respondents who say that environmental, social, and governance programs create value has grown over the past ten years (Exhibit 21).

Private markets firms have taken note of these developments. It is now rare to encounter a sizable GP that does not produce an annual sustainability report—in 2019, nine of the ten largest private markets firms published reports on their ESG policies and performance. Similarly, many firms have created new positions in recent years to oversee ESG efforts. These roles, with titles such as “global head of ESG” and “chief sustainability officer,” are generally fairly senior executives in an n-1 or n-2 seat.

High-profile steps such as these represent progress. At the same time, however, most GPs have yet to shift their investment processes or value-creation playbooks in a substantial manner to focus more on ESG impact. One exception is infrastructure GPs, which are at particular risk from rising sea levels, more violent and frequent storms, and other manifestations of climate change. Many of these firms are moving actively to manage the risks and invest behind the larger trends.

GP s can choose from a variety of approaches—with varying degrees of rigor—to instill ESG

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1 Question was asked only of respondents who said environmental, social, and governance programs increase shareholder value. Respondents who said “substantially negative,” “negative,” or “no effect” are not shown; total n = 136 in 2009 and n = 342 in 2019.

Data source: McKinsey analysis

12 For example, Sudheer Chava (2014) Environmental Externalities and Cost of Capital, Management Science 60(9):2223-2247.

Private markets can draw on a spectrum of approaches to ESG.

**Increasing consideration of ESG factors**

<table>
<thead>
<tr>
<th>Screening</th>
<th>Integration</th>
<th>Impact investing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusion or inclusion of an asset from investment consideration based on its performance on a set of predetermined ESG criteria</td>
<td>Consideration of ESG factors alongside other value drivers in investment decision making and portfolio management</td>
<td>Investment solely in opportunities that target measurable ESG impact (with or without specific financial goals)</td>
</tr>
</tbody>
</table>

Private market investors have in recent years taken strides in adopting ESG factors, but much upside remains. Most indications are that private market considerations into their core business processes, from deal sourcing to due diligence and value creation (Exhibit 22).

Two types of screening can help an investment firm filter potential investments for ESG factors. Negative screening—the simplest and most common variety—eliminates certain companies or sectors from the deal funnel according to a set of predetermined criteria. In many cases, these are written into fund documents at LPs’ insistence (for instance, “no coal” or “no gun” companies), and represent a blunt-force means of insulating institutions from reputational risks. In an innovative twist, some PE firms now target companies with ESG shortcomings as valuable buying opportunities—essentially, looking for ESG turnaround opportunities. One PE firm, for instance, recently purchased a materials company at a discount thanks to its poor track record on waste; the firm has made improving environmental performance a central lever of its value creation plan.

A second technique, positive screening, promotes investment in companies and sectors with strong ESG performance. This area is more nascent in private markets but is beginning to attract attention as investors see greater evidence of a connection between ESG factors and financial performance. For these investors, ESG metrics may serve as “alternative data,” an investible source where asymmetries of information and insight can still be found.

**Integration** refers to a more comprehensive consideration of ESG factors throughout a firm’s end-to-end investment process, from strategy formation and sourcing to due diligence and portfolio asset management. True integration remains for now much less common in private markets than screening. At the leading edge, some PE firms have begun pointing artificial intelligence at media events and other reports to flag ESG risks during diligence. It could help identify future winners in screening and diligence, investing in companies that stand to benefit from growing awareness and more stringent requirements. ESG integration can also help drive value creation during a GP’s holding period. In one example, a packaging company owned by a PE firm developed a plastic bottle that is easier to use, fully collapsible, recyclable, and produces 20 percent less carbon dioxide in manufacturing than the previous bottle. Better environmental performance and reduced materials costs lifted sales and EBITDA for the packaging firm and created more value for the PE firm.

Finally, impact investing is the highest-conviction approach, in which a fund’s entire strategy is built around ESG-related objectives. Several leading GPs have now launched impact-focused funds as extensions of their burgeoning product lines. In just the past three years, six of the largest PE managers have raised or announced plans to raise a total of about $9 billion in impact funds. Prior to 2017, those same six firms had no impact-focused funds whatsoever. Given the extent of LP demand, we expect these vehicles to scale and proliferate.
Investors lag behind their public market cousins both in integrating ESG factors into core processes and in developing new products targeted at ESG-driven demand. That said, firms across private market asset classes appear to have recognized the imperative and the opportunity, and many are moving quickly to catch up.

**Diversity and inclusion: Much more to do**

The growing prevalence of ESG-aware investors is putting a much-needed spotlight on diversity and inclusion in private markets—or rather, the lack thereof. Women and other minorities continue to be grossly underrepresented in private markets, and despite widespread recognition of the issue, change is coming only slowly. Preqin reports that only 20 percent of employees at private market firms are women, a figure that’s remained fairly steady in recent years (Exhibit 23).

The gender imbalance is even more apparent in leadership and investment roles. Most women in PE firms remain in back- or middle-office roles, rather than in better compensated front-office positions. Investment teams comprise only 13 percent women and investment leadership teams less than 10 percent (Exhibit 24).

### Exhibit 23

**Women account for one in five private market employees.**

<table>
<thead>
<tr>
<th>Female employees, %</th>
<th>2017</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private equity</td>
<td>17.9</td>
<td>20.5</td>
</tr>
<tr>
<td>Venture capital</td>
<td>20.5</td>
<td>21.1</td>
</tr>
<tr>
<td>Private debt</td>
<td>19.1</td>
<td>20.6</td>
</tr>
<tr>
<td>Real estate</td>
<td>20.6</td>
<td>19.2</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>20.3</td>
<td>21.0</td>
</tr>
<tr>
<td>Natural resources</td>
<td>20.0</td>
<td>20.6</td>
</tr>
</tbody>
</table>

**Data source:** Preqin

### Exhibit 24

**Most women in PE firms are in back- or middle-office roles.**

<table>
<thead>
<tr>
<th>Female employees in PE, 2019, %</th>
<th>13.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor relations/marketing</td>
<td>53</td>
</tr>
<tr>
<td>Finance/accountancy</td>
<td>54</td>
</tr>
<tr>
<td>Portfolio management</td>
<td>39</td>
</tr>
<tr>
<td>Operations</td>
<td>25</td>
</tr>
<tr>
<td>Investment team</td>
<td>13</td>
</tr>
</tbody>
</table>

**Note:**

1 Excludes venture capital. 

**Data source:** Preqin
McKinsey’s Women in the Workplace 2019 report underscores these findings. Among participating PE firms, female promotions tend to lag behind male promotions (Exhibit 25). If anything, this discrepancy is likely understated, as the firms that responded are larger than average, while the gender imbalance is often more pronounced at smaller GPs that lack formal diversity and inclusion programs. The survey found that, compared with other industries, PE firms have a lower proportion of women at almost every tenure.

This lack of gender parity contravenes emerging empirical evidence of women’s positive influence on investment returns. Some preliminary studies have found that investment committees that have female members may generate higher rates of return than those where women were not well represented.

While some private market firms are slowly moving to support gender parity, representation of other minority groups lags even further behind. McKinsey’s Women in the Workplace survey, for instance, finds combined Black and Hispanic/Latino PE representation at just 13 percent for entry-level positions and less than 5 percent for senior positions.

The industry is coming late to the recognition of the benefits offered by more diverse and inclusive workplaces, in both the firm and its portfolio companies. To the extent that positive change on these dimensions is occurring, much has been spurred by rising LP pressure. As pressure mounts from LPs and others, we expect private markets firms will continue to improve on this important dimension of talent and organization.

A widening aperture for digital and analytics

In last year’s edition of this report, we explored how 2018 seemed to signal the potential of digital to transform the business of private investing, including steps such as redesigning LP client journeys and automating GPs’ back offices. In 2019, the industry acknowledged this transformative potential and stepped up its pace to start claiming value. These moves ran the gamut from building in-house digital and analytics teams to augment firm and portfolio company operations to increased

Exhibit 25

Women are promoted at lower rates than men in PE.

Promotion rate into each level, 

<table>
<thead>
<tr>
<th>Level</th>
<th>Women</th>
<th>Men</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manager</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Senior manager/director</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>Vice president</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Senior vice president</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>C-suite</td>
<td>5</td>
<td>7</td>
</tr>
</tbody>
</table>

1Aggregate results across PE survey respondents (n = 9 firms). Titles vary by respondent and were mapped to a standard classification.
Data source: 2019 Women in the Workplace pipeline data for US/Canada

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Looking ahead to the new decade

venture investments in tech-enabled firms serving the industry, and on to significant acquisitions of private markets—focused tech, data, and analytics companies by their larger, more public markets—focused competitors. That said, only the largest and most sophisticated private market firms are starting to capture real business value from digital and analytics; most of the industry is watching from the sidelines, either unwilling to change established ways of working, unconvinced of the potential, or unable to design a path to build the desired capabilities.

Building skills and getting results
In 2019, several PE firms announced efforts to build or expand data-science and analytics teams (which most construe as separate from traditional IT groups), recruiting new tech talent and investing in new capabilities. One leading GP recently hired a new chief information and innovation officer to lead data strategy initiatives on investing and operations, while a rival hired a dozen data scientists to assist investment decision making and portfolio company support while developing a proprietary data platform. Another firm built a quantitative research group; its mandate is to use data science to better understand and evaluate risk exposures in its own portfolio and those of its LPs. Another firm’s venture arm has completely integrated algorithmic tools such as neural networks into its sourcing process, which drastically increased the pool of deals evaluated by targeting deals with similar characteristics to those that had been successful in the past.

Firms have supplemented their hiring efforts via acquisition and partnership. One large investment firm recently acquired a financial software company to expand its analytics capabilities in PE and real estate. In parallel, incidentally, some of the largest public market data providers are building out their private market data sets and analytics tools, seeing it as the next frontier of growth and innovation.

The flurry of activity has been largely confined to the best-capitalized firms, especially when it comes to incorporating digital and analytics into core investment processes. While most firms acknowledge the potential for digital tools to play an important role in investment decisions, far fewer are actually integrating digital tools and data analytics into how they source and evaluate investment opportunities. Even the institutions that are ahead in adoption of data science often struggle with data quantity and quality, which can hamper the training of machine learning algorithms.

Yet in asset classes with reliable and readily available data, firms are obtaining real insights on which to make investment decisions. Take real estate, where investors can draw on large data sets covering exposure to factors (such as macro-economic and demographic indicators) and combine them with nontraditional variables (such as the tone of Yelp reviews for nearby businesses, or the change in number of coffee shops nearby). Such mash-ups can result in more accurate appraisals, more sophisticated forecasts, and smarter investment decisions. In fact, recent McKinsey research finds that nearly 60 percent of predictive power can come from nontraditional variables. In one example, a large database of traditional and alternative data was used to forecast the three-year rent per square foot for multifamily buildings in Seattle. A machine-learning model was trained on the data, and predicted rents with an accuracy rate that exceeded 90 percent. With results like that, it’s not surprising that more firms are beginning to make moves in this direction.

Analytics are becoming essential. But there’s another reason that digital is now an essential battleground for real estate operators. The rise of real estate as a service (for example, coworking spaces offered by the day, week, or month) is causing allocators to seek operating partners with a clear digital strategy to lower operating costs, increase revenue growth in the form of better customer experiences, or both. Tenants require an increasingly sharp digital offering from operators. Allocators recognize that the ability to service these demands will factor into the return on their capital investments, and will affect their partner and
property choices. As the landscape shifts, these allocators may increasingly turn to operators with a proven ability to create value for their tenants through digital tools.

**Creating value in portfolio companies**

Over time, PE firms have relied first on financial engineering, then on cost reduction, and increasingly on top-line growth to create value in portfolio companies. Now, with multiples at record highs, the aperture for value creation is widening to permit greater focus on digitization, talent management, and optimizing capital expenses. Operating groups that support value creation in PE portfolios have become an increasingly important feature of private markets firms. Today, every one of the largest 25 firms has such a team. When we surveyed PE firms on their operating groups in 2015, these groups spent almost a third of their time "monitoring and reporting" portfolio company performance; that figure had fallen to 19 percent by 2018. Instead, time spent “driving measurable performance improvement” is increasing (it’s now at least half their time). Operating groups today tend to support portfolio companies across a variety of topics, often through a value-creation “playbook.” Some GPs are now writing new pages in these playbooks to take advantage of the transformation potential of digital and analytics levers. Two areas especially ripe for digital improvement are pricing and procurement.

Historically, PE companies have often overlooked the potential of pricing in B2B contexts, with many citing concerns over competitive responses and customer defections. Our experience, however, suggests that when portfolio companies reprice in the right pockets of opportunity, customer loss is minimal, and investments in pricing capabilities provide a high, quick, and relatively reliable return. Margin expansion of between three and seven percent within one year is typical.

Digital and analytics tools are broadening the set of opportunities where meaningful value can be created through B2B pricing. Some firms are using analytics-based microsegmentation to identify locations where tactical price increases and price structure changes are possible. Others are adopting an integrated set of digital tools to deliver recommendations from the central pricing team to the field force. And several are keen on dynamic pricing, which allows companies to predict the right times to push prices higher (to capture incipient demand) or lower (to avoid volume losses). Analytics can light the way, by scoring deals against peer groups and factoring multiple criteria into price recommendations, such as strategy, deal size, customer type, and product type and mix.

Some private market firms have also begun applying digital and analytics levers in procurement, where the biggest challenge has long been tracking and recording procurable spending. New digital solutions now allow companies to make sense of diffuse spending data in a matter of weeks, paving the way for analysis that can identify areas of opportunity. Our experience suggests that a comprehensive, digitally driven overhaul of purchasing can lift run-rate EBITDA in portfolio companies by 20 percent within six months. And other savings are possible: for example, digital transportation management tools are allowing companies to optimize their logistics networks, and then renegotiate with suppliers on the basis of smaller, tighter footprints.

Pricing and procurement are only two of the ways that digital and analytics tools are driving value creation in PE portfolios. Many other value-creation levers are also being enhanced through the application of digital tools, as GPs continue to seek out new ways to drive earnings in an increasingly competitive marketplace.

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Other GP/LP developments

In last year’s edition of this report, we profiled developments across a range of GP and LP tools and trends that have emerged as private markets mature and deepen. Here are the latest developments on three of those: secondaries, GP stakes, and co-investment.

Growth of GP-led secondaries. Interest in secondaries stayed strong in 2019. We expect that once fully reported, transaction volumes will total $90 billion, up 35 percent annually since 2016 (Exhibit A). GP-led secondaries are at the forefront; such deals accounted for one-third of the total in both 2018 and 2019. Whereas GPs used to turn to the secondary market mostly as they wound down funds, they increasingly regard it as a tool for fund management—for example, to reduce administrative burdens or to facilitate the raise of a new fund.

Fundraising looks set to stay strong. Six major secondary managers were in the market at the end of 2019, targeting a collective $46 billion in capital (including a $14 billion fund closed in January, the largest secondary fund ever); smaller managers were targeting another $10 billion. It seems 2020 has the potential to be a strong year for secondary fundraising.

A wave of GP stakes fundraising. In 2019, more than $9 billion was raised for funds that invest in GPs, nearly three times the amount raised the previous year (Exhibit B). Most of that happened when one of the three largest firms focused on GP-stakes investing closed a record-breaking $9 billion fund in December 2019, its fourth vehicle for this strategy. And at year-end, six funds were in the market to raise a targeted $13 billion.

GP stakes investing serves the needs of both buyers and sellers. LPs see these funds as a mechanism to gain insight and acquire long-term exposure to

Exhibit A

Secondaries volume, particularly GP-led deals, is rising rapidly.

Secondary deal volume, $ billion

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>GP-led</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>25</td>
<td>24</td>
</tr>
<tr>
<td>2013</td>
<td>28</td>
<td>26</td>
</tr>
<tr>
<td>2014</td>
<td>34</td>
<td>8</td>
</tr>
<tr>
<td>2015</td>
<td>40</td>
<td>7</td>
</tr>
<tr>
<td>2016</td>
<td>37</td>
<td>9</td>
</tr>
<tr>
<td>2017</td>
<td>58</td>
<td>14</td>
</tr>
<tr>
<td>2018</td>
<td>50</td>
<td>24</td>
</tr>
<tr>
<td>1H 2019</td>
<td>42</td>
<td>14</td>
</tr>
</tbody>
</table>

Data source: Greenhill

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high-performing managers. Meanwhile selling a stake is an expedient means for GPs to build a balance sheet of “permanent” capital for activities such as backing new acquisitions, expanding firm operations, and often, monetizing illiquid stakes to facilitate founder succession.

Founder succession isn’t always aided by private sale of stakes—some firms solve that via IPO, for instance—but it is an increasingly popular route as it is faster, narrower, and less invasive than offering shares to the public. As the industry matures, the wave of succession has become particularly noticeable. In the past five years, for instance, six of the top ten PE firms have seen significant succession occur in their leadership teams. The result has been a sort of youth movement in the industry’s leadership, with the average age falling from 60 to 49 at these firms (Exhibit C).

Co-investing still makes sense. A year ago, we discussed the imbalance of supply and demand in the market for syndicated co-investments. That pressure hasn’t subsided, and investors seeking to achieve higher net returns continue to push for fee-free co-investment to lower their average costs. That creates a logistical challenge for managers. Moreover, to differentiate from the ever-growing queue of investors seeking free syndicated stakes, leading-edge institutional investors have accelerated the build-out of their own internal deal teams. As discussed last year, those teams most often partner with general partners, replacing the club deal of old with co-underwriting checks that often top $100 million or even $500 million on a single transaction. In all of this effort, cost removal seems a given. But does it work?

Research by CEM Benchmarking, a leading data provider for institutional investors globally, suggests that the answer is yes. In a survey of 28 of the largest institutional investors around the world, which collectively hold $500 billion in PE investments, CEM finds that investors with large co-underwriting and direct investment programs average about $42 of co-investment for every $100 they commit to commingled funds. As co-investment tends to be fee free, it seems likely that these large co-underwriting programs are achieving their objective of lowering the costs of accessing the PE asset class.

Building programs capable of deploying capital in this manner—and deploying it well—is not without challenges, however. Most of the institutions with large co-underwriting programs benefit from best-practice governance norms that set up these programs for success (in particular, Canadian pensions and sovereign wealth funds with similar models). Co-underwriting programs require a large, well-compensated front office and substantial support staff, many times larger than that required to execute fund investments and syndicated co-investments. Building these capabilities internally may seem expensive on its face; it can multiply the internal cost of a PE team. But from a “total cost of ownership” perspective, taking into account fees paid...
PE leadership teams are getting younger.

Age of top executives at largest 10 PE firms, 2010, 2015, 2020

Looking ahead to the new decade....
4 Resiliency in a downturn

The global economy has been on an unprecedented growth streak for over a decade. Yet factors that could undermine growth are constantly appearing on the horizon (or closer), including geopolitical concerns (see: Brexit), trade wars, regulatory pressures, tax policy uncertainty, and the potential of a global pandemic. While nobody can predict precisely how long this bull market will last, there is value in identifying the assets best positioned to weather the eventual downturn and capitalize on the discontinuities it spawns. Many sponsors are thus reflecting on how they and their portfolio companies might navigate a recession and mulling whether, how, and when to prepare.
What is the extent of this preparation? We recently surveyed 22 general partners on this topic, including executives at several of the top PE firms in the world. The survey found that nearly all firms have considered cyclical risk in their investment process, but only a third have adjusted their portfolio strategy (Exhibit 26) and only 40 percent have pursued moves aimed at bolstering resilience, such as optimizing the cost base and augmenting sources of liquidity.

This relative inattention to portfolio recession downside poses several risks. Firms that rely on their due diligence work for too long can be caught off guard later; outside-in risk assessments tend to age quickly, especially as macro shifts affect individual assets. Exit valuation and timing can be impaired when cyclical risk begins to affect buyer sentiment. Assets in unprepared portfolios may be unable to fund growth investment or in a worst-case scenario could face liquidity challenges and breach covenants. Even the firms that assess risk consistently and regularly may stumble at the last step, by failing to take meaningful action to mitigate risk at the asset or portfolio level. Only about 10 to 40 percent are actively taking steps to divest cyclical assets or adjusting their investment strategies (Exhibit 27).

Exhibit 26

Most firms assess cyclical risk in diligence; few make changes to their portfolio strategy.

What actions (if any) is your fund taking to manage cyclical risk?, % of surveyed firms

<table>
<thead>
<tr>
<th>Action</th>
<th>% of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessing cyclical risk in diligence</td>
<td>91</td>
</tr>
<tr>
<td>Assessing cyclical risk in specific portfolio assets</td>
<td>86</td>
</tr>
<tr>
<td>Actively taking actions to reduce cyclical risks for specific portfolio assets</td>
<td>59</td>
</tr>
<tr>
<td>Developing a view on overall portfolio cyclicity and risk</td>
<td>50</td>
</tr>
<tr>
<td>Changes to portfolio strategy and allocation</td>
<td>36</td>
</tr>
</tbody>
</table>

Data source: McKinsey Private Equity Resilience Survey, Fall 2019; n = 22.

Exhibit 27

Few firms are adjusting their investment strategies.

What actions (if any) is your fund taking to reshape the portfolio?, % of surveyed firms

<table>
<thead>
<tr>
<th>Action</th>
<th>% of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investing in less cyclical assets</td>
<td>36</td>
</tr>
<tr>
<td>Changing leverage ratios</td>
<td>23</td>
</tr>
<tr>
<td>Revising investment thresholds</td>
<td>18</td>
</tr>
<tr>
<td>Adding or tightening top-down limits on sector or asset exposure</td>
<td>18</td>
</tr>
<tr>
<td>Proactively divesting more cyclical assets</td>
<td>14</td>
</tr>
</tbody>
</table>

Data source: McKinsey Private Equity Resilience Survey, Fall 2019; n = 22.
A salient point from this research is that portfolio operating groups may have proved their worth most strikingly in the downturn. We reviewed the performance of 120 PE firms active since 2009 and with more than $5 billion in total PE fundraising, calculating their returns before, during, and after the global financial crisis, and compared the figures for firms with and without portfolio operating groups (Exhibit 28). Performance differences were not apparent between the groups before (2004–08) and after (2014–18) the last recession. During recession-era vintages (2009–13), however, GPs with operating groups achieved IRRs roughly 500 basis points higher than those without operating groups. This is a striking difference. To be sure, this analysis shows correlation, not causation, and is not intended to be a conclusive assessment of the value of operating groups in different eras. But it seems safe to say that firms that went to the expense and effort of building portfolio operating groups were also, more generally, those best prepared to weather the downturn. This may provide food for thought to GPs as they consider how to prepare for the next correction—and to LPs assessing the relative risk of different potential managers.

After years of whirlwind growth, private markets are settling in for a new decade of opportunity. We hope that this report offers insight on the industry’s growth and shifting dynamics, and ideas to help leaders build strong investment firms.
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