ALLEN & OVERY

Private markets 2023 – Let's check the pulse!

01
Fundraising pressures increasing

Private capital reached a record of almost US$1.2tn in 2021 (McKinsey, March 2022). From second half of 2022, we've seen a slowdown in global fundraising, reflecting a challenging macro-economic environment with uncertainty and disruption driven by inflation, rising interest rates, higher debt financing costs, volatility of public markets, supply chain disruptions and labour challenges – not to mention - geopolitical turmoil.

Private capital raised globally came in at $645 billion during first half of 2022 vs. $789 billion during the first half of 2021 (Bain & Co, July 2022). The decline was predictable given the record setting pace of fundraising in late 2020 to mid-2022. In 2023, the pace of fundraising remains sluggish in a stressed market.

There remains a tale of two cities when it comes to managers: investors are re-upping with existing managers who have long track records and weathered different market cycles. These tend to be large established household names, which have become multi-strategy firms as they cater to the varying needs, objectives and preferences of different investors. It's a challenging market for first time or emerging managers, who as a result are seeking to differentiate themselves through specialism.

Capital was concentrated among fewer managers, with the average fund size reaching over $1bn for the first time in the last five years. We're seeing investors having to select who those managers are and, in this market, there's opportunity for those that have capital to access and/or increase allocations to funds with managers, which may not have been accessible previously.

From geographical perspective, North America dominates. It accounts for 44% share of global fundraising. This is followed by multi-region funds (38%), Asia Pacific (10.6%) and Europe (6.5%). Investor constraints including overallocations, the denominator effect and a steep decline in fund distributions have forced private equity firms to seek capital from new sources such as high-net-worth individuals, insurance companies and non-US investors (including, in particular, the Middle East).

02
Fundraising periods

One-and-done closings have disappeared. The amount of time that sponsors are taking to raise funds has increased. The average number of months to final close in 2022 is around 15-20 months. We're seeing managers revert to their investors with requests to extend the fundraising timeline.

In addition, the initial closing has been extended. This has now become the "initial closing period" that is a 3-4 months long. Investors committing during such period tend to get a discount on their management fee.

There's also a trend towards rolling closings: as soon as investors agree terms with a manager, the manager closes the investor into the fund resulting in more frequent closings (e.g. every week or so) to secure commitments as soon as possible, and keep the momentum going.

Some managers are also offering a co-investment transaction alongside a commitment to the main fund.

03
Co-Investments & Follow-On Investments

In 2022 and continuing into 2023, there has been significant interest in co-investments from both investors and sponsors alike. As it is taking longer for sponsors to reach desired target sizes in raising new funds, they have increasingly turned to co-investors that have more capital to deploy and the ability to handle more complex transactions to co-underwrite deals.

Where co-investors are investing greater capital than the main fund in an investment, we're seeing a lot of focus on managing conflicts of interests, information flows, valuations and investment horizons.

From investors' perspective, needless to say that the key focus will be deal selection given the chunkier size of the deals.

Sponsors are increasingly turning to co-investors for follow-on capital to fund add-on acquisitions by portfolio companies (which sponsors may have traditionally funded with debt financing) or for working capital or to repay existing debt.

04
GP-led secondaries continue to grow

The secondaries market has grown rapidly over the last 5 years or so as more investors seek liquidity, portfolio rebalancing, risk management and exposure to alternative assets. According to Lazard, the market could exceed $200 billion in 2025, driven by factors such as the maturation of the primary market, the expansion of the buyer universe, the emergence of new strategies and structures, and the increased acceptance and transparency of the secondaries market.

Although we have seen a slowdown from second half of 2022 and into 2023, the market is continuing to expand as more players enter and differentiate themselves, transactions involve multiple assets, geographies (including emerging markets such as Asia-Pacific and Latin America) and diverse strategies such as infrastructure, real estate and private credit. According to a report by Preqin, market will experience volatility, divergence in pricing and performance as well as increased scrutiny from regulators; however, we expect it to continue to grow in the long-term. Given fundraising pressures, we're seeing interest in continuation funds, with focus terms such as reinvestment of 90-100% of the sponsor's carry, lower / no management fees, enhanced information rights, oversight scope of and consent rights and use of deferred consideration to existing LPs that are seeking liquidity. We expect activity to pick up in this area once the bid/ask spread has stabilized.

05

GP Stakes

We're seeing an increased interest in taking GP stakes and also commitments into GP stakes funds.

GP stakes are typically passive non-controlling / minority investments, typically ranging from 10-40% of the general partner, management company and/or carried interest as sponsors seek stable sources of capital and liquidity to expand their platforms and launch new products and strategies, invest in talent and technology and enhance their relationships with strategic investors. Investors are attracted to this asset class to diversify their exposure to alternative assets, generate long-term income streams from management fees and carried interest as well as enhance their relationships with strategic managers.

There remain challenges in this space including valuation uncertainty, economic terms and potential misalignment of incentives with LPs in the funds, governance complexity, conflicts of interest, information asymmetry and market concentration. Careful thought also needs to be given to potential exit avenues.

06

Rise of Private Debt

Private debt has taken off since the GFC. Although private debt fundraising slowed down in 2022, it remains an attractive asset class for investors given higher risk-adjusted yields, degree of protection from interest and inflation risk due to exposure to floating interest rates, proliferation of strategies and products and resilience to market volatility. Accordingly, continued growth is expected.

Investors attracted to this asset class include US and other pension funds, SWFs and insurance companies. US and Europe continue to be the most popular regions.

Private debt funds are more diverse. Direct lending is the most prominent strategy; however, there are also special situations, mezzanine debt, real estate debt, infrastructure debt and venture capital debt strategies.

07

Strong demand for infrastructure led by energy transition and renewables

Spurred by the US Inflation Reduction Act, investors are increasingly interested in infrastructure funds. The inflation protection afforded by many infrastructure assets and the net cash flow of the asset class make these investments attractive to investors in uncertain economic times. Infrastructure fundraising reached record levels in 2022, with the majority being focused on North America.

Investment products in this sector are becoming more diversified with the revolution in energy, mobility and digitization. Managers are looking beyond the core infrastructure assets and there's an increasing focus on energy transition and digital infrastructure assets. Such projects often align with investors' environmental, social and governance (ESG) goals, adding to the growth in fundraising in this sector.

We are also seeing managers expand their strategies (e.g. infrastructure debt funds) and target investment jurisdictions (including emerging markets) as well as setting up funds to invest in early stage assets.

With government support for infrastructure investment, investor interest in infrastructure funds will continue to increase in 2023.

08

Increasing focus on ESG

Environmental, social, and governance (ESG) factors remains at the top of the agenda and is a key topic that we hear from both managers and institutional investors about. Many investors have made ESG a part of their investment policies, with a specific ESG policy related to private market allocations. In fact, 66% of fundraising in 2022 flowed to managers with formal investment policies in place (McKinsey). All types of fund and asset class now need to consider ESG: either as a result of regulatory need or market impetus.

We're seeing alternative asset managers can tap into the increasing demand and opportunities for investing in sectors or themes that address global challenges, such as climate change, renewable energy/energy efficiency, clean technology, social inequality, health, and education.

But I would say it is an evolving area, where regulators, managers, investors and the industry at large are seeking to find their feet. ESG has a different meaning to each of them: for example, some may focus more on the E and others on the S. ESG-related rulemaking across Europe and Asia Pacific is expected to further crystalise, as rules around fund disclosures and transparency come into effect. The US is also setting its sights on the regulation of responsible investing, although the politicisation of ESG across the red-blue divide could frustrate some efforts on that front. Big focus on ESG in the Middle East region with upcoming COP 28.

One of the continuing challenges is a lack of specific data standards and best practices related to ESG is hampering investors' ability to consistently evaluate ESG performance across their portfolios. Need for alignment and standardization in the industry on KPIs and metrics to collect and data quality integrity. Confidence and transparency are key, including reliable data at firm, portfolio, and asset levels.

09

Retailisation

Access to alternative investments is expanding. I believe the makeup of the demand for alternative investments will shift meaningfully over the next few years. Mass affluent wealth channels will play an increasingly larger role going forward.

The mass affluent wealth segment has been significantly underallocated to private equity. According to Franklin Templeton report, wealth allocation (excluding ultra-high net worth) has typically been 2%-5% versus institutional investors at around 20%-25%. The report further provides an estimate that private equity within the wealth segment would move toward 5%-10% in the next 3-5 years.

Although HNWIs can invest in alternative investment funds directly, they often invest through distribution channels like bank or fintech platforms or feeder structures. The use of such distribution channels means there is not a material change in fund terms to accommodate the HNWIs because the counterparty is the third-party conduit that often has pre-existing terms and a relationship with the retail investor. We do not expect all managers to be able to access this market and this may lead to further bifurcation of the market.

There are regulatory challenges but we're seeing regulators looking set to allow private capital firms to accept allocation from private investors.
So watch this space!

10

Impact of AI and technology

Innovation and interest in blockchain technology continues to rise – and the private equity industry has come aboard. Although this technology has primarily been used as a record-keeping system for ownership of currencies, blockchain has a number of potential applications for private equity firms, including onboarding LPs, making capital calls and distributions, investor reporting, fund transfers, voting and compliance. Forward-thinking GPs are allocating resources to new technologies in order to increase efficiency, improve transparency and simplify the investment process.

Some of the biggest industry names are 'tokenising' their funds by converting interests in their funds into tradeable digital securities that are offered to investors. Tokenization provides a new way for GPs to access capital from individual investors at scale. While the industry may have some barriers to overcome before getting completely comfortable with tokenization, there is growing interest among GPs and LPs in the digitalization of private equity fund interests.

Despite the hype, the digital assets industry remains in its infancy, and as such, will continue to experience enormous innovation as it finds its place within established financial markets. Investors will also increasingly look to technology to determine how they invest, "construct" and monitor their portfolios.

Interested in hearing more? Let's connect

Kamar Jaffer
Partner, Middle East
Tel +9714 426 7163
kamar.jaffer@allenovery.com