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Why investors are flooding private markets

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As investors and asset managers shift away from weakened public markets, private markets are seeing immense growth, which, in turn, is changing the very definition of "performance."

While investors have been revising down their expectations of public markets, more and more of them have turned to private markets, which have seen swift and serious growth recently. In this episode of the *McKinsey Podcast*, McKinsey senior partner Aly Jeddy and associate partner Matt Portner speak with McKinsey's Mark Staples about the tremendous growth of private markets, the challenges that arise because of that progress, and what investors can look forward to in the year ahead.

Podcast transcript

Mark Staples: Hello and welcome to the *McKinsey Podcast*. I'm Mark Staples, an editor with McKinsey Publishing. Today we're going to be talking about global private markets. Here to tell us more are two members of McKinsey's global Private Equity and Principal Investors Practice.

Aly Jeddy is a senior partner in the New York office. Matt Portner is an associate partner in the Toronto office. They are two of the authors of McKinsey's Global Private Markets Review published earlier this year. Hello, guys.

Aly Jeddy: Hello, this is Aly.

Matt Portner: Hi, this is Matt.

Mark Staples: So let's start. What do we mean by private markets? It's not a terribly familiar term to some people. Aly, what do you mean by the term?

Aly Jeddy: One of the indicators of how dramatically the industry is changing is that we no longer have the vocabulary to talk about this industry. If you just pause and reflect for a minute, private equity is an obsolete term because private equity today includes things that are neither private nor equity.

If you think about the term limited partner (LP), some of the folks in that segment are neither limited nor partners. They're often becoming direct competitors and certainly not limited in the rights that they're seeking. And by the way, even as you stretch beyond to, say, fixed income, it's either fixed at zero or it's not income.

So a lot of the words that we've traditionally used have started to fail us. And as they do so, we've coined this term and used this term, which others use as well, called private markets to refer to all things illiquid, where there isn't a mark to market on a very regular, frequent basis. It includes, for us, everything like private equity but also illiquids of other forms such as credit, real estate, and parts of infrastructure.

Mark Staples: You called your report *A Routinely Exceptional Year*. Matt, could you tell us more about what that title means?

Matt Portner: In any other year, this would look pretty remarkable in terms of fund-raising and assets under management (AUM). That's actually been a continuation of a cycle of expansion that began back in about 2008. So this was yet another year of great fund-raising, great results, and participation from LPs. The qualifier on that continued strong growth is, with growth comes challenges. And in terms of increased competition, rising multiples, there are some challenges emerging in the industry.

Mark Staples: Matt, you mention that the industry's been in a long cycle of growth. It's managing a great deal of capital. Can you say just how much capital is privately managed?

Matt Portner: It was about $4.7 trillion by the end of 2016, and that's in assets under management. That's driven by a lot of factors. Obviously, there's incredible LP demand and desire, based in part on the $4.3 trillion liability gap that we currently see in the US, but also the belief of LPs in the asset class. So that money has continued to flow in. Looking forward, if investors were just to hold the allocations they have now, so thinking about it as organic growth, another $700 billion or so would flow in over the next three to four years. If they were to hit some of their long-term allocation targets in private markets, that number could be substantially more. So fund-raising is very healthy right now.

Many of the states in the US in particular are struggling to meet the liabilities that they have on their books. That gap has continued to increase over time to the extent that's it's now $4.3 trillion, with no signs of abating. LPs need to put their money to work, and they need to allocate capital. Part of the hope is that gap will be closed by the returns from private market's asset classes. The other factor to consider there, based on a lot of the research that the McKinsey Global Institute has done, is that we foresee, structurally, some challenges for the public markets going forward. That outlook for the public markets will also drive more capital into private markets.

Aly Jeddy: There's been a lot of discussion of the cyclical high in fund-raising that we're going through. We all know that fund-raising is cyclical in our industry. But let's not forget the structural forces that are driving some of the increase in fund-raising that we've seen in recent times. Fundamentally, there are a couple of things going on.

The first of which is that the financial crisis opened up a substantial gap between the assets and the liabilities of public pension funds. That gap has not closed. In fact, it's even worsened since the 2008 time frame. Today, that gap stands at $4.3 trillion. If you are a chief investment officer (CIO) of a public pension fund sitting there and looking at that kind of an underfunded status—and by the way, on average, pension funds have a funded status of 66–67 percent—so you look at that, what are your choices for closing that gap? You might turn to the public market, such as equities and fixed income. Those markets have, in recent time, not delivered anywhere close to the actuarial assumptions that most pension funds have. If you look at the recent McKinsey Global Institute data, it will show that nor are they likely to. In fact, the prognosis that the MGI has come up with for the next 20 years or so for equities and fixed income is considerably worse than the actual performance we saw in the last 30 years.

That then forces you to say, "Where will I get the return to close this gap?" What we are suggesting is that private-markets investing is likely to be the place to which they will turn. We are not making a forecast on returns. But what we are saying is that when we look at the most reputable consultants to the industry, what they are projecting, and what they are telling their clients, is that private markets will considerably outperform public markets in the foreseeable future.

Mark Staples: OK. So put it all together and fund-raising has been fairly spectacular, at least through 2016. What about this year? The first half is in the books now. What does 2017 look like so far in terms of fund-raising?

Matt Portner: If you look at the first part of 2017, even just at Q1, we're already on track for about a 15 percent year-over-year bump in fund-raising. So while 2016 was certainly high, it was really matching the highs of previous years, and we're now seeing 2017 on track for a record year, driven by, of course, some well-publicized megafunds raising some of the largest funds ever.

Mark Staples: The industry is raising tremendous amounts of capital. How about the investment side? What's it doing with the capital that it's investing? What do deal volumes look like so far this year?

Matt Portner: This is an interesting dynamic. So I think it's been fairly well reported and certainly well discussed that the increasing number of firms and the increase in competition for deals are making attractive deals harder to come by and harder to find.

In the report, we discuss a metric to look at that, that only 25 percent of public companies in the Russell 3000 Index were valued below the median buyout multiple at the end of 2016. That's dramatically down from 68 percent in 2008. All of which is to say attractive deals are harder to find.

What you saw at the end of 2016 was a commensurate drop in deal activity, whether measured by dollars or counted deals. There was quite a dramatic drop, and that was the first time in seven years that we've seen activity fall. But we certainly shouldn't overreact to that too much.

It seems to be bouncing back this year so far. Already, private-equity deals in the US are up 43 percent from this time last year. Certainly, part of that is driven by investors, LPs specifically, getting impatient with the amount of dry powder out there in putting some pressure on their GPs [general partners] to invest that capital.

Mark Staples: They're plunging in and are willing to pay the multiples, even though they're unattractive by historical standards; is that right?

Aly Jeddy: Mark, there's a broader structural change here that we should acknowledge, which is that the very definition of performance is changing. To cite another obsolete word, "alternatives" is an obsolete word now because the amount of capital that needs to flow to meet the large asset-liability gap we're talking about is a substantial portion of investors' portfolios. This is no longer the alternative allocation that sits in the corner of a portfolio. This is the mainstay. As it becomes the mainstay, the performance expectation, or the very definition of what constitutes good performance, is changing. It used to be that everyone promised a 20 percent return, and some of the very best GPs delivered an even higher result than that.

What LPs are increasingly asking for is not necessarily 20 percent, but rather actuarial progress against their liabilities. What they are asking for is consistency at scale. So what they're saying is, "I don't want you to knock the ball out of the park. I want you to make a credible promise that is better than my other options for investing and then deliver against that number." What that allows GPs to do is to be more transparent about the return they expect to achieve and to be able to even do deals at slightly higher multiples and yet make that lower, but promised, return, which is better than what the investor could've gotten in the public markets or in fixed income or other arenas.

Mark Staples: As LPs and GPs find this common ground and expectations merge, does that mean the stocks of dry powder [the inventory firms use to make deals]—which many observers noted are quite high, about $1.6 trillion—can we expect them to go down?

Matt Portner: Well, it's a bit of a math equation, right? What we talked about in the report is that there's obviously been a fair bit of hand-wringing over the increasing amount of dry powder over the last few years. One thing we touched on in the report was if you look at the increase in dry powder relative to the increase in deal activity over the last number of years, you've seen the deal activity has largely kept pace. Meaning that if you view dry powder more as sort of inventory on hand, the industry has managed it reasonably well.

Now the drop in deal activity and commensurate rise in dry powder at the end of last year would've raised some alarm bells and certainly looked a bit more concerning. But given the bounce back in activity so far this year, due in no small part to the pressure to put that capital to work by LPs, it's less of a concern going forward.

Mark Staples: All in all, sounds like a picture of an industry in the pink of health. Are there any short-term challenges that you see that the industry should be aware of, or are we headed for another routinely exceptional year in 2017 and maybe 2018?

Aly Jeddy: This will be another routinely exceptional year, for sure. But I think there are absolutely challenges that make the industry pretty different going forward. The first of which is a very obvious one, which is as you start to move into the mainstay of the portfolio, as I call it, yes, people allocate a lot of capital in that component; so most of the sophisticated CIOs we speak to today would say equities, within which are public and private, as opposed to alternatives. The good news is, in equities, there is a lot of capital. That's what's driving some of the AUM growth that we were just talking about.

The bad news is no one pays two and 20 for that part of the portfolio. In fact, we often joke that two and 20 has gone from being a fee structure to being a nursery rhyme. So fee pressure is absolutely going to be an important component of what drives behavior and LP–GP discussions in the near term.

Another challenge I would point to is the fact that LPs are going direct. I alluded earlier to LPs not being limited nor partners. A number of LPs are competing directly for deals and becoming competitors rather than partners. On the deals in which they are invested through GPs, they are wanting more and more governance oversight and transparency rights than they ever had before. So the LP–GP relationship itself is getting redefined in pretty interesting and different ways.

Matt Portner: In addition to what Aly just talked about in terms of the emergence of some LPs as direct competitors, there's a bit of, I'll say, a bifurcation, in that others are doubling down on more of an external manager strategy. What I mean by that is there's a rise of this notion of strategic partnerships, which is LPs having stronger but fewer relationships with their GPs, so committing more capital to fewer GPs and actually having a closer, more strategic relationship that includes potentially fee reductions but also more research sharing, opportunities for training, leveraging those relationships to get more out of them in exchange for increased allocations, recycling capital back into funds, and actually being the anchor tenant for new funds that GPs have.

Mark Staples: LPs are placing bigger bets with fewer firms, it sounds like. One might expect that to be driving consolidation in the industry. In other words, we would expect to see a few firms at the top getting bigger and other firms falling down the league table. Is that, in fact, the trend that you're seeing?

Matt Portner: Interestingly, that's not what we're seeing, unlike other industries and what you might expect. It's an interesting dynamic. What you do see is that the largest funds are capturing a larger share of new capital, to the extent that one in every four dollars raised in private markets in 2016 went to a megafund.

So LPs are consolidating their holdings into fewer large funds, but when we look at firms, instead of funds, there's actually very minimal consolidation. A portion of annual fund-raising flowing to the top five and top ten firms has actually decreased slightly over time. So, net, what we're seeing is consolidation of LPs' capital to a smaller number of larger funds, but not necessarily fewer firms raising them.

Mark Staples: So a lot of capital flowing into the industry is going to the larger firms in proportion to the overall flow. But there's some big differences that you spotted among the world's major regions. For example, in private-equity fund-raising in 2016, you reported that European firms raised or grew at 42 percent, [North America] at 6 percent, but Asia fell 21 percent. One of the CEOs who you interviewed for this research looked at this and said that, if you inferred people's opinions from their current asset allocations, you would think that Europe was fastest growing, Asia was underperforming, and the US was stable. And you'd be wrong on all three counts. Now that struck me as interesting. Are we still seeing these trends playing out?

Aly Jeddy: Mark, the point that the CEO we interviewed was making, which I think is a fundamental one, is that LPs' investment allocations often lag the economic fundamentals on the ground. One of the reasons they lag those fundamentals is that we don't have a good metric for risk in our industry. For example, LPs have a view that some of the higher-growth markets in Asia and elsewhere are high-risk markets and, frankly, more unknown markets. Part of what we perceive as risk is just a lack of knowledge about those markets.

So what that CEO was saying was that, while there are the greatest investment opportunities in Asia—by greatest, I mean not the best but the largest—LPs don't yet have the familiarity with those markets to be able to increase their allocations with the level of conviction that those markets today justify.

There is a real lag between the level of insight that LPs have and the level of conviction they can develop, versus the asset allocation. As a consequence, they continue to plow more and more capital into markets where the prognosis is not as attractive as it has been in the past.

Mark Staples: What do you think needs to happen in order for them to develop the level of conviction necessary?

Aly Jeddy: Part of what will need to happen is that those markets will just need to continue to mature. The problem with many of those markets is that we have seen many good deals. We have seen a few good funds. We have yet to get conviction that there are some very good firms.

The problem is not that there aren't good firms. The problem is what we call good in the US is a track record of ten, 15, 20 years, multiple funds, etc., because that's how LPs' algorithms have been built. The reality is there aren't 20-year-old firms in many of these markets. Private equity itself in most of these markets is 20 years old.

Remember, in the US even, it's only about 30 years old. It's a function of a maturing industry. It's a function of a rapidly growing and, frankly, in many markets, a nascent industry. But what that means is that investors who are willing to sift through specific opportunities, who are willing to take the time and invest the resources in understanding the market dynamics of individual places, will have materially different allocations from the conventional wisdom and will get outperformance as a result of that.

Matt Portner: And you are seeing some indicators that that sentiment is starting to shift. Some of the megafunds have recently started fund-raising for very large funds that are Asia focused. If you look as about June this year, Asia-focused private-equity funds have raised about $32 billion to $33 billion so far, which is about 80 percent of all that was raised last year. So there are some indicators that the sentiment is starting to shift. People are getting more comfortable allocating capital to the region.

Mark Staples: Both of you work with both the private investors and private asset managers—in other words, with limited partners and general partners. What's the sentiment like inside their walls? Are they seeing the same things that you're seeing? What's their perspective?

Matt Portner: I think that's right. On the GP side, we're certainly seeing success with regards to fund-raising, and many of our clients are performing very well in a competitive environment. That being said, we are hearing some expressions of frustration with where multiples and valuations are at right now.

Some of our clients are being a little bit more judicious and starting to pull out of select processes earlier than they might have before, given where the multiples are at. But we're also seeing an increasing focus on portfolio value creation, and not just the sort of standard cost-cutting levers that GPs may have been pulling in the past but an increased focus on digital and advanced analytics and talent to think about how to drive value in the portfolio.

On the LP side, I would say, very similar to what we discussed earlier, which is either, "What capabilities do I need to start considering going direct?" or, on the flip side, "How can I actually develop more strategic relationships with my GPs to get more out of the relationships?"

Aly Jeddy: I think that's broadly consistent with what I would say as well. The first opportunity, as well as challenge, that firms are facing and focusing on is how to scale the platform, not for firm growth reasons but because the amount of capital that LPs need to deploy and want to deploy is just greater than you can do in private equity alone, because private equity is comprised of so many bespoke transactions that are hard to do quickly. They are hard to do in a cookie-cutter kind of a way. So there's a natural limit to scale in private equity, specifically, which is why firms are turning more to areas like credit, like real estate, and like infrastructure, where they can maintain consistency while also deploying more capital that responds to the LP need to earn yield on a higher capital base.

The second area of priority and importance that clients discuss extensively with us is how to build the spine of the firm—the talent spine, the infrastructural spine of compliance, investor relations, finance, regulatory compliance—because it has become so important, in order to support large mandates and to support a large number of LPs, that you have a well-oiled machine that can serve clients in a high-standards, high-quality kind of way as the industry continues to mature and develop.

The third area that I would mention, which was implicit in the discussion we had around high multiples, is the value-creation algorithm itself at the asset level. In the next decade or so, we'll see material innovation in how portfolio companies and the assets that are owned by some of these GPs are improved during the period of ownership. Value is created in them over the period of ownership because that is ultimately the antidote to paying a high price and yet being able to get a high return.

Mark Staples: Thank you so much. This has been a fascinating conversation. I'd like to thank both of you for your time. Aly, Matt, much appreciated.

Aly Jeddy: Thank you for having us.

Matt Portner: Thank you, Mark.

Mark Staples: To learn more about McKinsey's work with private-capital managers and investors and to get a copy of the report *A Routinely Exceptional Year*, please visit McKinsey.com. □

About the authors

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