A Special Report from

SAVVY INVESTOR

Private Markets: Evolution and opportunity

Key trends and investment implications of a rapidly growing market

Authored by Savvy Investor

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Special Report

Private Markets: Evolution and opportunity

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Private Markets: Evolution and opportunity

DAVID BRANNON
HEAD OF RESEARCH
SAVVY INVESTOR

David has over 15 years of investment industry experience. Working for a top tier investment bank he spent the majority of his career in investment analysis, most recently managing fixed income investment performance and attribution within the asset management division.

"DISRUPTION BY ITS NATURE IMPLIES CHANGE, AND WHETHER IT IS POSITIVE OR WELCOME CHANGE DEPENDS ON THE FORCE IN QUESTION."

Disruption in financial markets is now the norm. Established rules and correlations have not fared well in the years since the Global Financial Crisis. Disruption by its nature implies change, and whether it is positive or welcome change depends on the force in question. There are certainly some investors that would crave a bit of boredom over some of the recent market upheavals.

The growth and evolution of private markets represents a fascinating market shift. Just the word 'private' conjures up an opaque world closed to most, but that is far from the reality. It can be complex no doubt, and investors would be wise to push those private gates open carefully. Once inside though, the opportunities could make it worthwhile.

Private capital is revelling in healthy supply and demand. It's not just private equity and private credit either – real assets, in particular infrastructure, are making a strong investment case. Investors seeking to fight near-term volatility without sacrificing long-term green objectives may have found their home.

PGIM's paper 'The New Dynamics of Private Markets' explores the transformation of private capital markets. They cover the key factors behind the market's evolution and provide practical portfolio implications. Through deep dives into private equity and private credit they appraise the investment risks and opportunities.

In our 'Ask the Expert' interview, we uncover some of the important trade-offs investors must factor in. Regional and sector analyses are discussed, as well as the compatibility of private market investing with ESG and the green transition.

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PGIM's Investment Expert

Jakob Wilhelmus
Director, Thematic Research, PGIM

Jakob Wilhelmus is Director of Thematic Research at PGIM, the $1.3 trillion global asset management business of Prudential Financial Inc. He is responsible for PGIM's flagship research series, Megatrends, examining broad, secular forces that impact long-term investors and their portfolios.

Prior to joining PGIM, Jakob spent over seven years at the Milken Institute as Director in International Finance and Macroeconomics and later as Head of the Finance and Technology program. In these roles, his work focused on topics relating to financial risk, credit markets, and the economics of public and private equity. He also managed the Milken Institute's finance program across conferences, roundtables, and workshops.

He holds an M.Sc. in economics from the Free University of Berlin, Germany, and is a certified Financial Risk Manager by the Global Association of Risk Professionals (GARP).

Featured Paper from PGIM:

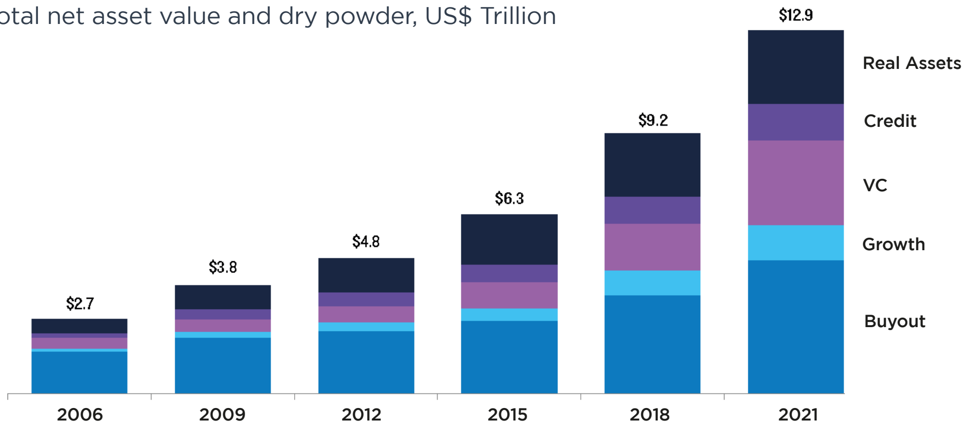
The New Dynamics of Private Markets

CLICK TO VIEW FULL REPORT

Global pools of private capital – including private equity, private credit and real assets – stand at over $12 trillion, double the size from just six years ago. What's more, the complexity, breadth and influence of private capital on markets and the global economy is greater than ever.

Why should investors care about these shifting dynamics? Traditional models of raising capital through bank loan officers and stock exchanges have been disrupted. The resulting growth and transformation in private capital markets is opening new investment opportunities and risks.

Exhibit 1: Private market funds have doubled in the last six years
Total net asset value and dry powder, US$ Trillion



Four Key Factors Driving the Transformation of Private Capital Markets Today

1. Banks and finance companies receding from riskier segments of lending.
2. Investors seeking income and yield increase allocations to privates.
3. A growing number of businesses can be better appreciated and funded via private markets.
4. Companies are staying private longer given the breadth of private capital.

Private Credit – Expanding Its Reach

Private credit is gaining share and moving to larger deals in corporate lending
With banks receding from the leveraged loan market, private credit providers will continue to fill the void.

Real asset debt is growing as an asset class
The amount of private capital deployed across real estate and infrastructure has almost doubled over the last eight years to $2.6 trillion.

"THE AMOUNT OF PRIVATE CAPITAL DEPLOYED ACROSS REAL ESTATE AND INFRASTRUCTURE HAS ALMOST DOUBLED OVER THE LAST EIGHT YEARS TO $2.6 TRILLION."

Investment Risks and Opportunities in Private Credit

Look beyond sponsored lending
Attractive investment opportunities in private credit lie beyond the crowded sponsor-driven segment where capital is less ample.

Exhibit 1 Source: Pitchbook
Note: Real Assets include both real estate and infrastructure

"WITH THE PRICE OF INDIVIDUAL HOMES SURGING IN MAJOR URBAN AREAS GLOBALLY, MORE HOUSEHOLDS ARE TURNING TO MULTIFAMILY RENTAL HOUSING."

Energy infrastructure offers unique opportunities
For direct lenders, the middle-market segment of conventional energy in North America offers intriguing opportunities as capital can be scarce.

Multifamily housing is an enduring global trend for real estate
With the price of individual homes surging in major urban areas globally, more households are turning to multifamily rental housing.

Private Equity – Entering a New Phase

Private equity secondary markets are deepening
The secondary market has proven to be an effective tool for managing both GPs' and LPs' desire for flexibility and liquidity.

Private equity firms are seeking more permanent sources of capital
Permanent sources of capital reduce PE's reliance on perpetual fundraising. Several ways of accessing this are emerging, including acquisitions of insurance firms and structures tailored towards individual investors.

Investment Risks and Opportunities in Private Equity

Secondary markets increase flexibility for LPs and create new opportunities for investors
As private markets grow, so does the need for portfolio rebalancing, fund restructuring and liquidity options. Secondary transactions also provide low entry points for investment and transparency into the identity of portfolio companies.

LPs should closely monitor fund practices and structures
Transfer of assets to continuation funds can be done responsibly but do have the potential to misalign interests of GP and LP investors. Also, if misused or undisclosed, subscription lines can be a source of hidden leverage and distort performance metrics.

Renewable and digital infrastructure provide global investment opportunities
With regard to renewable, the best opportunities will be in adjacent areas such as energy storage and low-carbon hydrogen. Within digital infrastructure, hyperscale data centers are an example of a sector seeing growing global demand.

Portfolio Implications

1. **Consider an investment approach that spans both public and private markets**
Investors need to look across both public and private markets to identify and evaluate the best investment opportunities. They should also consider broader investment mandates for managers that include both public and private realms.

"THE NEW DYNAMICS OF CAPITAL MARKETS REQUIRE A PORTFOLIO LIQUIDITY FRAMEWORK THAT INCLUDES TIMING OF CASH FLOWS ACROSS BOTH PUBLIC AND PRIVATE ASSETS..."

2. **A more sophisticated understanding of portfolio liquidity risk from private assets is essential**
The new dynamics of capital markets require a portfolio liquidity framework that includes timing of cash flows across both public and private assets and can be used to stress test liquidity and model different market scenarios.

3. **ESG is only beginning to shape private markets**
It is conventional wisdom that private markets lag their public counterparts in ESG considerations. However, since private equity (and, in some cases, private debt) investors have broad influence over portfolio firms' practices and operations, they can potentially achieve more direct impact.

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Ask the Expert with PGIM:

Why Invest in Private Markets?

Jakob Wilhelmus is Director of Thematic Research at PGIM, the $1.3 trillion global asset management business of Prudential Financial Inc. He is responsible for PGIM's flagship research series, Megatrends, examining broad, secular forces that impact long-term investors and their portfolios. He holds an M.Sc. in economics from the Free University of Berlin, Germany, and is a certified Financial Risk Manager by the Global Association of Risk Professionals (GARP).

Jakob Wilhelmus
Director, Thematic Research
PGIM

David Brannon
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Savvy Investor

"ULTIMATELY, IT IS A DECISION EACH INVESTOR NEEDS TO MAKE FOR THEMSELVES – HOW TO ADDRESS THE TRADE-OFF BETWEEN LIQUIDITY AND ALLOCATIONS TO PRIVATE MARKETS."

David Brannon: Why do you think private capital has seen such huge growth in recent years?

Jakob Wilhelmus: There are many forces at play, but the key is how three players have changed. First are banks, who had to adjust their business model to new regulation and had to recede from riskier parts of the market. The second player is investors who, faced with a zero lower bound, had to look for alternatives in a search for yield – so they have allocated more and more to private markets. Nowadays U.S. pension funds allocate about 20% to privates – up from 10% in the early 2000s. And then the third player, companies who, instead of being forced to rush public via IPO, now have a broad alternative across various stages in the private markets. So they can stay private longer and not feel pushed towards public markets.

"Investors are realising they need to adjust their playbook because private markets today are very different from what they were just 10 years ago."

David: With that growth, how have private markets evolved?

Jakob: As you've mentioned, private markets have grown tremendously since the Great Financial Crisis (GFC), and have really changed into something broader and deeper. Investors are realising they need to adjust their playbook because private markets today are very different from what they were just 10 years ago. For example, venture capital (VC) is not only growing, but pushing further and further into the later stages. An amazing stat to me is in 2021 in the U.S., we had more new unicorns than we had companies going public via IPOs.

Private credit has also seen expansion and growth. This part of private markets basically was a niche market prior to the GFC. Now it has grown to be the same size as the leveraged loans and high yield bond markets. So it's pushing upwards and outwards, but becoming deeper and more competitive across market segments.

David: How much should investors consider allocating to private markets?

Jakob: It really depends on the investor – there's no magic number. It's down to each investor, endowment, or pension to develop a more sophisticated framework that takes liquidity into consideration, which is a big concern when you allocate to private markets. But that framework should not be focused solely on the allocation to private markets. It should look across your portfolio. Ultimately, it is a decision each investor needs to make for themselves – how to address the trade-off between liquidity and allocations to private markets.

David: Thinking about that trade-off, what are the key risks that investors should keep in mind?

Jakob: I repeat liquidity just because it is such an important one. The market turmoil in the UK has shown how crucial it is to not only keep that liquidity in mind for your private assets, but what does it mean across your portfolio? And specifically, how do you handle liquidity during volatile times?

The other thing is, over the past 10-15 years markets just knew one way – up. A lot of the new products and structures, for example, around AI driven credit models, have not been tested under more challenging conditions. They worked really, really well over the past 10 years, but we are starting to see some cracks around those credit models. Investors will need to look again at the models in those untested products, because maybe they are not suitable outside the 'lower for longer' macro environment.

> “So we had those very violent market moves in public assets whereas private assets basically sailed through it. That's something that's very attractive to investors.”

David: With market volatility rife, do you see that as a headwind or tailwind for private markets?

Jakob: Volatility is interesting. The lower volatility of private assets is attractive for a lot of investors. They mark to market less frequently. The greatest example is probably 2020, right around the COVID pandemic, where public markets dropped sharply and then recovered. So we had those very violent market moves in public assets, whereas private assets basically sailed through it. That's something that's very attractive to investors.

But it can also complicate the overall portfolio because you have the denominator effect. Right now, public markets have adjusted their valuation and private markets haven't. Leaving a large part of your portfolio allocated to private markets – simply because they have held their value better. If an investor needs to reduce their private market allocation in response to this, they might be forced to sell into a difficult market.

> “ASIA AND LATIN AMERICA ARE REALLY BIG IN VENTURE CAPITAL, AND THAT'S BECAUSE THEY HAVE AN EVER-GROWING CONSUMER BASE, AND A REGULATORY ENVIRONMENT THAT IS VERY CONDUCIVE TO THOSE NEW IDEAS.”

David: How do private markets differ regionally?

Jakob: Private markets are a global trend, but there are differences in how they work and where they are in their development. For example, Asia and Latin America are really big in venture capital, and that's because they have an ever-growing consumer base, and a regulatory environment that is very conducive to those new ideas. Venture capital is a big play in Latin America and Asia, with private equity and direct lending a little bit less.

Europe is similar to the U.S., but Europe's big difference is that it is very bank-centric. In most European countries, it is still 60-70% bank dominated. European banks are facing the same regulatory considerations as those in the U.S. – receding from riskier segments of the markets and are just now beginning to adjust their business models. It just takes a little bit longer. That is why private markets are still relatively small in Europe compared to the U.S.

> “There are a lot of opportunities in private markets in both the conventional energy space as well as green and renewable infrastructure.”

David: Looking on a sector basis now, which parts of the market are you most excited about in the short and mid-term?

Jakob: It really is real estate and infrastructure right now. In the short-term, as was mentioned, everybody is concerned about growth and inflation – multifamily rentals, for example, is a real estate space that has been more resilient to growth downturns. But at the same time, it is driven by a long-term secular change of more expensive single-family housing in major urban areas. You sort of get the best of both worlds, something that protects you in the short-term, while also being a long-term play.

"A PRIVATE EQUITY INVESTOR IS DIRECTLY INVOLVED IN THE OPERATIONAL AND MANAGEMENT OF THEIR COMPANIES. THAT LEAVES BIGGER POTENTIAL FOR ACHIEVING MEASURABLE AND DIRECT IMPACT WITH PORTFOLIO COMPANIES."

Infrastructure is probably a little bit more medium to long-term – specifically around green transition and digitization. There are a lot of opportunities in private markets in both the conventional energy space as well as green and renewable infrastructure. Digitization is another strong theme in that our lives will continue to push online, push virtual, push remote and we will all need hyperscale data centres to support it. That is a global enduring opportunity.

David: Is private market investing compatible with ESG investing?

Jakob: Yes, private markets can be compatible. But right now, there are issues around transparency. The data concerns are still being worked out, and how to standardise it across sectors.

But ESG and impact investing is also top of mind for investors, and the big benefit that private markets offer is that they're directly involved in their portfolio companies. If your pension fund invested in a public company, then you're just one of many shareholders, whereas a private equity investor is directly involved in the operational and management of their companies. That leaves bigger potential for achieving measurable and direct impact with portfolio companies.

David: Good point – that can be a concern with public investing that you will be too far removed to make an impact...

Jakob: You would have to start a coordinated campaign or similar, which costs millions and takes a lot of time. That barrier to change is much lower in private markets.

> **"Renewable energy is transient, so storage and updating the grid to be able to manage those new needs is something that needs to be addressed in the medium- and long-term. VC is particularly well positioned to do that."**

David: Finally, how will the energy transition affect private market opportunities?

Jakob: The amounts of investment needed for the green transition is staggering, and there'll be a lot of opportunities, long-term opportunities for investors. The way I think about it is future and present. The future part is really where we all know we want to go – a net zero, carbon neutral, renewable-driven energy grid. As we shift from cost being the main issue, it becomes about interoperability and storage. That's really where private markets play a major role, specifically on the VC side. Renewable energy is transient, so storage and updating the grid to be able to manage those new needs is something that needs to be addressed in the medium- and long-term. VC is particularly well positioned to do that.

The other part is, we know where we want to go, but we also need to figure out how to provide power before we get there – and that is still through conventional energy. The Ukraine war has highlighted this. Private markets have an opportunity to provide capital to conventional energy firms, specifically in the middle-market. The middle-market is lacking access to capital – they cannot go to the public markets because they are not big enough. And at the same time, banks are receding as a capital provider and so private markets are basically the only game in town, which is a great opportunity for investors.

Savvy Investor’s Top Private Markets Papers

The following table features 25 of the top private markets papers uploaded to the Savvy Investor site.

On private credit, M&G Investments explore a dynamic and diversified asset universe that could offer resilience in a challenging market. New York Life Investments remark on the uptick in investor questions resulting from the unprecedented economic cycle. They advise investors to be prudent when considering how business and credit risk might feed through to their portfolios.

A webinar from Portfolio Management Research considers the challenges, risks, and opportunities associated with private equity. Elsewhere, a Rational Reminder Podcast acknowledges private equity as a nuanced subject that requires deep understanding. In the discussion, Ludovic Phalippou, a Professor of Financial Economics at the University of Oxford Saïd Business School, offers his thinking.

A number of other papers discuss sustainability in private markets, infrastructure investing, and performance persistence in private equity.

SAVVY INVESTOR'S TOP PRIVATE MARKETS PAPERS (BY DATE)

PAPER TITLE	DATE PUBLISHED
Drivers Wanted: Sources Of Return In Alternative Investments (Goldman Sachs AM)	21/10/2022
Global Trends in Private Infrastructure Investment 2022 (Global Infrastructure Hub)	18/10/2022
What Rising Rates And Inflation Mean For Private Debt (NN IP)	17/10/2022
The New Dynamics of Private Markets (PGIM)	14/10/2022
Capital Commitment - October 2022 (Amundi)	11/10/2022
Investing in Private Markets: History and rationale (UBP, 2022)	11/10/2022
Climate-Resilient Infrastructure: How to scale up private investment (LTIIA, 2022)	11/10/2022
Private Credit Investing: Whatever the Weather (M&G Investments)	07/10/2022
Private Markets: Asset allocation and portfolio construction (Investments & Wealth Institute, 2022)	20/09/2022
Sustainability In Private Markets (Franklin Templeton Investments)	16/09/2022
The Case for Unconstrained Multi-Asset Portfolios: Navigating Public-Private Investing (Neuberger Berman)	12/09/2022
Private Equity Fund Valuation Management During Fundraising (Harvard Business School, 2022)	30/08/2022
European Venture Capital Landscape (Wilshire Associates, 2022)	30/08/2022
Secondaries: A New Way to Access Infrastructure Assets (Macquarie Asset Management)	19/08/2022
Asset Allocation With Private Equity (2022)	16/08/2022
Private Equity and Inflation (WTW, 2022)	16/08/2022
The Four Myths of Private Credit (New York Life Investments)	11/08/2022
Private Equity Webinar: Risk and Opportunities (Portfolio Management Research)	05/08/2022
Private Credit: Differentiated performance in the midst of rising interest rates (Ares, 2022)	02/08/2022
The Role of Venture Capital and Governments in Clean Energy (VoxEU, 2022)	02/08/2022
Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds (2022)	02/08/2022
Building a Better Private Market Factor Risk Model (Qontigo)	28/07/2022
Currency Effects on Private Market Portfolios (Hamilton Lane, 2022)	26/07/2022
Predictably Bad Investments: Evidence from venture capitalists (2022)	26/07/2022
Podcast: Prof. Ludovic Phalippou on Private Equity (Rational Reminder Podcast, 2022)	26/07/2022

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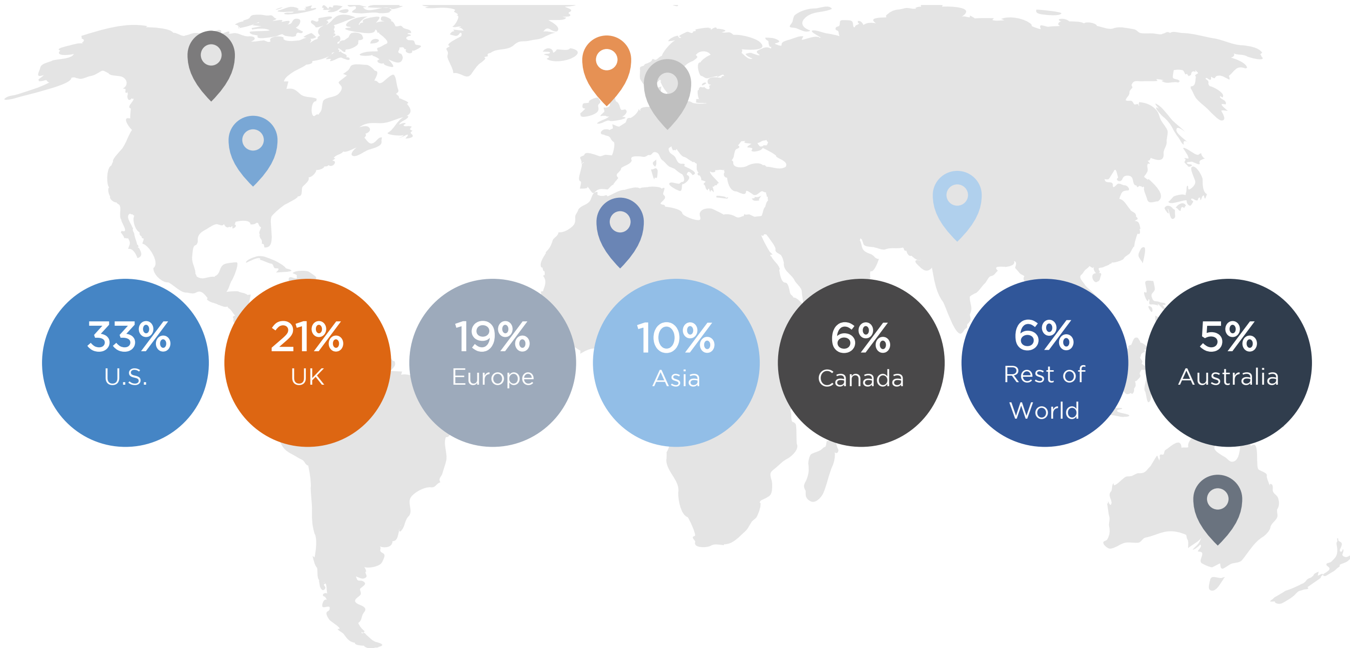

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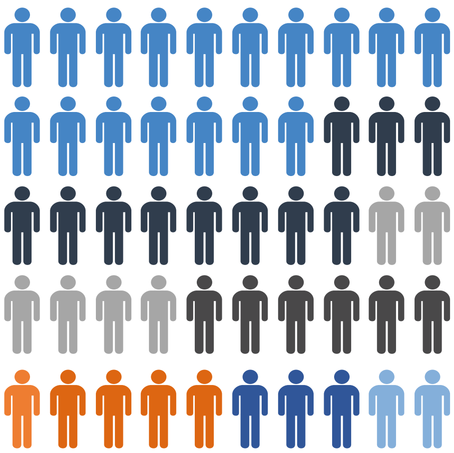

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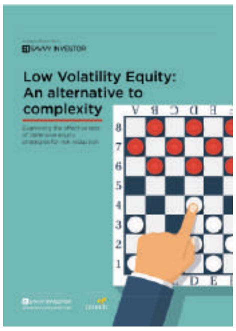

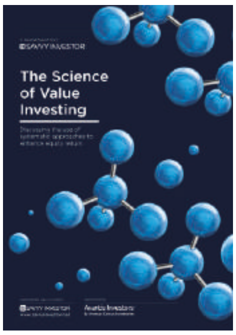

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Fixed Income

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FX/Currency Investing

Investment Outlook 2023

February 2023

Real Assets

Economy/Inflation

Subject to demand (at any time)

The Business of Asset Management

Insurance Asset Management

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Other topics upon request...

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