

How private equity fared in 2017, and what's ahead

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The industry continued to scale, but amid growth in private markets, some challenges remain. Here's the state of the industry and a look ahead to its future.

Private equity saw another strong year in 2017, as our recently released global private markets annual review showed. In this video interview, McKinsey senior partner Aly Jeddy and partners Bryce Klempner and Matt Portner discuss the findings of the report, the continued rise of private markets, and the outlook for the coming year.

Video transcript

Matt Portner: 2017 was another year of great growth for private markets. When we talk about private markets in the report, what we're really talking about is closed-end funds. We're talking about private asset classes like real estate, infrastructure, private equity, and private debt.

Aly Jeddy: The big picture has continued to be the same between now and, say, last year or even the last couple of years, which is a structural drive toward these asset classes. I think what's driving it, ultimately, is the fact that while overall returns expectations have come down both for private markets and for the public markets, the delta has remained relatively constant.

Capital flows

Bryce Klempner: The big story in fundraising is one of scale—2017 was a record for fundraising in the private market space. Over \$750 billion was raised, up more than \$30 billion from the year before, capping an epic run that stretches back to 2009. What's fascinating about this number is that it's driven entirely by one sub-asset class. Megafunds now account for 15 percent of all funds raised within private equity. It's creating exposures that the institutional investors want at the scale that they need.

Deployment

Matt Portner: Along with that growth can come some strains, and GPs [general partners] have had some difficulty in deploying that capital. Deal activity is interesting when you look at

it on two different metrics. One is deal volume, which is value, and one is deal count, which is number of deals. When you look at deal volume, it actually increased again this year. When you look at deal count, it fell for the second year in a row. The rise in deal volume has been driven more by the increase in the average ticket size of deals than it has been by the count. And when you look at what's driven up the average ticket size or the average deal size, it's actually been the increase in multiples much more than it's been natural EBITDA [earnings before interest, taxes, depreciation, and amortization] growth, for example.

We've seen multiples rise yet again this year, from over nine last year to over ten this year, but the story is different by sector. That's been driven predominantly by healthcare and IT, where you've continued to see multiples increase quite significantly relative to financial services and consumer, which are two sectors in which multiples have come down over the course of the past year. With the increase in multiples and the increase in competition, what you're seeing is external managers getting a bit more gun shy about deploying capital in every situation.

There's a lot of hand wringing in the industry about dry powder, and there has been for a few years now. What we've said previously is that if you look at dry powder more as inventory on hand than as an absolute number, it's less of a concern, because deal activity has historically kept up with fundraising, meaning that if you look at it over time, it's been fairly consistent in how much dry powder the industry has on hand. What's changed in the past couple of years is that deal activity has started to fall; when deal activity starts to fall and dry powder continues to accumulate, that can become a problem overall.

Industry dynamics

Bryce Klempler: The demand for co-investment has risen considerably in the last few years for a couple reasons. The LPs [limited partners] like it because it's essentially a mechanism for deploying more capital within private markets at lower fees. The GPs like it because it provides them with more capital where they need it to do larger transactions.

Matt Portner: By and large, strategic partnerships are still in their relative infancy. We think as the benefits of these strategic partnerships for both external managers and limited partners become more apparent, the pace of adoption will increase. A number of years ago, there was a well-known strategic partnership that was the first of its kind. Surprisingly, it has not been replicated as fast as the benefits would lead you to believe.

Aly Jedly: What is interesting, and this is a marked change over the last, say, 12 to 24 months, is the very structure of how people think about portfolios has started to change.

So as opposed to alternatives—which was that corner allocation, the 5 or 7 percent that folks put in the corner and said, “That's where I'm looking for alpha”—what has happened is people have started to think about their portfolio in a more sophisticated way, where they will say equities, within which are public and private, or credit, within which are publicly traded fixed income and private credit. The reason that is important is, rather than playing in that corner allocation of 5, 10, 15, 20 percent, which alternatives or private equity used to do, we are now playing in the mainstay of the portfolio.

The 2018 outlook

Aly Jedly: My first prediction is that we continue to move but accelerate the move from an emphasis on top-quartile performance to consistency at scale. I think we are going to continue to see performance has always mattered and will always matter.

But increasingly, what investors are looking for is a credible promise made and kept on a capital base at scale. And I think what that's going to mean is a larger set of mandates being given to firms to deliver a more credible return level over time. The implication of that is fundraising capability becomes less important than deployment capacity.

My second view is that the industry continues its journey from art to science. Processes become more and more important. If you're going to deliver consistency at scale, you're going to need processes—and a wider recognition that good process does not create stars, but eliminating dogs yields to process. The focus on eliminating the left-hand side of the returns distribution through rigorous processes is taking hold in more and more firms and will continue to do so.

My third prediction, or hope, actually, would be that LPs stop thinking so much about fund size and start thinking more about firm capability.

The fourth prediction I would make is that performance becomes one of many criteria in GP selection. Increasingly, the spine of the firm, the robustness of the organization and the platform, the compliance, the investor relations, the investor service, the research support—those things start to matter more and more.

And my fifth prediction is that we move to net net returns, or the total cost of ownership of our product. If you buy a car, it's not just the purchase price, it's the maintenance, it's the parts, it's the service, it's all of the other things that you have to buy with it. The problem with the traditional private equity product, in particular, has been that it's a high-cost product not just because of the fee, which, frankly, sophisticated investors get over if the return is high. It's that you have to hold the money liquid until it is called. You then deploy it. It gets dumped back on you unexpectedly, creating reinvestment risk and manager-selection risk. You then deploy it again, and then it again gets dumped back on you. Those kinds of components of the cost, which have never been factored into the net return, are starting to figure more and more prominently in LPs' minds, which is why this idea of firms that have platforms that can lower the total cost of ownership of the product start to become more appealing. □

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