McKinsey&Company

The Private-Market Investing Revolution

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FOREWORD

We no longer have the vocabulary to talk about our industry. "Alternatives" is too marginalizing a word for an asset class that is an increasingly prominent—and often critical—component of the portfolios of many leading investors. Plus, there is no agreement on what it includes. Everything from some structured asset-management products to leveraged buyouts has found space within this word. Similarly, private equity is no longer always private nor necessarily equity. Equally, there is nothing limited, or partner-like, when limited partners increasingly show up on transactions as direct competitors. And then there are ambiguous terms, such as "real assets," which now encompass everything from affordable housing to commercial real estate, and from cellphone towers to oil-storage facilities.

We point out this disconnect between our words and our world for two reasons. First, it is a poignant reflection of the pace at which our industry is changing. Even our language cannot keep up! Day-to-day and deal-to-deal, the change feels evolutionary. Step back, though, and the transformation now under way is nothing short of a revolution. Second, we want to be careful about how we ourselves use words. By private-market investing, we mean illiquids, such as private-equity buyouts, direct investments in real estate and infrastructure, and nonpublicly traded debt. We exclude hedge funds and other so-called liquid alts.

This essay describes our perspective on where the private-market investing industry is headed. Of course, there is enormous uncertainty. But from our accounting of the forces at work in the industry and our understanding of the performance and growth imperatives facing key players, we believe we can see what the viable paths to future industry leadership look like, how they can best be navigated, and what this means for the firms and investors undertaking the journey.

A WALL OF WILLING MONEY

Conservatively estimated, US public-pension funds face a $600 billion shortfall of their assets against their liabilities. This 2015 number is up from $510 billion the year before. If you add in corporate and other pension plans, and make more realistic actuarial assumptions, the estimated deficit rises to $2 trillion or higher.

Public markets are unlikely to help close this gap. The McKinsey Global Institute (MGI) estimates that bond yields—which averaged between 5 percent and 6 percent across the United States and Europe over the past 30 years—are expected to be in the 0 percent to 2 percent range for the next two decades. Some corporates have already issued negative-yield bonds. The long-term outlook for equity returns is not rosy either. Over the past 30 years, US and European equities delivered real returns just shy of 8 percent. For the next 20 years, that number could halve. MGI expects it to range between 4.0 percent and 6.5 percent.

Against the backdrop of this yield drought in the public markets, institutional investors are naturally looking to private-market investing. Focus on private equity for a moment: over 1994 to 2010, median private-equity-fund net returns outperformed a public-market equivalent. Past performance may not indicate future results, but private markets would be enormously attractive if they could provide even a fraction of the outperformance they have delivered over the past two decades—especially in a prolonged low-returns environment. Out of despair, if not desire, that is exactly the bet many institutional investors are placing. Our estimates show that if institutional investors simply hit their currently slated target allocations for private equity, an additional $1.4 trillion would flow into PE alone by 2020. If MGI's prognosis of weak equity and fixed-income yields proves correct, target allocations to private-market investing could rise further.

In addition, institutional investors not currently investing in private markets could be attracted to them, increasing the amount of capital available even more. The fastest-growing sources of capital entering the private markets have changed since the financial crisis. Today, the fastest growth in the money pouring in is coming from sovereign-wealth funds, endowments, and high-net-worth individuals rather than pension funds.

This is not all. Retail investors could be the source of another significant wave of capital. The last time we measured, our US Retirement Readiness Index stood at 64 percent, which means that average US households are so severely undersaved that they will have 36 percent less income per year than required to maintain their current standards of living, assuming they receive their full currently slated benefit payouts. Consequently, individual savers too may find their way to private-market investing if that turns out to be a refuge from uninspiring public-market performance.

Collectively, these dynamics could drive significant growth in the $2.3 trillion currently managed in private markets. Specifically, we believe private-market investing will garner a significant share of the trillions expected to flow into all alternatives over the next five years.

THE NEXT TRANSFORMATION OF OUR INDUSTRY

So our industry, going forward, will be much larger than it has ever been before. However, we believe that the future will be different, not just in degree but in kind, from the past. Specifically, our conversations with institutional investors consistently demonstrate a movement away from the singular focus on alpha that characterized their early motivation for investing in private markets. Consistent with the funding gaps, public-pension funds are looking for what they call "actuarial progress against liabilities." This goal changes their returns objective fundamentally, as one chief investment officer put it, "from S&P 500 plus 500 basis points to CPI plus 700 basis points." Add to this the magnitude of the capital that needs to be deployed, and it becomes clear why so many LPs are looking for performance consistency at scale rather than top-quartile returns.

It isn't just the yield objectives and the scale of the industry that are changing. How returns are pursued is being transformed, too. In our recent survey of 27 large pension and sovereign-wealth funds representing $7.4 trillion in assets, 77 percent of respondents said they are "likely" or "very likely" to build direct-investing capabilities in private equity in the next five years; 74 percent said the same for infrastructure and 74 percent for real estate. Limited partners will remain clients of general partners but they will also, increasingly, become direct competitors. As this occurs, a meaningful portion of the capital deployed in private markets may never go through a traditional fund structure.

Quite apart from the capital that LPs deploy directly, the term "assets under management" is becoming unhelpful, if not obsolete, because it excludes so much of the capital that GPs put to work. Fundless sponsors and deal-specific capital raises are clearly on the rise. Over 2009 to 2014, shadow capital—defined as co-investments, direct investments, and separate accounts—was one-fifth the amount raised through traditional fund structures. By 2015, it had risen to one-third. As this trend continues, we expect fees to erode for many GPs.

When large LPs do allocate to external managers, they are increasingly seeking cross-asset-class offerings from multiproduct firms. These increasingly come with a demand not only for reduced fees but also for a single hurdle rate to be met across the entire capital commitment. The GP bears the responsibility for dynamic asset allocation and netting risk across fund performance.

WHAT'S A GP TO DO?

This magnitude of discontinuity creates a disproportionately large opportunity for GPs that have the aspiration and the commitment to lead. Delivering strong returns while absorbing significant amounts of new capital requires the continuation of the product proliferation we have seen recently in private markets. Specifically, private equity is devilishly hard to scale quickly. Consequently, we expect significant growth to occur in real estate, in infrastructure, and in other private-investment strategies where greater amounts of capital can be effectively deployed more quickly. Some of this product-offering expansion may have to occur inorganically because of the speed at which it will need to be achieved.

Because these changes will occur just as the sources of value, the nature of competition, and the economics of the LP–GP relationship are all up for grabs, the need for purposeful strategy and the importance of consistent execution have never been greater. Our work advising winning firms on these questions over the last 15 years leads us to believe that every private-market investment firm seeking to win must purposefully decide how much energy to put into each of three major differentiating capabilities. No firm can realistically expect to be distinctive in each area. Every firm must choose one in which to excel and then meet the minimum acceptable standard in the other two.

1. *Superior returns:* There are three oft-repeated lies in private-market investing—"we have proprietary sourcing," "we add postacquisition value," and "we deliver top-quartile returns." Firms that can actually and credibly make these claims will have a standout advantage both over their peers and over LPs that choose to go direct. But the definition of superior returns is changing. It is no longer a target IRR of 20 percent. Rather, it is (i) differentiation of investment strategy; (ii) consistency with what was promised to investors; (iii) absence of volatility in returns; (iv) repeatability of core-investment selection, execution, and value-creation processes; and (v) a high-quality, seasoned team with a culture of openness, debate, and dynamism. Our work with investment firms on each of these attributes demonstrates that firms can choose any one of multiple

paths to achieving them. Without them, however, excellence in returns cannot be claimed and is not possible.

2. *At-scale spine:* For a large and growing class of postcrisis volatility-fatigued institutional investors with billions to deploy, a strong, consistent return on a large mandate is preferable to a superlative return on a small allocation. These investors don't have the resources to sift through a long list of midsize managers to pick a few. They find the selection risk associated with such a process unacceptable. And they don't have the capacity to manage hundreds of GP relationships efficiently. Such LPs will skew toward GPs that have the organizational capacity and institutional spine to serve as fiduciaries on mandates that range from several hundred million dollars to $1 billion or more, even if these GPs do not have the best returns in the industry. GPs that meet these criteria (i) do not consider "process" to be a dirty word—in fact, they rely on it to minimize the left-hand side of the returns distribution and deliver solid performance; (ii) offer a full suite of private-market investment products at scale and prune as well as add to the portfolio of their offerings as investors' needs change; (iii) build out the investor-relations and service capabilities (including technology) that make them easy to do business with; (iv) provide risk management, research, and other value-added services; (v) maintain rigorous compliance and monitoring to ensure the integrity and robustness of their platforms, not just individual funds or deals; and (vi) build a brand known for quality and reliability, independent of the performance of any individual product.

3. *Solution providers:* As LPs think more deeply about the risks and sensitivities inherent in their liability profiles, they will be more open to engaging with GPs on holistic and customized multi-asset strategies that directly address the GPs' needs. For example, liability-driven investing is already emerging, creating an opportunity for GPs that can assemble the modular suite of exposures required to meet each investor's objectives. GPs focusing on this dimension will (i) build out client-centric distribution capabilities that go far beyond episodic fund-raising; (ii) reduce the total cost of ownership of private-market products by making capital calls more predictable and distributions better timed to match clients' needs; (iii) use all of their capital, not just the portion committed to a particular GP, to invest in capabilities (such as research, risk management, and portfolio construction) that help their clients; and (iv) overhaul their governance and incentives to create internal cooperation (for instance, cross-collateralization of performance fees within a mandate).

Few firms will succeed by focusing exclusively on one of these dimensions. Fewer still will succeed at all three. Winners will choose one of these as the organizing axis of their firms and then build an adequate competence in other areas. The answer for each firm depends on its DNA, its history and capabilities, and its aspirations.

Importantly, the models we have articulated reflect our belief that GPs will need to define themselves based on what they do for their LPs, not what they do to themselves. Of course, how GPs organize themselves—geographically, sectorally, or functionally—is critical to which LP needs they can meet and how well they do so. But the question must be asked backward from LPs' needs rather than played forward from how GPs are organized today. All LPs care about is that a GP's model addresses an investment need they have, is fit for purpose to meet that need, attributable, repeatable, and (if the strategy calls for this) scalable.

"Scalable" is a word we expect to hear more and more frequently, especially for firms that choose the at-scale-spine or solution-provider models. We believe there are already economies of scale in our industry, and these will only become more pronounced. The minimum efficient scale required in private-market investing is rising, not just for critical functions like investor relations, but also to allow firms to invest in their brands and attract the best talent. This is true in absolute terms within our industry, but it is also true in relative terms from a market perspective: GPs choosing the at-scale-spine or solution-provider models will find that some of their most formidable competition will come not from fellow GPs but from considerably larger traditional asset managers, which are increasingly turning to alternatives—including private-market investing—in search of profitable growth.

WHERE TO BEGIN

Our experience helping most of today's leading firms navigate this evolution suggests four clear priority areas, no matter which choice a GP makes.

1. *Rethink deal sourcing:* The best GPs don't just find deals; they manufacture access to the exposures they want. Exclusive reliance on "chasing the book" or on "two guys and their rolodex" does not work very well anymore. Sourcing is now proactive—driven off preferred themes, anticipated changes in value chains and industry structure, and strong conviction around specific value-creation theses.

2. *Bring new rigor to due diligence:* Big data and advanced analytics are creating distinctive insights that allow more accurate valuations. Moreover,

the best firms are systematically probabilistic and use formal techniques to debias decision making.

3. *Overhaul the approach to postacquisition value creation:* Many firms created operations groups to drive value in their portfolios. In most cases, these groups have been more helpful in impressing investors than in creating actual upside. As competition increases, real portfolio-company value creation will be an imperative. This is likelier to come from a carefully curated network of external advisers and executive talent than from an in-house operations group that—with a few notable exceptions—is subscale in its capacity, suboptimal in its expertise, and relegated to second-class citizenship within a firm. Moreover, key assumptions are being turned on their head: for example, the risk of replacing underperforming portfolio-company managers has been vastly overstated in the past. Similarly, the point of developing a 100-day plan is not to develop a 100-day plan. Rather, it is to assess the management team, test the team's commitment to the value-creation thesis, and develop the forward-looking scorecards off which the investment will need to be managed through exit. More fundamentally, a core advantage of the private-investing model is the governance arbitrage it provides versus publicly owned companies. A couple of new attacker firms are now demonstrating radically effective ways to capture this arbitrage. Their approach requires more conviction and courage than most incumbents have yet shown, but we expect it to spread.

4. *Reorient around talent:* Most GPs are run by deal professionals. Successful deal professionals are not necessarily great managers. As the industry grows in scale and complexity,success will become as much about managing talent as it is about managing money. Governance and culture, often dismissed as touchy-feely mumbo jumbo today, will become near-dispositive drivers of long-term success. We expect this will happen suddenly and almost without warning as firms' founders retire. However, leading firms are already investing heavily in these areas for two reasons. First, they have figured out that their founders are mortal. And, more astutely, they recognize that robust, depersonalized talent models are a prerequisite for the successful integration of the inorganic additions they will need to make to their platforms to capture their share of the opportunity ahead.

A TASTE OF THE FUTURE

We know of no other industry with as vast a range in the quality of the products being offered, and with as little variation in price, as we see in private-market investing. We know of no other asset class with over $2 trillion under management and no way to measure risk. We know of no other financial product to which it is more difficult to commit capital and from which receiving disbursements is as unpredictable. If private-market investing is to realize its full potential, it will have to solve these problems. In short, our industry will have to emerge from its adolescence, to embrace the adulthood that is so clearly beckoning. It is beginning to do so.

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McKinsey is the leading adviser to investors in private markets. Our work is driven by the collaboration of our partners, advisers, and specialists with a deep understanding of private equity and the intricacies of the investment life cycle. With over 13,200 consultants working in 124 offices spanning more than 62 countries, our firm has the scale and scope to bring unparalleled insights across industries, geographies, and functional areas, allowing us to offer a fundamentally different approach to consulting in the investing industries.

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