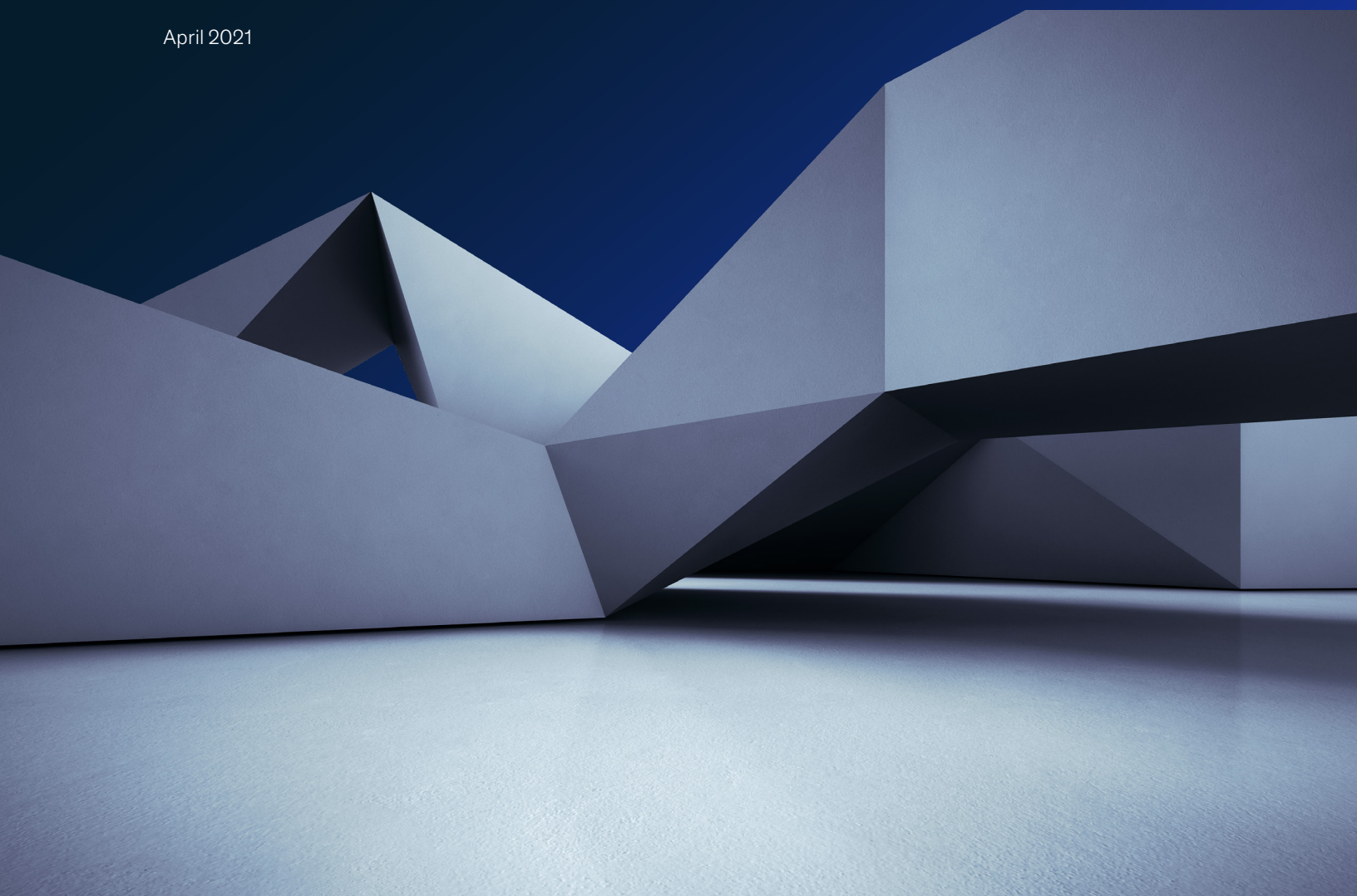


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A year of disruption in the private markets

McKinsey Global Private Markets Review 2021

April 2021



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Executive summary

The year 2020 was turbulent for private markets, as it was for much of the world. We typically assess meaningful change in the industry over years or decades, but the pandemic and other events spurred reassessment on a quarterly or even monthly basis. Following a second-quarter “COVID correction” comparable to that seen in public markets, private markets have since experienced their own version of a K-shaped recovery: a vigorous rebound in private equity contrasting with malaise in real estate; a tailwind for private credit but a headwind for natural resources and infrastructure.

Private equity (PE) continues to perform well, outpacing other private markets asset classes and most measures of comparable public market performance. The strength and speed of the rebound suggest resilience and continued momentum as investors increasingly look to private markets for higher potential returns in a sustained low-yield environment. The most in-depth research continues to affirm that, by nearly any measure, private equity outperforms public market equivalents (with net global returns of over 14 percent). We highlight several trends in particular:

- PE investors appear to have a stronger risk appetite than they did a decade ago. During the global financial crisis (GFC) in 2008, many limited partners (LPs) pulled back from private asset classes and ended up missing out on much of the recovery. This time, most LPs seem to have learned from history, as investor appetite for PE appears relatively undiminished following the turbulence of the last year.
- All things considered, it was a relatively strong year for PE fundraising. Overall funds raised declined year on year due to an apparent short-term discontinuity in the early months of the pandemic, but the pre-pandemic pace of fundraising returned by Q4. Growth in assets under management (AUM) and investment performance in most asset classes eased off in the spring, as the industry adjusted to new working norms, then came back strong in the latter half of the year. Venture capital (VC) bucked the broader trend with strong growth, driven by outsize interest in tech and healthcare.
- In PE, fundraising growth of successor funds strongly correlates with performance of the preceding fund at the time of fundraising launch. This is an intuitive pattern, now backed up by data. But another bit of conventional wisdom among LPs—that growth in fund size risks degrading performance—turns out not to hold up under analysis. Growth in fund size seems to have little correlation with performance.
- Private equity purchase multiples (alongside price-to-earnings multiples in the public markets) have kept climbing and are now higher than pre-GFC levels. In parallel, dry powder reached another new high, while debt grew cheaper and leverage increased—factors providing upward support for PE deal activity. Few transactions were completed in the depths of the (brief) slide in the public markets, reminding many in the industry that “waiting for a buying opportunity” may entail a lot more waiting than buying.
- Fundraising for private equity secondaries flourished in 2020, tripling on the back of strong outperformance in recent years. The space remains fairly concentrated among a handful of large firms, with the largest fund sizes now rivaling buyout megafunds.

Continued evolution in secondaries may be key to making private markets more accessible to a broader range of investors.

- The phrase “permanent capital”—like “private equity” itself—means different things to different people. To some, it refers to GPs’ sale of a stake in the firm, either directly to an investor, or via a fund-of-funds stake, or via IPO. Others interpret the term to allude to LP fund commitments of longer-than-normal or even indefinite duration. Many now also use the term to connote GPs’ acquisition of insurance companies with balance sheets that may be investible at least partly in the GPs’ offerings. In all of these forms, permanent capital has accelerated as private markets firms continue to diversify their sources of capital away from traditional third-party blind-pool fundraises.
- Another form of permanent capital, special-purpose acquisition companies (SPACs), boomed in 2020. Enthusiasm for the tech, healthcare, and clean-energy sectors propelled a huge surge of SPAC deals. Private markets firms dove in, both as deal sponsors and as sellers. SPAC activity has continued into 2021, as many investors remain optimistic that this third wave of SPACs will prove more durable than those in prior market cycles.

Real estate was hit hard by the pandemic, though the degree of recovery within the asset class remains unclear as the public-health crisis continues. Fundraising and deal making fell sharply, as owners avoided selling at newly depressed (and uncertain) prices. Rapid changes in how the world lives, works, plays, and shops affected all real estate asset classes. Office and retail saw the most pronounced changes—some of which seem likely to endure—which are causing investors and owners to rethink valuation and value creation strategies alike.

- The success of the unplanned transition to a remote workplace surprised employers and initiated a review of both their footprints and their in-office experiences. Office values fell on the

expectation of lower demand, forcing investors to contemplate the office of the future as they rethink their investment approaches.

- A rapid shift to omnichannel shopping impaired retail real estate valuations, particularly for shopping malls. The industrial sector proved less vulnerable, benefiting from a surge in demand for direct-to-consumer fulfillment.

Private debt was a relative bright spot in 2020, with fundraising declining just 7 percent from 2019 (and North America fundraising increasing 16 percent). The resilience of the asset class owes to a perfect storm of long-term growth drivers (for example, low-yielding traditional fixed income) that were complemented in 2020 by renewed investor interest in distressed and special situations strategies. The asset class is likely to continue growing into 2021, entering the year with a record fundraising pipeline.

Natural resources and infrastructure had a challenging year, with lackluster investment performance and further declines in fundraising. Energy transition remains the main story, as depressed demand for conventional energy increasingly contrasts with growing interest in renewables.

Change is more than just numbers. In some respects, the PE industry in early 2021 strongly resembles the picture a year earlier: robust fundraising, rising deal volume, elevated multiples. But for the institutions that populate the industry, transformation has come faster than ever, accelerating old trends and spawning new ones. We consider three notable vectors of change for GPs and LPs over the last year:

- **Who they are.** Diversity, equity, and inclusion (DE&I) made strides in private markets in 2020—in focus if not yet in fact—with consensus rapidly building on the need for greater attention and action. Both GPs and LPs are beginning to be more purposeful in

identifying and tracking DE&I metrics, both within their own ranks and in their portfolio companies. Change is afoot.

- **What they consider.** At the same time, more GPs and in particular LPs are now tracking environmental, social, and governance (ESG) metrics in earnest. Some—a small but growing minority—have begun to use these “nonfinancial” indicators in their investment decision making. Whether this trend ultimately proves a boon for investment value (in addition to investors’ values) remains to be seen, but one thing is becoming clear: our research increasingly suggests that the individual companies that improve on ESG factors also tend to be the ones that improve most on total return to shareholders (TRS). That, plus growing pressure from customers and shareholders alike, suggests that more focus here is likely.

- **How they work.** Remote interactions have proven more effective for raising funds and making deals than many in the industry expected. Faced with this involuntary proof point, reasonable minds differ on the extent to which GPs and LPs will return to business as used to be usual. It seems likely that norm-defying decisions in pre-COVID times—for example, the online annual meeting or the deal team that signs a term sheet before meeting management—may henceforth just be run-of-the-mill process options.

About this report

McKinsey is the leading adviser to private markets firms, including private equity, real estate, and infrastructure firms, with a global practice substantially larger than any other firm. We are also the leading consultant partner to the institutional investors that allocate capital to private markets, such as pensions, sovereign wealth funds, endowments, foundations, and family offices.

This is the 2021 edition of our annual review of private markets.¹ To produce it,

we have developed new analyses drawn from our long-running research on private markets, based on the industry’s leading sources of data.² We have also gathered insights from our colleagues around the world that work closely with the world’s leading GPs and LPs.

This report consists of two main sections: the first more numbers driven, the second more qualitative. The first section includes in-depth analysis of industry developments and trends in fundraising,

performance, AUM, and deals across several private market asset classes: private equity, private debt, real estate, and natural resources and infrastructure. The second section explores changes in private markets firms themselves, including profound shifts in the way the industry works, which have been accelerated by the pandemic.

We welcome your questions and suggestions at investing@mckinsey.com.

¹ We define private markets as closed-end funds investing in private equity, real estate, private debt, infrastructure, or natural resources, as well as related secondaries and funds of funds. We exclude hedge funds and, except where otherwise noted, publicly traded or open-end funds.

² Data cited in this report were produced by McKinsey and by Adams Street Partners, Altvia, Bloomberg, Brackendale, Burgiss, Cambridge Associates, CBRE Research, CEM Benchmarking, Citadel Securities, Cobalt, Coresight, CoStar, Earnest Research, EMPEA, Ernst & Young, FTSE Russell, Greenhill Associates, Green Street, Hamilton Lane, *Harvard Business Review*, Hedge Fund Research, Institutional Real Estate, Jones Lang LaSalle, MSCI, Nareit, National Bureau of Economic Research, National Council of Real Estate Investment Fiduciaries, NIC, PitchBook, Preqin, PricewaterhouseCoopers, Private Equity International, Real Capital Analytics, Refinitiv, S&P Capital IQ, S&P Global, Securities and Exchange Commission, Silicon Valley Bank, SPAC Analytics, SPACInsider, Trepp, *Wall Street Journal*, World Bank, World Federation of Exchanges.

1 A turbulent start to the decade

After record activity in 2019, private markets fundraising in 2020 declined on an annual basis across most asset classes and regions, reflecting the impact of COVID-19. North America and Europe saw their first drop since 2014, while Asian fundraising declined for the third straight year. But equally notable is the rapid recovery in the second half of 2020 across most asset classes, with the notable exception of real estate.

Despite fundraising volatility in the first half of 2020, total AUM across private markets

continued its march upward and grew 5.1 percent to another all-time high of \$7.4 trillion. AUM saw increases in most asset classes, with PE accounting for the largest growth.

Over the longer term, industry structure remained consistent, with surprisingly little evidence of consolidation of assets. Top players have pursued increasingly divergent paths to stay on top, however, with some raising a growing share of capital for non-flagship strategies.

Fundraising

Total fundraising across private markets slowed from 2019's record clip, falling to \$858 billion (Exhibit 1). At the time of publication, fundraising was down 21.4 percent year over year, with some firms yet to report 12-month totals. Yet, this headline number belies the year's real story, which was one of pandemic shock and then rapid recovery. Fundraising fell sharply in the second quarter, at the height of uncertainty, before rebounding in the fourth quarter as confidence returned and LPs and GPs alike adjusted processes to accommodate the remote environment.

The decline in private markets fundraising was broad based across all regions (Exhibit 2). While North America and Europe each experienced their first respective drop in fundraising since 2014, Asia had its third straight year of decline. In North America, overall private markets fundraising decreased by 21.3 percent to \$508 billion, driven primarily by a decline in private equity. Europe had the most moderate fundraising decline (down just 8.5 percent), though 25 percent declines across natural resources and infrastructure and private debt fundraising dragged down overall totals in the region. The sharpest fall was in Asia, where fundraising nearly halved to \$98 billion, driven primarily by private equity.

Exhibit 1

Private markets fundraising fell 21 percent in 2020.

Private markets in-year fundraising,¹ 2020 and year-over-year change, 2019–20

		Private equity	Closed-end real estate ²	Private debt	Natural resources and infrastructure	Private markets
North America	Total, \$ billion	300.1	73.8	79.8	54.6	508.2
	Change, \$ billion	-90.0	-46.5	10.9	-11.6	-137.3
	Change, %	(23.1)	(38.7)	15.8	(17.6)	(21.3)
Europe	Total, \$ billion	111.1	38.5	37.6	31.3	218.6
	Change, \$ billion	7.8	-4.9	-12.8	-10.4	-20.3
	Change, %	7.6	(11.3)	(25.4)	(25.0)	(8.5)
Asia	Total, \$ billion	72.9	14.1	6.0	4.8	97.7
	Change, \$ billion	-63.0	-8.5	-5.2	-0.2	-77.0
	Change, %	(46.4)	(37.8)	(46.3)	(3.9)	(44.1)
Rest of world	Total, \$ billion	18.8	3.8	1.0	9.7	33.3
	Change, \$ billion	4.8	-0.3	-1.8	-1.5	1.2
	Change, %	34.2	(8.4)	(63.3)	(13.2)	3.7
Global	Total, \$ billion	502.9	130.2	124.4	100.4	857.8
	Change, \$ billion	-140.4	-60.3	-8.9	-23.7	-233.4
	Change, %	(21.8)	(31.7)	(6.7)	(19.1)	(21.4)

¹Excludes secondaries, funds of funds, and co-investment vehicles to avoid double counting of capital raised.

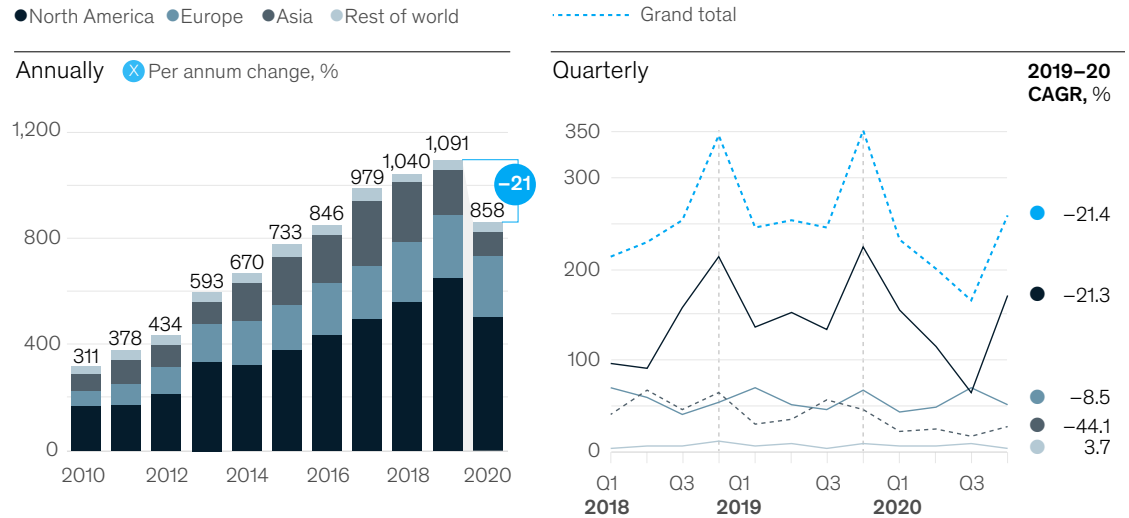
²Closed-end funds that invest in property. Includes core, core-plus, distressed, opportunistic, and value-added real estate, as well as real-estate debt funds.

Source: Preqin

Exhibit 2

2020 fundraising declined across almost all regions.

Global private markets fundraising by region,¹ \$ billion



¹Private markets refers to private equity, real estate private equity (ie, closed-end funds), private debt closed-end funds, natural resources closed-end funds, and infrastructure closed-end funds. Funds raised exclude secondaries, funds of funds, and co-investment vehicles to avoid double counting of capital raised. Source: Preqin

Industry structure

The long-term growth in private markets has been quite substantial. The number of active firms in private markets topped 11,000 in 2020, growing 5.0 percent during the year and 8.0 percent per annum since 2015 (Exhibit 3). Attractive economics and significant liquidity have continued to drive new entrants into the space, even in a challenging year. Private equity represents the largest share of private markets firms at approximately 75 percent of the total, as well as the fastest growing at 9.1 percent per annum. By contrast, the count of active hedge funds continued to decline, shrinking 2.0 percent per annum since 2015.

Our analysis indicates that the market remains highly fragmented but may be consolidating slowly at the top end. This effect is subtle in the available closed-end data—less than 2 percent share captured

collectively by the top 25 players over the last five years³—but may be more pronounced when considering the growth in other vehicle types, particularly in real estate, where several top players have raised open-end vehicles. Moreover, the firms that comprise the top 25 players have rotated over time, and a 20-year tidal wave of private markets growth has created a number of very large players that play an outsize role in shaping private markets and, increasingly, the broader economy.

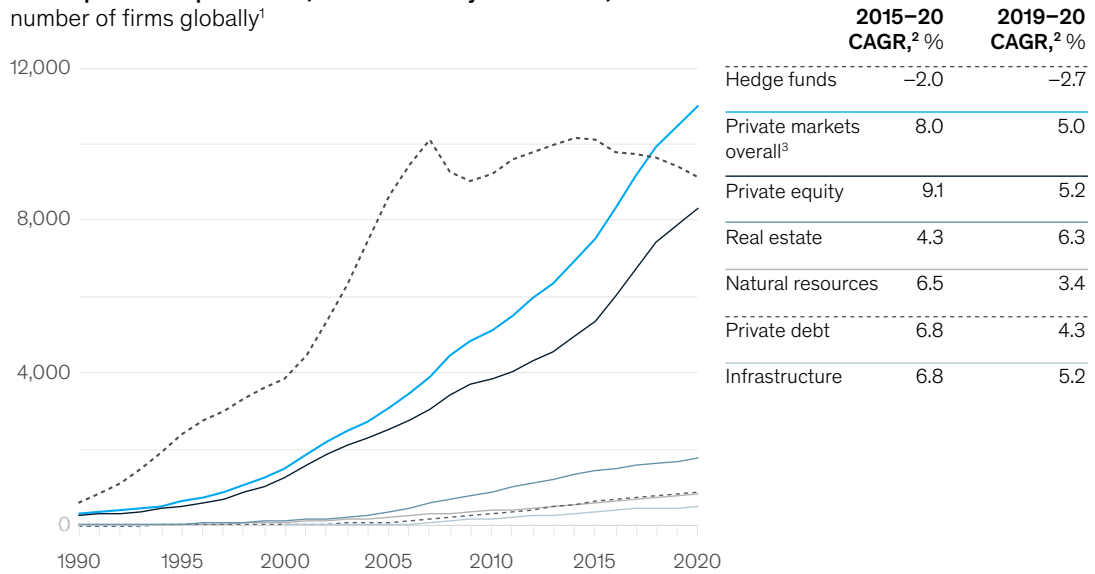
To better understand the drivers of this growth, we have partnered with Hamilton Lane to conduct a series of new firm-level analyses. The results suggest a cohort of meaningfully more complex institutions than those that led the industry at the turn of the century, with most top players operating several strategies and playing across multiple geographies.

³As measured by trailing five-year cumulative fundraising.

Exhibit 3

The number of active private-capital firms has surpassed that of hedge funds.

Active private-capital firms, 1990–2020 by asset class,
number of firms globally¹



¹Firms that have raised a fund in the previous 10 years. If a firm has not raised a new fund in the past 10 years, it is assumed to be defunct. Active private market firms calculated at the start of each year.
²Compound annual growth rate.
³Total is less than sum of individual asset classes, as some funds count across multiple assets.
 Source: HFRI; Preqin; McKinsey analysis

General partners have grown assets in two main ways: within the flagship fund family (defined as the largest specific fund family at a given GP) and with new-product launches. The largest single fund raised before 2006 totaled \$8.5 billion. The pre-GFC spike in fundraising ushered in the megafund era, and the first fund to top \$10 billion was raised in 2006. Fifteen years later, the definition of “mega” has changed, as funds exceeding \$20 billion are now commonplace. Six megafunds have been raised in the last three years, despite the trend of GPs splitting a single flagship into more focused funds and strategies.

A significant contributor to fundraising growth has been the expansion in the number of strategies that GPs pursue. In all vintages prior to 2009, flagship fundraising accounted for 75 percent or more of total dollars raised (Exhibit 4). Since 2009, however, the opposite has been true: flagships have accounted for more than 75 percent of fundraising

in only one vintage, 2012. For most of the last eleven vintage years, flagship fund lines accounted for less than 70 percent of fundraising, and in 2019, just 66 percent, a new low.

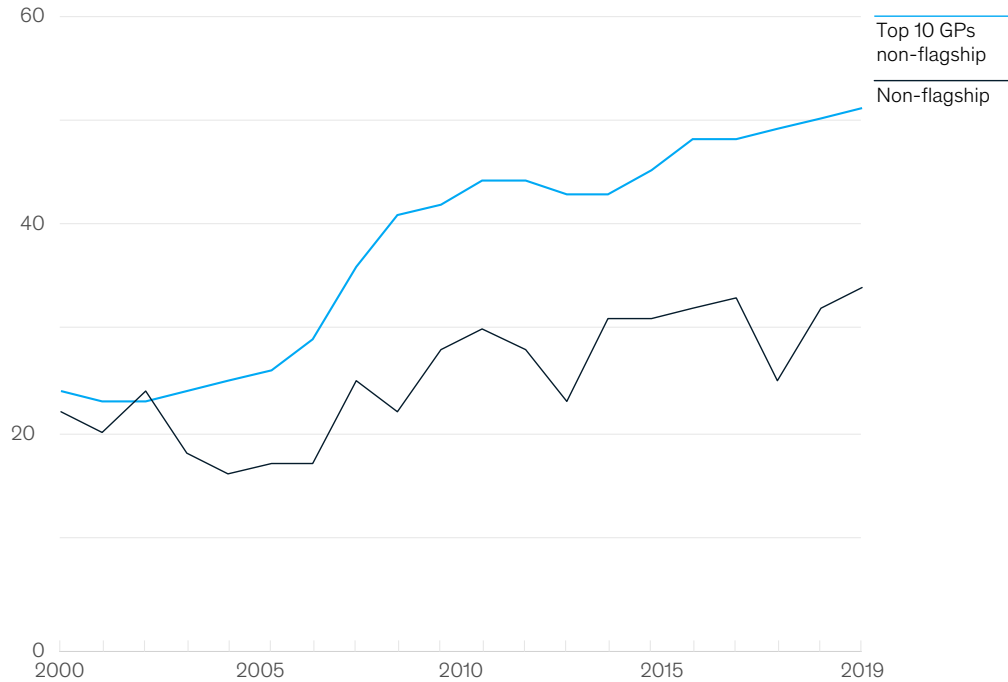
This trend has been even more visible among the top ten GPs. Flagship fundraising for the top ten firms has contributed less than 70 percent in all vintages since 2007, as non-flagships have taken an ever-increasing share. In 2019, for the first time, non-flagship fundraising contributed more than half of all dollars raised.

Coinciding with this trend, the number of fund families managed by top ten GPs has grown consistently over time. In 2000, each of the firms currently in the top ten managed one active strategy. By 2008, these firms averaged two active products. Product proliferation has accelerated since the GFC, and these firms now manage an average of seven active product families (Exhibit 5).

Exhibit 4

Non-flagship funds have accounted for an increasing share of funds raised, especially among the largest GPs.

Non-flagship private markets fundraising,¹% of fundraising by vintage year

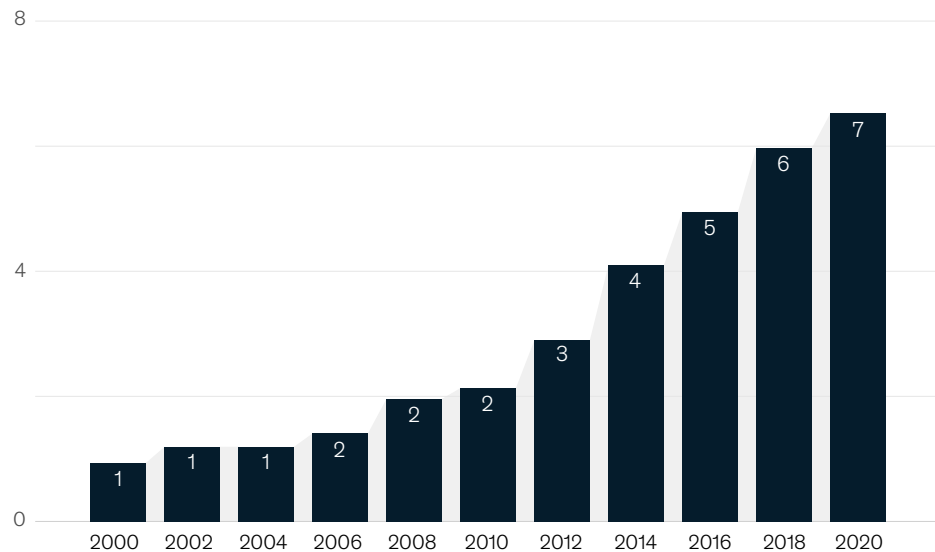


¹Private markets include closed-end private equity, real estate, private debt, natural resources, and infrastructure. Source: Cobalt (January 2021); Hamilton Lane

Exhibit 5

Product proliferation has grown consistently.

Average number of active product families for top 10 GPs



Source: Cobalt (January 2021); Hamilton Lane

Product proliferation has taken two forms: strategy and geography. Three strategies have driven the vast majority of product proliferation: credit, real estate, and non-flagship buyout funds (eg, midmarket buyout). Among today's top ten GPs, none had a dedicated credit vehicle as of 2000. In the intervening years, they have collectively raised 41, including 29 in the last decade. Similarly, these GPs collectively had raised just two real estate funds in 2000, but by 2020, that number had grown to 34. Finally, the top ten firms had raised three non-flagship buyout funds by 2000, but by 2020, that number had grown

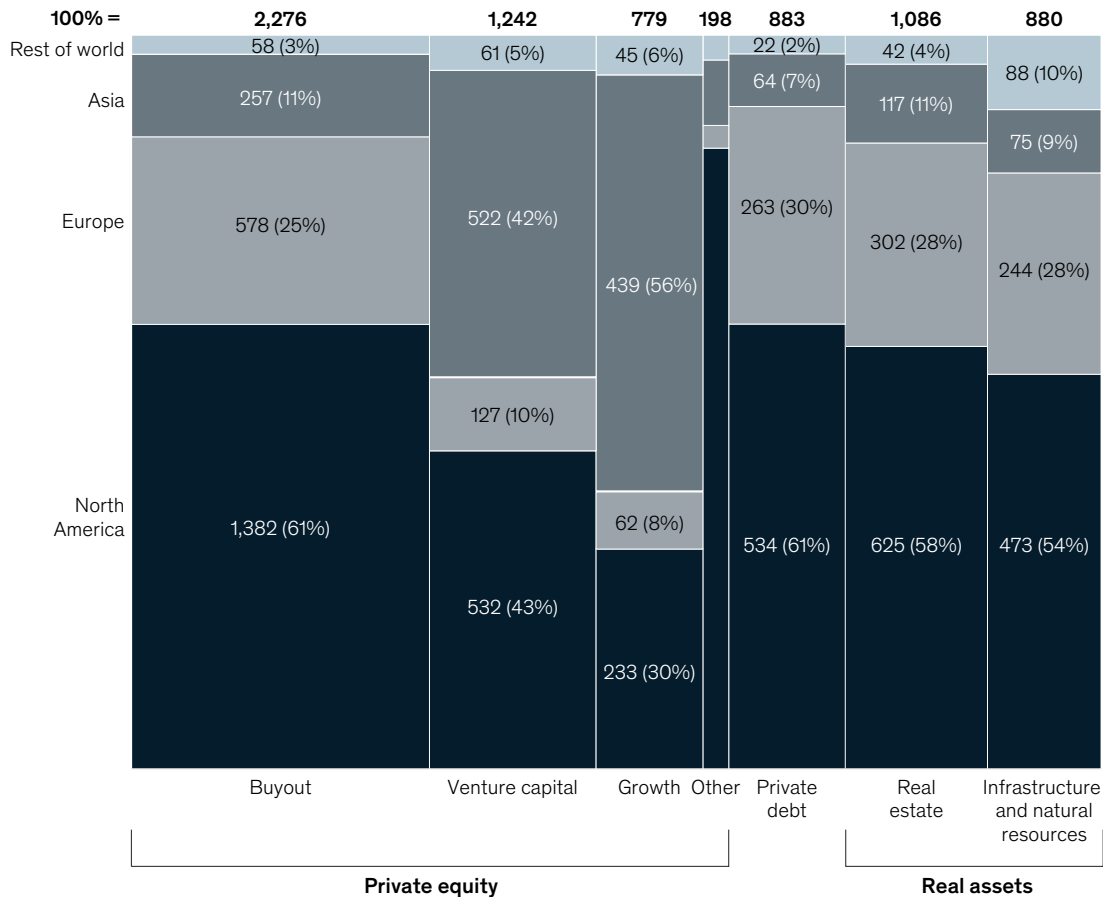
to 32. This growth across strategies has been both inorganic (ie, by acquiring other firms) and organic (often through hiring new talent).

Geographic growth also has been widespread. Funds focused on investing in North America account for 39 percent of the 127 unique non-flagship funds raised by the top ten GPs since 2000. Funds with a global mandate accounted for another 28 percent. This latter group has expanded rapidly in the last decade, enabled by the broader footprint of many of the largest players. Today's top ten GPs had raised just five global funds through 2010, but 25 in the decade since.

Exhibit 6

Private market closed-end assets under management surpassed \$7.3 trillion.

Private market assets under management, H1 2020, \$ billion



Note: Figures might not sum to 100%, because of rounding.
Source: Preqin

Assets under management (AUM)

Despite last year's volatility in fundraising, private markets AUM grew by 5.1 percent, reaching \$7.3 trillion, another all-time high (Exhibit 6). AUM increased in most private asset classes, but PE was the biggest driver, growing 6 percent to \$4.5 trillion, about 61 percent of total private markets AUM. Growth in the Asian private markets has continued to outpace other regions, and Asia now accounts for a greater share of AUM in VC and growth than North America. European markets saw slow growth in the first half of 2020, with a slight uptick in private equity. In

North America, AUM growth was driven primarily by private equity and private debt, while real estate and infrastructure lagged behind.

Performance

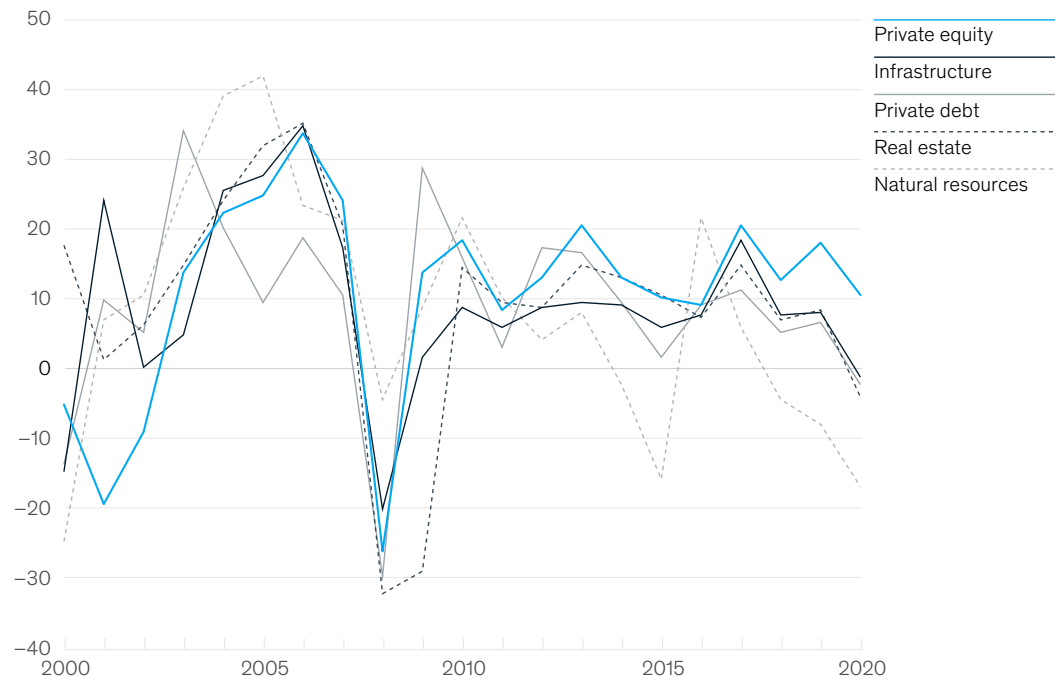
Private equity investment performance outpaced that of other private markets assets for the fourth consecutive year⁴ (Exhibit 7). After a sharp decline in performance in the first quarter, private equity recovered quickly to post a nine-month trailing pooled net IRR of 10.6 percent through September 30. All other private markets asset

Exhibit 7

Private equity has outperformed other asset classes and has experienced less volatility since 2008.

Global fund performance over 2000–20 by asset class,¹ global funds raised in 2000–17

1-year pooled IRR for 2000–17 vintage funds,² %



¹Fund performance assessed using IRR calculated by grouping performance of 2000–17 funds during 2000–20. Some data not available for certain periods.

²Internal rate of return for 2020 is 9 months (YTD, Q3 2020).

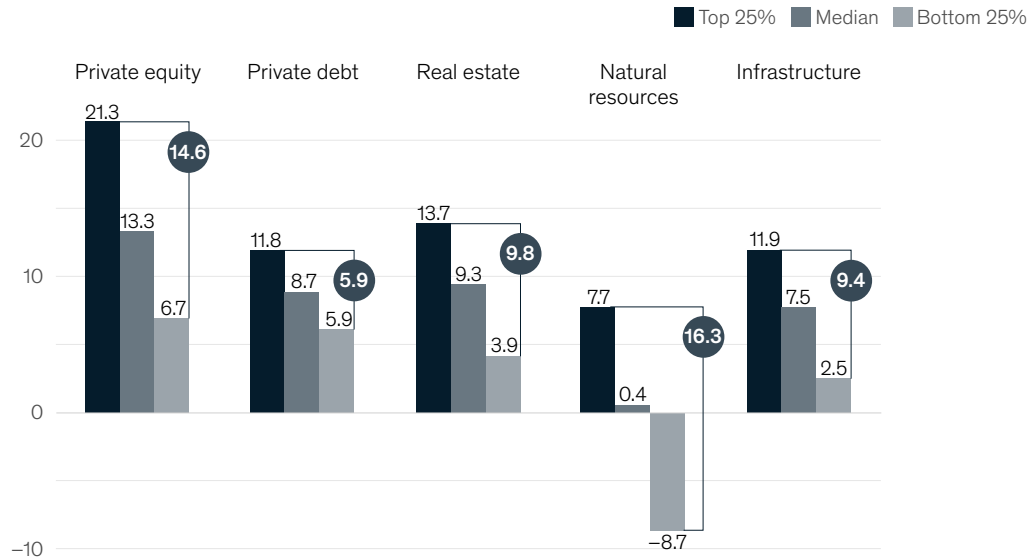
Source: Burgiss

⁴ Based on year-to-date pooled net internal rate of return as of third quarter 2020.

Exhibit 8

Though performance dispersion is higher in private equity, the median fund in PE has outperformed top-quartile funds in other asset classes (except real estate).

Global fund median IRR and percentile spreads by asset type, net IRR to date through Sept 30, 2020, for vintage 2007–17 funds, %¹



¹Methodology: Internal rate of return (IRR) spreads calculated for funds within vintage years separately and then averaged out. Median IRR was calculated by taking the average of the median IRR for funds within each vintage year. Source: Burgiss

classes posted negative returns in the same time period. Infrastructure (-1.3 percent) and private debt (-2.1 percent) came closer to breaking even, while closed-end real estate (-4.2 percent) and natural resources (-16.7 percent) faced more challenging return environments.

Over the longer term, private equity has remained the highest-returning asset class in private markets since 2006. Median performance to date of PE funds raised between 2007–17 is

13.3 percent net IRR (Exhibit 8). But the real prize in PE, as many LPs see it, is the potential for outperformance above median. The top-quartile cutoff for the 2007–17 vintage period, for instance, is a net IRR of 21.3 percent. In PE, some firms significantly outperform the rest of the pack. Additionally, the risk of underperformance has been lower over this period, with bottom-quartile PE funds returning well above other private market asset classes.

2 Private equity rebounds quickly

The year in private equity was marked by volatility and resilience. While fundraising declined overall and across most sub-asset classes, it rebounded vigorously in the latter half of the year. Buyouts and growth equity bore the brunt of fundraising decline. VC had a standout year on the back of enthusiasm for technology and healthcare. And secondaries continued their rapid growth and entry into the mainstream.

As it has for the last decade, PE as an asset class continues to outperform other private markets asset classes, as well as public market equivalents, by nearly all measures. Among PE sub-asset classes, VC continues to outperform buyouts at the median but sees greater

performance dispersion, and the top performers remain difficult to access for many investors. As strong performance continues to drive growth for individual GPs, new research shows that growth in fund size turns out to be largely uncorrelated to subsequent performance, allaying a concern commonly voiced by LPs.

Volatility was not limited to fundraising. Deal activity also declined in the early months of the pandemic but rebounded strongly in the latter half of the year. Despite the turbulence, PE multiples continued to climb this year, reaching heights only seen previously just before the GFC. In parallel, dry powder reached another new high, while debt grew cheaper and was utilized more liberally.

Fundraising

Overall PE fundraising declined 21.8 percent from 2019. In North America, PE fundraising declined by 23.1 percent to \$300 billion (Exhibit 9). Buyouts, which account for 56.0 percent of PE fundraising in North America, dropped by a record 39.5 percent year over year but recovered rapidly in the second half of the year as investors retooled processes to reflect the new environment and LPs gained comfort writing checks from afar.

There is no question that the pandemic was the most significant driving force behind the first-half slowdown. At the same time, however, the decline also reflects some degree of “lumpiness” in the timing of large raises, a perennial issue in taking a short-term view of the asset class. In 2019, seven buyout funds closed with at least \$10 billion; 2020 saw only three such funds close, both in the second half.

The fundraising environment in Europe proved incredibly resilient, growing by 7.6 percent on increased raises in both buyout and VC. Third-quarter fundraising was particularly strong; it included the closing of the largest European fund on record, which surpassed its stated fundraising target by more than 20 percent.

In Asia, PE fundraising fell by 46.4 percent, or \$63 billion. Growth equity had a particularly poor year, falling 81.0 percent. This was the third year of decline in a row for Asia fundraising, which dropped by roughly 29 percent per annum from 2017 to 2020. Many believe this slowdown is simply a function of the disproportionately large amount of dry powder in the region, which reached a new high of \$439 billion in 2020.

On a global level, buyouts, which account for over half of PE fundraising, saw a 28 percent year-on-year decline. Funds with sizes of \$5 billion or more remain a primary driver of buyout growth, but the

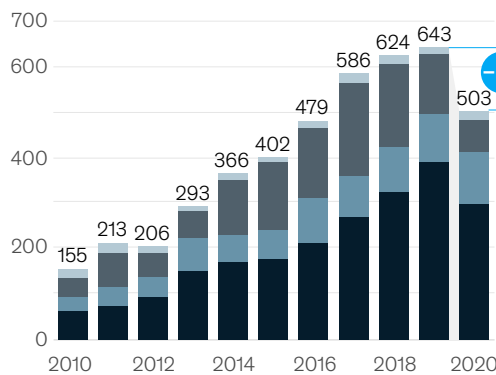
Exhibit 9

Private equity fundraising in 2020 was down from the prior year in North America and Asia.

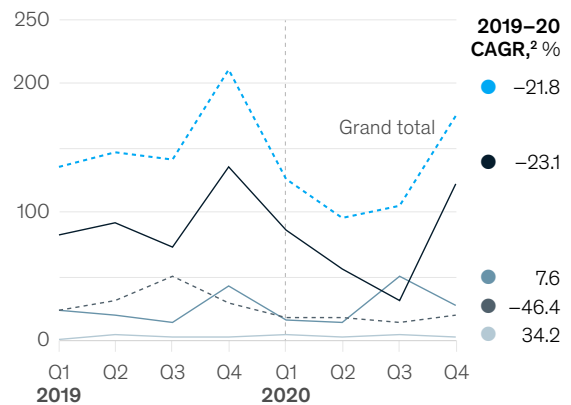
Global private equity fundraising by region,¹ \$ billion

● North America ● Europe ● Asia ● Rest of world

Annually Per annum change, %



Quarterly



¹Excludes secondaries, funds of funds, and co-investment vehicles to avoid double counting of capital raised.

²Compound annual growth rate.

Source: Preqin

absolute number of buyout large-cap funds dropped, and the amount they raised declined by approximately 40 percent. Following a depressed first half of the year, buyout fundraising roared back (Exhibit 10), with fundraising nearly doubling in Q3 and Q4 relative to the first half of the year in North America and more than tripling in Europe. Growth in North America and Europe, which together comprise nearly 90 percent of global buyout fundraising, offset a continued decline in fundraising in Asia.

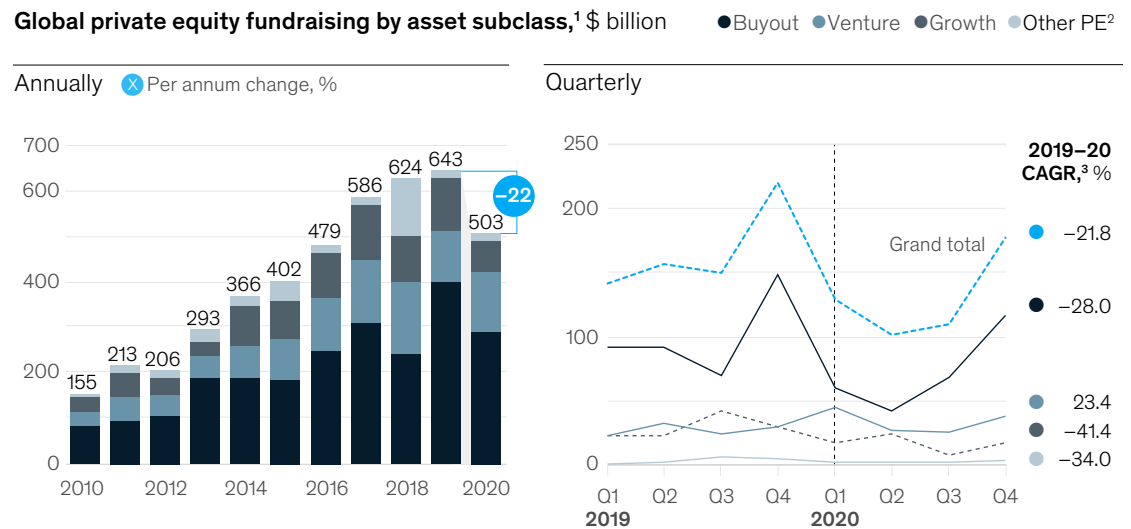
denominator issue—that is, their allocation to PE increased on a percentage basis, surpassing strategic asset allocation targets. In the most unfortunate cases, LPs faced true liquidity concerns and feared being unable to meet their cash liabilities, including unfunded commitments to PE funds. Together, these concerns led LPs to minimize new commitments, which ultimately destroyed potential value for LPs, as crisis-era vintages proved to be some of the top-performing funds of the last two decades.

The speed of fundraising recovery in this downturn looks different from the pullback that followed the onset of the GFC. The recovery from the GFC was a protracted process, taking nearly five years for fundraising to reach pre-crisis levels. A primary reason the recovery was slow was that many investors had accelerated their commitments prior to the crisis and found themselves unable to maintain pacing and take advantage of depressed valuations. And unlike the past year, during which equity markets rebounded quickly, many LPs during the GFC found themselves with a

This time appears to be quite different. After the steep decline in the first half of the year, fundraising in the fourth quarter was 9.1 percent higher than the total raised quarterly, on average, in 2019, which was the largest fundraising year on record. Further, the first quarter of 2021 appears to be on pace to match previous years. Of course, this downturn has included an even more abrupt economic contraction as well as a much faster recovery. Still, LPs had voiced for years that they had learned the hard lessons of pulling back from PE during a downturn; early evidence suggests that may be true.

Exhibit 10

Private equity fundraising showed signs of recovery in the second half of 2020 due to the increased fundraising of buyouts.



¹Excludes secondaries, funds of funds, and co-investment vehicles to avoid double counting of capital fundraised.

²Other private equity includes turnaround PE funds and PE funds with unspecified strategy.

³Compound annual growth rate.

Source: Preqin

While buyout and growth equity fundraising fell 28.0 percent and 41.4 percent respectively, VC was an outlier in 2020, growing by 23.4 percent. With this surge, venture's share of total PE fundraising increased from 17.1 percent in 2019 to 26.9 percent in 2020. As the asset class has grown, large funds have become more prevalent: fundraising for funds greater than \$1 billion more than tripled in 2020, accounting for 32.6 percent of total VC fundraising.

A significant driver of VC's strong growth in 2020 was the prominence of healthcare VC, which enjoyed record fundraising growth of 70.5 percent (Exhibit 11). Healthcare VC fundraising was particularly high in North America, where it grew from roughly \$10 billion in 2019 to \$19 billion in 2020, exceeding 75 percent of the sector's fundraising across PE asset classes. While the number of funds was down, likely reflecting the temporary fundraising pause across all PE asset classes, the average size of healthcare VC funds doubled, mainly driven by the closure of the biggest healthcare fund on record.

In a down year for PE fundraising overall, secondaries bucked the trend, raising about \$90 billion to more than triple 2019 totals (Exhibit 12). Secondaries funds have now achieved something more like mainstream status in the eyes of many LPs, spurred by relatively high median returns and low dispersion among managers. While secondaries growth has been material, fundraising remains largely concentrated in fewer than ten managers. The spike in 2020 was driven primarily by several of the largest managers closing funds in the same year. Four funds raised \$10 billion or more in 2020, versus just one such fund in 2019, while a single \$19 billion fund set a new all-time high in 2020. To put secondaries growth into perspective, only one year prior to 2012 exceeded \$20 billion—for the entire asset class.

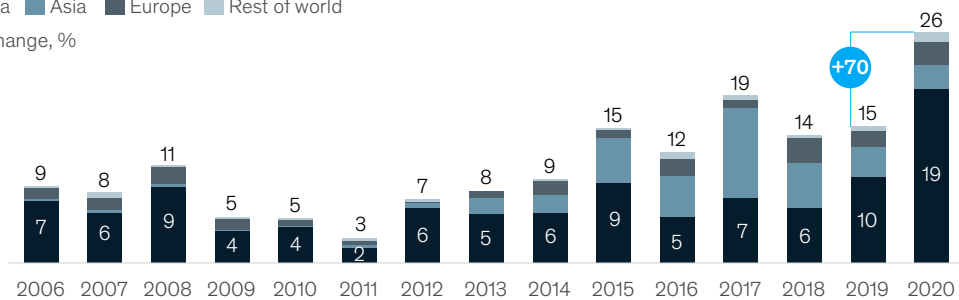
While secondaries fundraising accelerated in 2020, pricing and deal volume fell sharply. Average price as a share of net asset value (the pricing mechanism in secondaries) fell 800 basis points during the year.⁵ At a market average price of about 80 percent of net asset value (NAV), many

Exhibit 11

Healthcare venture capital fundraising market had a record year with annual growth of 70 percent.

Healthcare VC global fundraising, \$ billion

■ North America ■ Asia ■ Europe ■ Rest of world
 x Per annum change, %



Healthcare VC funds closed, number	61	58	69	56	44	29	49	78	83	127	143	188	143	115	97
Average fund size, \$ billion	0.14	0.15	0.16	0.10	0.12	0.11	0.16	0.12	0.14	0.14	0.10	0.11	0.11	0.15	0.30

Source: Preqin; McKinsey analysis

GP-led secondaries composed one-third or more of total secondaries deal volume in each year over 2018–20, and the trend is accelerating. Along with that shift, deal size has increased, with most secondary deals now topping \$1 billion.

potential sellers held onto their positions rather than choose to lock in losses, so deal volume dropped considerably. Yet the decline in deal volume came predominantly in the second quarter, at the height of the market uncertainty, and the asset class finished the year largely back on track on a run-rate basis. In the last downturn, secondaries performed similarly, as discounts to NAV expanded rapidly to 50 to 60 percent before recovering within about four quarters.⁶

One important factor underlying growth in the secondaries market has been growth in the primary PE market: for secondary buyers, the pool of positions to be transacted has grown significantly over the last decade. Moreover, the share of positions that transact in the secondary market has grown as the practice has gained acceptance among LPs and GPs. Many LPs now view secondaries as a portfolio management tool, while GPs' hesitancy to allow LPs to exit positions has declined over time. These dual factors have set baseline growth for the industry at a higher rate than for the primary market.

Perhaps even more important to the industry's growth has been the evolution of the GP-led secondary market, in which secondaries players partner with direct PE sponsors to reconstitute an investment vehicle, allow the sponsor to extend its ownership period of one or several assets, and enable LPs to exit or join the new vehicle at their discretion. The GP-led market emerged in the years following the GFC, as GPs struggled to raise new vehicles while managing underperforming portfolios. The resulting income prospects for these GPs drove concerns about talent retention, and secondaries firms stepped in as solution providers with fresh capital to improve deals and fresh economic structures to enable employee retention.

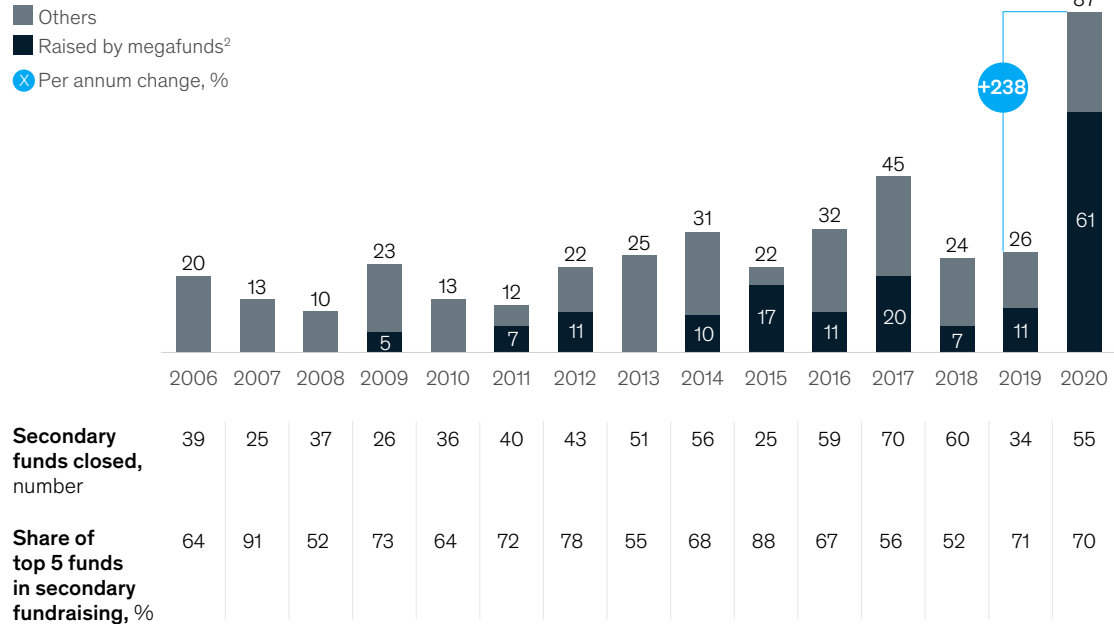
While the initial GP-led secondary deals (circa 2012–16) proved the model, the market has accelerated more recently. The GP-led market has shifted from providing struggling managers with solutions to enabling primary GPs to recapitalize funds, hold onto assets longer, or accelerate economic realization for LPs and GPs alike. Perhaps the natural end point to

⁵ Greenhill Cogent, *Global Secondary Market Trends & Outlook*, July 2020, greenhill.com.

⁶ Greenhill Cogent, *Global Secondary Market Trends & Outlook*, January 2016, greenhill.com.

Private equity secondaries raised roughly \$87 billion and nearly tripled 2019 totals. Market remains concentrated.

PE secondary fundraising by closing year,¹ \$ billion



¹Excluding real estate and infrastructure secondaries.
²Funds with a close size >\$5 billion.
 Source: Preqin; McKinsey analysis

this trend, single-asset secondaries are growing in prominence, as sponsors recapitalize individual holdings in order to continue managing assets that they believe have continued value creation opportunities rather than exit positions to a third-party buyer in a traditional process.

GP-led secondaries comprised one-third or more of total secondaries deal volume in each year over 2018–20, and the trend is accelerating. Along with that shift, deal size has increased, with most secondary deals now topping \$1 billion. This growth in deal sizes underscores the need for scale to compete and suggests that current levels of industry concentration—which are high vis-à-vis primary PE—may persist. That said, the

rapid market growth and strong performance tend to attract new entrants, and several large GPs have been reported to be considering raising their own secondaries funds.

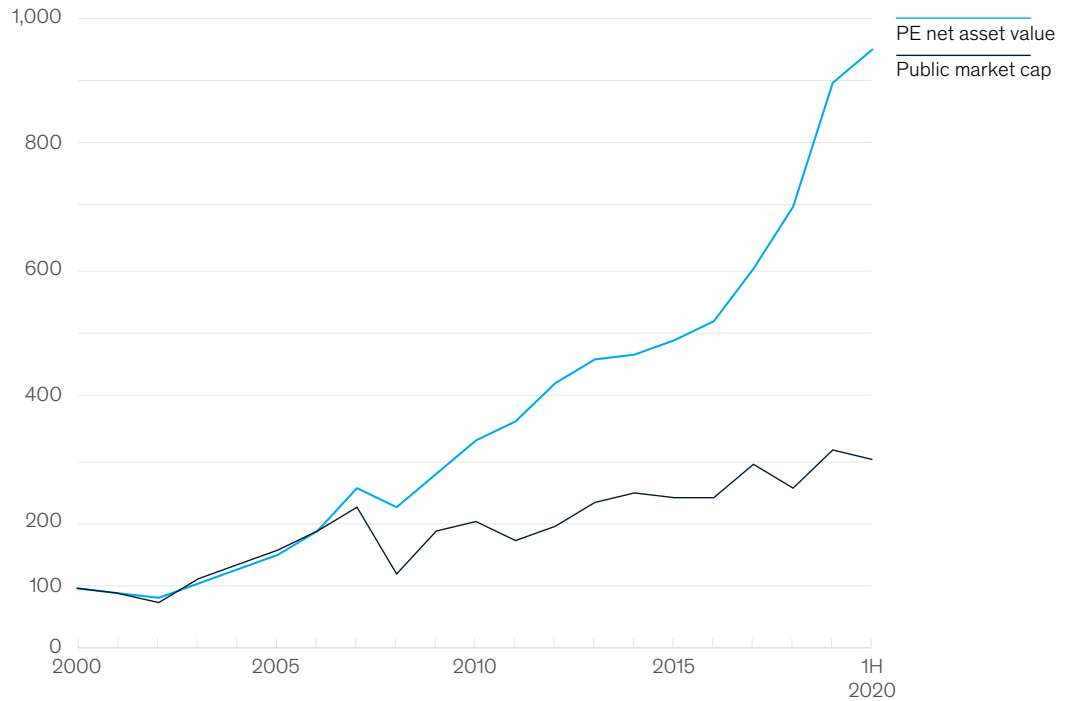
AUM

By net asset value, global PE has grown by a factor of nearly ten since 2000, outpacing growth in public equities market capitalization nearly threefold over the same period (Exhibit 13). Growth rates for private markets net asset value and public market capitalization first diverged during the GFC, and that divergence has accelerated over the last decade.

Exhibit 13

Private equity net asset value growth outpaced total market cap of listed companies.

Growth of global PE net asset value and public market capitalization, 2000–1H 2020, (2000 = 100)



¹Net asset value equals assets under management less dry powder. Market cap is based on the total market cap of companies globally. Source: World Federation of Exchanges, Preqin

Global private equity AUM reached \$4.5 trillion in the first half of 2020—growing 6 percent from year-end 2019, or an annualized 16.2 percent since 2015—and more is expected to come. A strong driver of this predicted growth is the expectation of increased allocations to private markets generally and PE specifically over the next five years. As of August 2020, 79 percent of LPs surveyed indicated plans to increase allocations to PE; 23 percent intended to do so significantly.⁷ According to CEM Benchmarking, PE currently represents just 5.7 percent of institutional

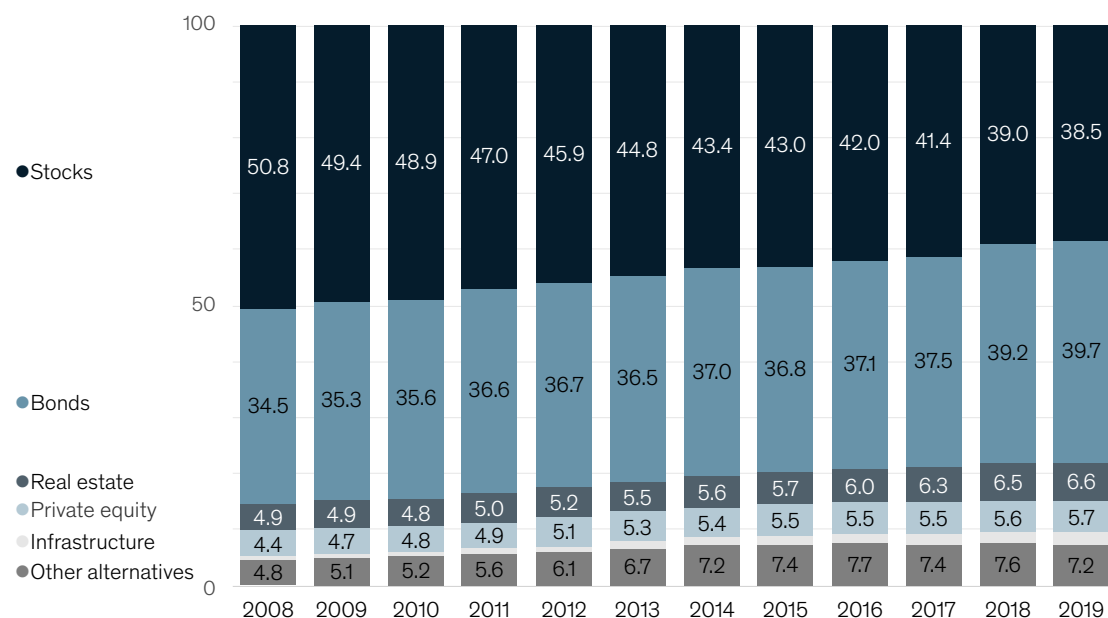
portfolios, having increased 1.3 percentage points since 2008 (Exhibit 14). Still, LPs widely consider themselves underweight by an average of one to three percentage points. With the early signs of re-acceleration in fundraising now in place, forward-looking AUM growth seems poised to continue.

Beyond growing institutional investor allocations to private equity, new sources of capital are helping to fuel growth. For example, GPs have been ramping up fundraising efforts with retail

⁷ Preqin Investor Survey, August 2020.

Investors are steadily increasing allocation to alternatives.

Institutional investors' portfolio allocations, 2008–19, %



Source: CEM Benchmarking

investors. In 2020, the SEC reduced income requirements for “accredited investor” qualifications, retaining the lone requirement that investors must obtain certain professional certifications from accredited institutions such as FINRA or RIA. Further, the US Labor Department in June approved private equity inclusion in defined-contribution plans such as 401(k)s—a \$6.2 trillion market—provided careful consideration is given to fees and risk. Liquidity needs mean that wide-scale adoption may take a few years, but the wheels have been set in motion.

Industry performance

As previously described, private equity has remained the highest-returning asset class in private markets, with a 13.3 percent median return for 2007–17 vintage funds as of September 30, 2020. Among private equity sub-strategies,

venture capital continues to be a bright spot. The median net IRR for VC and growth equity funds in vintage years 2007–17 is 14.1 percent, compared with 13.0 percent for buyouts (Exhibit 15).

Over the past year, a long-running public debate has gained attention: whether private equity has earned its illiquidity premium and truly created more value for investors than have the public markets. The short answer is yes. Private equity has outperformed public markets quite consistently.

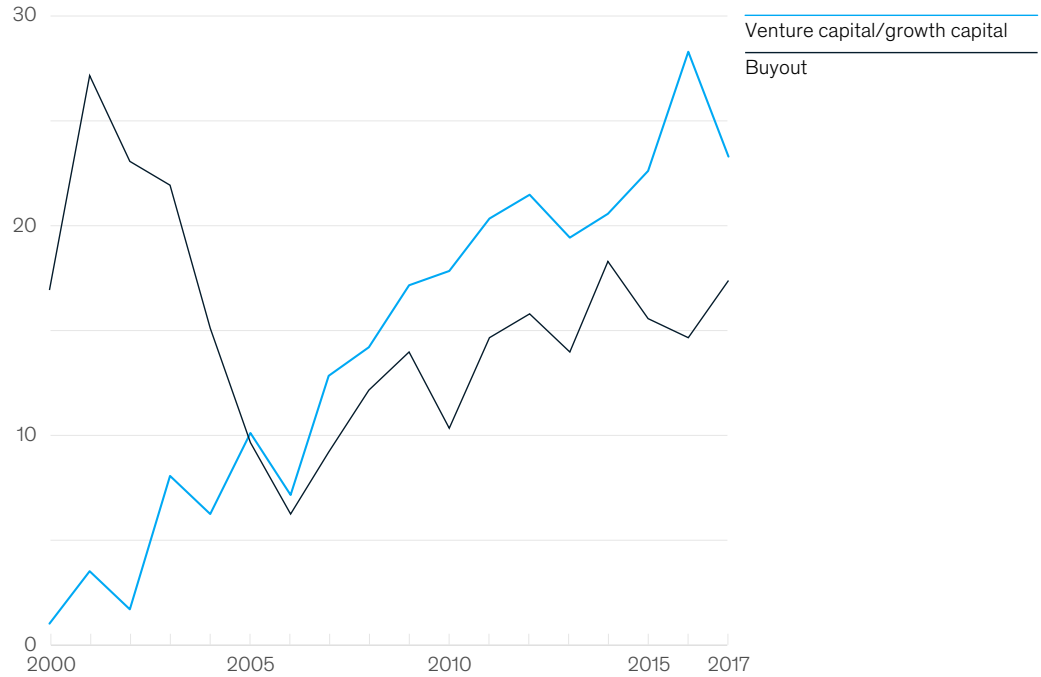
First, private equity has outperformed reasonable public market benchmarks over the last five-, ten-, and 20-year periods. On a pooled basis, private equity has produced a 14.3 percent annualized return over the trailing ten-year period, beating the S&P 500 return of 13.8 percent by 50 basis points.⁸ Over the trailing 20-year period, outperformance

⁸ Through September 30, 2020, inclusive of vintage years 1978–2017.

Exhibit 15

Global venture capital funds have outperformed global buyout funds in pooled internal rates of return (IRRs) for vintages 2007–17.

Global private equity fund performance by asset type,¹
pooled internal rate of return per vintage, %



¹Fund performance assessed using pooled IRR and calculated by vintage year. Asset type classifications are assigned by the underlying portfolio companies; if 70% of capital is invested in a single asset type, that will be the fund classifications. A fund can only have one asset type classification. Source: Burgiss

has been even greater: private equity has produced a 9.9 percent annualized return, beating the S&P 500 return of 6.4 percent by 350 basis points.⁹

A more nuanced view requires choosing comparisons specifically: which data set, public market equivalent (that is, benchmark), time period, and so forth. In 2020, some market observers made a splash by cherry-picking among these variables and highlighting the rare combination of factors that would make public markets appear to have outperformed. Such analyses garnered much press but appeared to convince few LPs or others

with experience deploying capital. Without belaboring the analytical choices, suffice it to say that the most in-depth research—whether conducted by academics,¹⁰ benchmarking firms,¹¹ or industry participants themselves¹²—affirms that, by nearly any measure, private equity has continued to outperform public market equivalents. This conclusion holds over multiple time periods and against large-cap or small-cap benchmarks.

The most commonly accepted measure of private equity performance, public market equivalent (PME) performance, considers the timing of capital

⁹ Through September 30, 2020, inclusive of vintage years 1978–2017.

¹⁰ Steven N. Kaplan, “What do we know about private equity performance?,” University of Chicago, August 2020.

¹¹ CEM Benchmarking, cembenchmarking.com.

¹² Hamilton Lane, hamiltonlane.com.

Hamilton Lane finds that buyout pooled returns have outperformed on a PME basis against the MSCI World for all but one vintage year (2010) over the last 20 measured vintage years (1999–2018).

calls and distributions, synthetically investing those cash flows into the public markets (thus creating equivalency). Using this methodology, Professor Steve Kaplan finds that, of the 20 vintage years between 1996 and 2015, buyouts in only one vintage year (2008) have underperformed their respective public market equivalent return. This finding holds mostly true whether measured against the S&P 500 or the Russell 2000, though the 1998 vintage underperformed the Russell 2000, a factor driven by the boom and bust of the dot-com era.¹³ Using a different index, Hamilton Lane reaches a similar conclusion, reporting that buyout pooled returns have outperformed on a PME basis against the MSCI World for all but one vintage year (2010) over the last 20 measured vintage years (1999–2018).

For venture capital, the story is one of two distinct eras, with recent performance exceeding that of funds raised in the early 2000s. Kaplan finds that the median US venture capital fund in all vintages 2000–08 *underperformed* respective PMEs, while all vintages 2010–15 have *outperformed*. In VC, LPs do not target the median return, as home-run exits play an outsize role in industry

performance. Considering that effect, on a pooled basis, VC has collectively outperformed in all but two vintages since 2003.

Though private equity at the industry level continues to outperform, achieving industry-level performance requires careful manager and fund selection. Further, most LPs invest in private equity with the expectation of outperformance, and private equity teams at institutional investors are often measured against their ability to outperform the median. There is good reason behind that rationale. The difference between top- and bottom-quartile performance is worth more than 1,000 basis points in IRR. Where there is opportunity for outperformance through manager selection, there is nearly equivalent downside risk.

Within buyout, fund selection risk and opportunity are largely correlated with fund size. The median performance of buyout funds is comparable across funds of all sizes. The median performance for funds worth \$2 billion to \$5 billion is essentially equivalent to that of funds greater than \$10 billion, for example. However, fund selection risk lies in the outliers, and the dispersion in returns between top-performing

¹³“What do we know?,” August 2020.

and lower-performing funds of \$2 billion to \$5 billion—roughly 30 percentage points in net IRR—is nearly twice that of funds greater than \$10 billion (Exhibit 16). For this reason, many LPs focus their efforts on manager cultivation and selection within the middle market.

Driven by large dispersion between top and bottom performers, manager and fund selection go a long way in determining portfolio-level performance for LPs. The wrinkle for LPs is that the task has only grown more challenging. As we noted last year, the

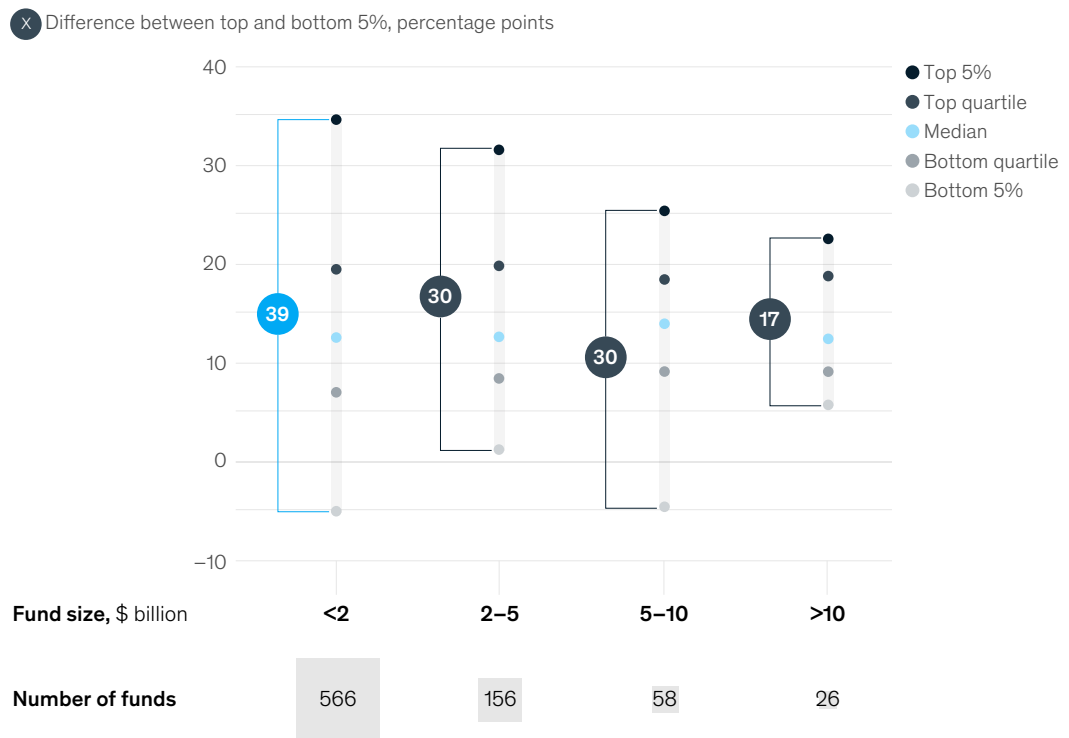
persistence of performance at the PE firm level has declined considerably over time, though there is some evidence that performance persistency exists for individual decision makers, such as deal partners.

Though performance persistency may have declined, the impact of performance on a GP's ability to raise capital in a subsequent fund has not. Together with Hamilton Lane, we studied growth within a fund family (defined as the next vintage of a given strategy) against performance of the fund's

Exhibit 16

Median returns for buyouts were similar across fund sizes, with larger spread in returns for small-cap buyout funds.

Global buyout fund percentile performance over 2000–20 for buyout funds raised in 2000–17,¹ IRR for 2000–17 vintage funds,² %



¹Fund performance assessed using internal rate of return calculated by grouping performance of 2000–2017 vintage buyout funds during 2000–2020. Some data not available for certain periods.
Source: Burgiss

immediate predecessor *at the time that fundraising of the successor vehicle launched*. The relationship holds as one might anticipate. Better performance leads to higher growth. In the studied sample, top-quartile funds grew the successor vintage 30 percent, on average, while second-quartile funds grew the next fund 19 percent. Performing below the median is penal: third-quartile funds grew successor vehicles just 5 percent, while bottom-quartile funds shrank 6 percent, inclusive of many funds unable to raise a follow-on vintage because of that poor performance. Though many GPs have invested in professionalizing their marketing and distribution capabilities to enable growth, investment success remains a top contributor to that objective.

For LPs, the key question, of course, is the impact of growth on performance. “Asset gathering” has long been the bugbear of LPs, wary that fund growth may distract the attention or sap the motivation of top deal makers from creating the very outperformance that enabled that growth. An analysis of North American buyout funds with vintages of 2000–17, however, reveals that fund growth has no statistical impact on performance.

The growth rate of a given fund relative to its predecessor has limited predictive value in determining the performance quartile that a fund achieves, even for funds that more than doubled their respective predecessors. This finding is consistent with earlier research on the topic. The evidence suggests that LPs may not need to be concerned with growth within a fund family.

Deal activity

Private equity deal volume globally fell 22.5 percent in 2020. While the data on deal volume are far from final—most years, data continue to be refined for several months after year-end—in any case this is in marked contrast to a decade of near-constant growth. With just over \$1.1 trillion in total volume, 2020 was the lowest year since 2015. Most of the decline occurred in the second quarter at the peak of pandemic-related uncertainty, as existing deal processes were put on pause and GPs focused on triaging their portfolio companies. The quarter’s \$208 billion in transaction volume was a decline of 43.9 percent from the second quarter a year earlier.

30%

Better performance begets higher growth. In the studied sample, top-quartile funds grew the successor vintage 30 percent, on average, while second-quartile funds grew the next fund 19 percent.

The rest of the year, then, was a comeback story. Spurred by the reopening of capital markets and businesses and by increasing confidence in remote interactions for deal processes across the investment community, deal activity resumed apace. Amplifying this rebound, central banks in the United States and Europe quickly began infusing their economies with trillions of dollars; this massive influx of liquidity increased investor confidence across public and private markets. Third-quarter deal volume increased 34.8 percent over the second quarter, and the fourth quarter added another 15 percent (bearing in mind that Q4 deal volume is often revised upward when final data is available) (Exhibit 17).

The decline in deal activity was broad based but not uniform. North America experienced the greatest shock, with volume falling 24.1 percent to \$631 billion and number of deals down by

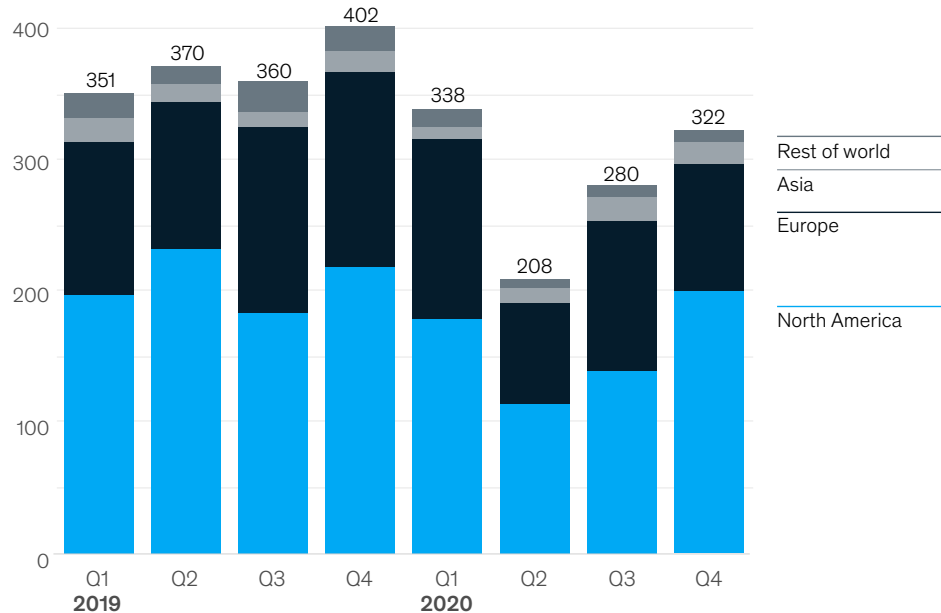
17.8 percent (Exhibit 18). European deal activity slowed to \$423 billion, down 18 percent from the prior year, with deal count falling by 18.7 percent. In Asia, where deal volume had already fallen 35.7 percent from 2018 to 2019, 2020 deal volume was relatively resilient, declining just 8 percent to \$57 billion.

At a sector level, investments in technology companies proved most resilient, with volume dropping just 5 percent in 2020 relative to the 22.5 percent drop for global PE as a whole. Investors in both private and public markets favored the sector, as demand for cloud, software, e-commerce, and other tech-related services boomed in a global economy rapidly transitioning to virtual work. Many view the pandemic as having accelerated the shift toward technology, suggesting that the sector may continue to see an outsize share of investor interest.

Exhibit 17

After a 38 percent quarter-over-quarter drop in Q2 2020, global private equity deal volume gained momentum through the rest of the year.

Global private equity deal volume,¹ \$ billion



¹Includes private equity (PE) buyouts and leveraged buyouts, PE growth and expansion, and platform creation. Source: Pitchbook

Multiples and leverage

In a highly volatile year for valuations, purchase multiples continued a decade-long upward march. In 2020, investors paid an extra turn on every dollar of earnings before interest, taxes, depreciation, and amortization (EBITDA), and the two-year rolling average multiple expanded from 11.9 times to 12.8 times (Exhibit 19). Part of that resilience was driven by low deal volumes in the second quarter, when sellers waited for prices to emerge from the trough. To put multiple growth over the decade in context, an investor in 2020 paid at least 30 to 40 percent more than would have been necessary a decade ago to acquire the same EBITDA (depending on the reference year).

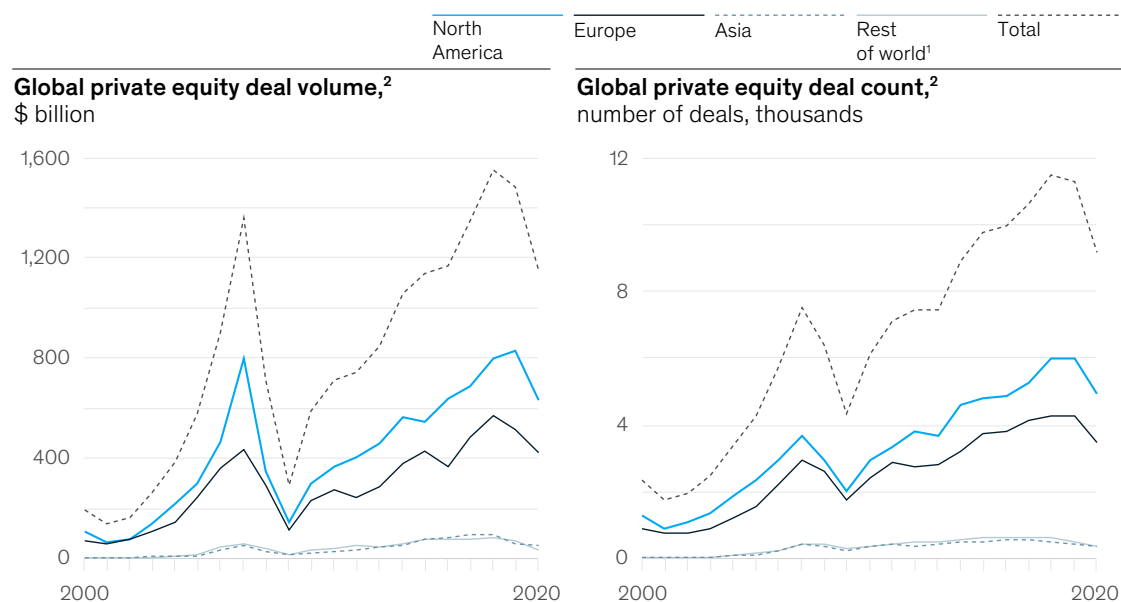
Sector mix plays a role in average valuations in any given year. In 2020, rapid growth in the technology sector in both public and private markets has

pushed multiples upward, as investors pay up for higher growth. In 2020, tech increased its share of deal volume from 18.5 percent to 22.7 percent, with a 5 percent decline in tech volume, versus a 22.5 percent decline overall. The year included several tech deals in excess of \$15 billion, providing a tailwind for multiples in general. The tech-driven tailwind may continue, as PE funds dedicated to the space have outperformed. Tech-focused buyout funds have generated pooled IRRs 6.4 percentage points higher than those of nontech funds over the last decade.

In response to record-high multiples, private equity firms are taking two approaches in underwriting. First, GPs are doing more to underwrite value creation, increasingly pressure-testing specific opportunities for EBITDA expansion during the due diligence phase. Second,

Exhibit 18

Private equity deal volume declined by approximately 20 percent from 2019 to 2020.



¹Rest of world (ROW) includes all regions outside North America, Europe, Asia.
 ²Includes private equity (PE) buyouts and leveraged buyouts, PE growth and expansion, and platform creation.
 Source: Pitchbook

a growing number of firms are underwriting an expectation for multiple contraction to ensure a deal still makes financial sense in a less favorable market environment upon exit.

Debt was cheaper still in 2020, and real government rates approached or fell below zero in several countries. GPs took advantage, adding more than a quarter turn of leverage from 2019 (Exhibit 20). As markets rebounded late last year, leverage climbed even higher, crossing the seven-times threshold for deals completed in the fourth quarter of 2020. PE leverage multiples are now higher than in any period since before the GFC.

Dry powder

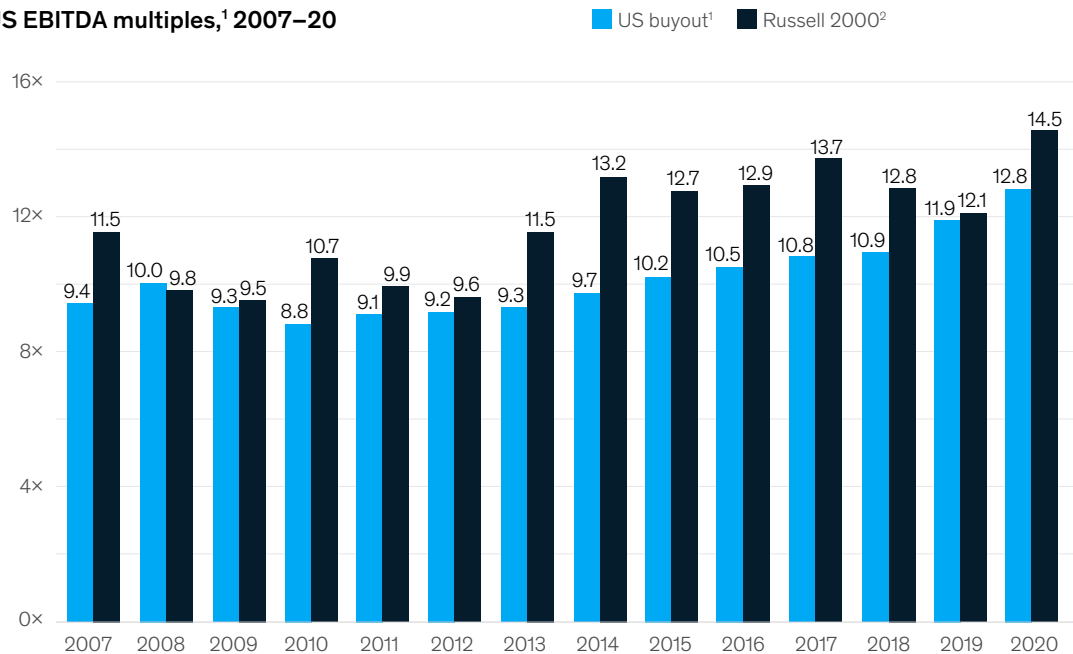
Private equity dry powder stands at \$1.4 trillion (60 percent of the private markets total) and has grown 16.6 percent annually since 2015. Dry powder

stocks are best viewed in the context of deal volume, and as a multiple of average annual equity investments over the prior three years, PE buyout dry powder inventories have crept higher, growing 11.9 percent since 2017. However, normalizing for abnormally high deal volatility in 2020, PE dry powder as a multiple of deal volume remained largely in line with historical averages (Exhibit 21).

Dry powder growth reflects fundraising in excess of capital deployment. Its continued growth in 2020 highlights a common misperception among industry participants and pundits: the belief that stocks of dry powder can be deployed quickly in a market correction. While fundraising fell sharply in the first half of 2020 (–22.8 percent relative to the first half of 2019), so too did deal volume (–22.5 percent). Despite the sharp (and short-lived) decline in mark-to-market valuations in the first half of 2020, PE investors were largely

Public and private valuations ticked higher in 2020.

US EBITDA multiples,¹ 2007–20



¹Two-year trailing average multiple of purchase price to earnings before interest, taxes, depreciation, and amortization (EBITDA).
²Two-year trailing average multiple of enterprise value to EBITDA as of Q1 2021.
 Source: Refinitiv LPC; S&P Capital IQ

unable to take advantage, as private owners exercised a key feature of PE—the right to hold. Without willing sellers, dry powder stocks rose once again, piling pressure on deal multiples, which once again reached all-time highs in 2020.

Permanent capital

Fundraising in traditional closed-end private-equity-style vehicles has soared across private markets asset classes for more than a decade, and though 2020 saw a softening, it was still the fourth-highest year on record. Even this understates total fundraising growth, however, as many private markets GPs have successfully expanded their capital bases to include “permanent” capital. In recent years, there have been three main avenues through which GPs have sought permanent capital: long-dated fund vehicles, acquisitions or partnerships in the

insurance space, and sales of an interest in the GP itself (“GP stakes”). In 2020, the SPAC reasserted itself as a fourth such avenue.

Long-dated fund vehicles

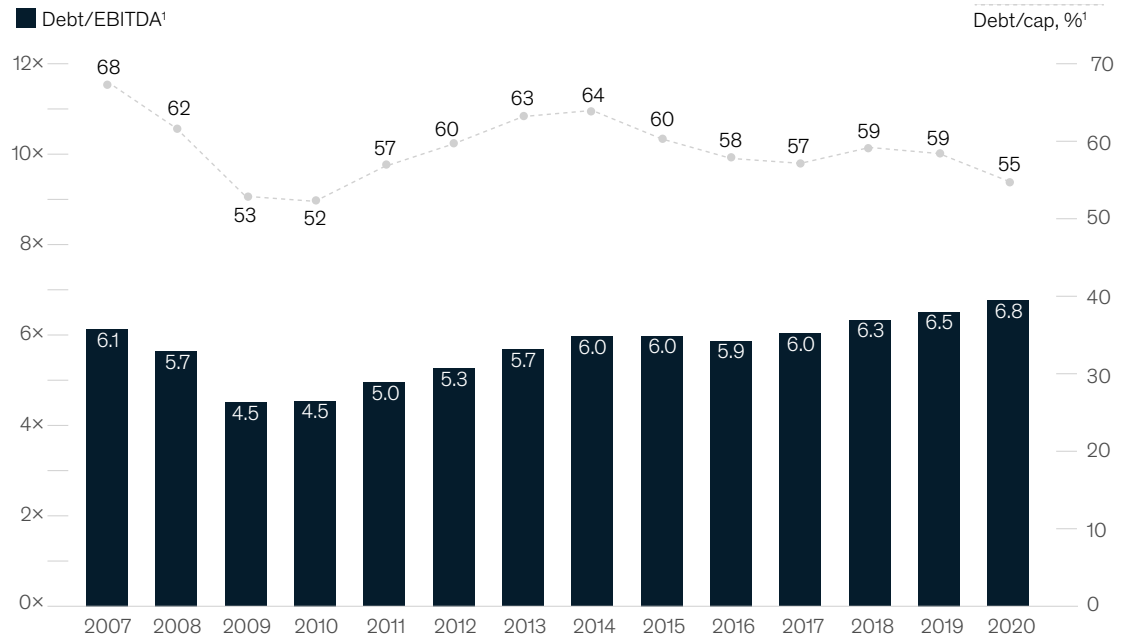
Long-dated private equity funds have grown in popularity in recent years. This new class of funds spans as long as 15, 20, or even 25 years. Since 2015, the 15 largest long-dated funds have raised, collectively, nearly \$50 billion in capital. This trend continued in 2020, with long-dated funds raising over \$13 billion despite the turbulence.

Among other benefits of the structure, GPs cite the opportunity to take a longer-term outlook on underwriting, choosing companies with growth profiles that may be less certain in the short term but more attractive over time, while also giving operational improvements more time to bear fruit. Fund vehicles like this also confer greater flexibility

Exhibit 20

US buyout leverage approached 7× in 2020.

US buyout debt multiples and debt share, 2007–20



¹Two-year trailing averages.
Source: Refinitiv LPC

to invest in businesses hitched to longer-term macroeconomic shifts, with less pressure to sell “good” companies simply because the fund vehicle is nearing the end of its contractual life. And, statistically, the odds of an economic contraction negatively impacting exit timing are lower when sellers have greater flexibility on time horizon; their hope is that this may prove to limit volatility across vintage years as this trend plays out over time.

For LPs, long-dated commitments can also reduce underwriting volume, meaning fewer new annual fund commitments. Many managers of such funds market lower target IRRs but anticipate higher multiples of paid-in capital through the life of the fund. Whether the promise

proves true and whether LPs favor that trade-off in the medium term will likely determine whether the recent popularity of long-dated funds is sustained.

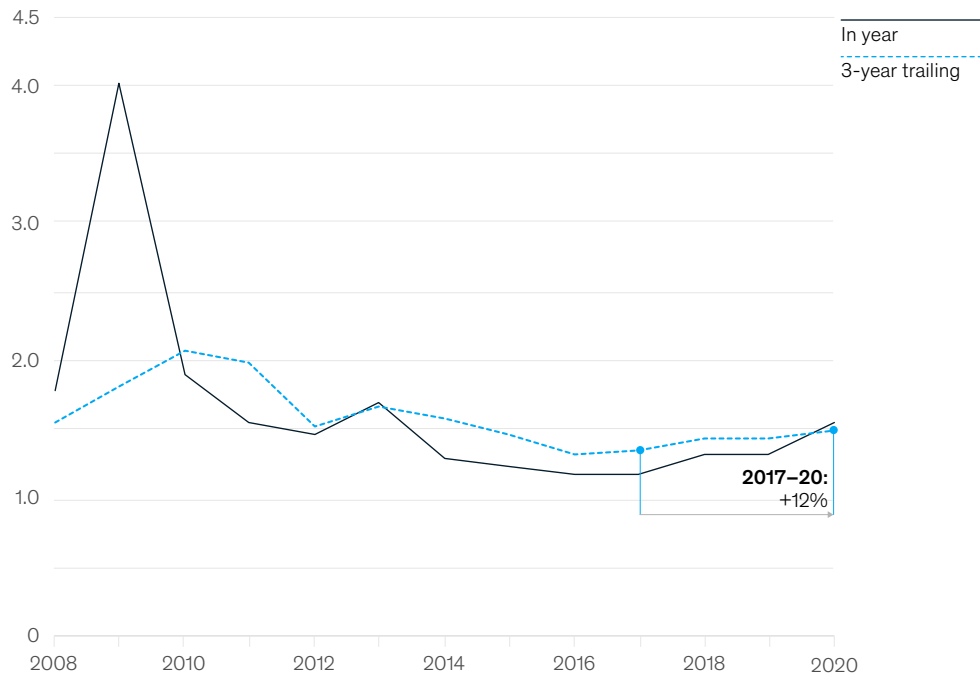
Insurance assets

GPs have targeted an even more “permanent” form of capital in recent years: insurance company balance sheet capital which they or affiliates come to control. In 2020, over \$75 billion of liabilities were acquired or reinsured by GP-affiliated entities in the United States, and insurance-related capital now accounts for 15 to 40 percent of total assets under management for some of the world’s larger PE firms.¹⁴ From a product standpoint, given the regulatory restrictions associated with insurance-backed liabilities, the majority of insurance AUM

¹⁴Ramnath Balasubramanian, Matthew Scally, Ruxandra Tentis, and Grier Tumas Dienstag, “Creating value in US insurance investing,” November 2020, McKinsey.com.

Global inventories of dry powder have continued to inch up.

Years of private equity inventory on hand,¹ turns



¹Buyout only. Adjusted for lower 2020 deal volume. Capital committed but not deployed, divided by equity deal volume. Equity deal volume estimated using transaction volume and leverage figures.
Source: PitchBook; Preqin; McKinsey analysis

is directed to fixed-income strategies, with only a small portion invested in private equity or real estate. Indeed, certain GPs have used this type of capital to fuel the growth of credit platforms that have become as large as or larger than their PE franchises.

Insurance capital supports GPs' business models in two primary ways. First, similar to long-dated funds, the enduring nature of this capital (as the assets typically back long-term life insurance liabilities and annuities) reduces GPs' fundraising burden (and expense) while increasing through-cycle investment flexibility. Second, it provides a "captive" stream of fee income to the GP.

As the persistent "lower for longer" rate environment puts even more pressure on insurance balance sheets, and as insurers seek higher returns to meet their commitments and obligations to policyholders and regulators, the industry is likely to see continued growth in GP insurance capital in coming years. General account liabilities of more than \$2 trillion remain on traditional insurers' balance sheets, representing a large pool of target assets for GPs.

GP stakes

Perhaps the most "permanent" of permanent capital varieties is the selling of GP stakes. A relative curiosity a decade ago has become almost commonplace today, facilitated by the continued growth of investment strategies specifically

targeting a share of ownership in alternative investors' management companies. Fundraising in 2020 reached \$22 billion by the third quarter for GP-stakes-focused strategies to complement 2019's record haul.¹⁵

LPs see investing in GP stakes as a way to acquire long-term exposure to high-performing managers, with an additional benefit being the effective (though very modest) discount they may obtain on management fees and carry—a portion of which are returned to the LP as a minority owner. For GPs, selling a stake is a convenient means to build a “balance sheet” of capital that can be more flexibly deployed than that managed within fund vehicles. Often, these dollars are used to monetize illiquid management company ownership interests to facilitate founder succession. They can also be reinvested in the firm itself, however, without impacting earnings or margins. When utilized in this way, this capital base can serve to finance acquisitions, modernize firms' operational and technological capabilities, and seed new funds, products, and origination platforms.

SPACs

Special-purpose acquisition companies (SPACs) have a single structural purpose: merge with a company in order to take it public (a process called deSPACing). SPACs undergo a regular IPO process insofar as sponsors file with a regulatory body such as the Securities and Exchange Commission (SEC) and publicly list their shares, before then finding and executing a “reverse merger” with a private company to create a joint public entity. SPAC IPOs afford sponsors great flexibility, with few constraints on the choice of target—hence the term “blank check” companies.

Though they have existed for decades, SPACs experienced a surge in popularity in 2020, accounting for 248 out of the year's 450 US IPOs.¹⁶ The 248 SPAC IPOs attracted unprecedented sums of capital, raising over \$83 billion in total with an average IPO size of \$335 million—up almost 50 percent from the year prior. As of April 2021, more than 400 SPACs actively seeking business combinations held about \$140 billion of capital, per Citadel Securities, as managers and investors continue to sponsor the vehicles.

¹⁵ Includes closed and actively raising funds.

¹⁶ SPACInsider, accessed February 10, 2021.

3 Real estate falls with the pandemic

Real estate had a particularly challenging year in 2020—little surprise given the constraints on gathering and mobility imposed by the pandemic. Fundraising fell broadly across geographies, strategies, and vehicle structures. In-year performance was better than many expected, though mark-to-market valuations were volatile by quarter and differed substantially by subsector (such as office). Preexisting trends in real estate investment management continued, including AUM share growth in open-end core-plus vehicles, and the pandemic has likely placed even greater

emphasis on through-cycle performance. In the United States, the switch to remote collaboration has challenged office valuations, and the transition to a hybrid experience leaves many questions unanswered. A rapid shift to e-commerce and new omnichannel habits (such as online purchase, in-store pickup) is a headwind for retail but a tailwind for industrial; moreover, those two sectors are converging. Whereas the last decade brought strong tailwinds for performance across most assets, outperformance going forward will require more creativity, technology, science, and tenant centricity.

Closed-end funds

Global fundraising in closed-end vehicles fell 31.7 percent year-over-year to \$130.2 billion, with third-quarter fundraising down more than 50 percent from the previous quarter, as the pandemic took its toll on the office, retail, and lodging spaces. The decline in fundraising was severe across the globe, with declines of more than 35 percent in the Americas and Asia and 24 percent in Europe. In total, 2020 was the weakest fundraising year since 2012.

The decline in fundraising was not uniform among investment strategies, however (Exhibit 22). Opportunistic fundraising fell 56.1 percent, while value-add fundraising actually grew by 12 percent. Those making commitments to real estate in 2020 perhaps traded down the risk spectrum amid uncertainty, but the year-over-year decline in opportunistic fundraising was exaggerated by a near-record year in 2019, when two of the three largest closed-end funds ever raised over \$15 billion each. Taking a slightly longer view, opportunistic fundraising fell 16.8 percent per annum between 2018 and 2020, in line with the decline in value-add fundraising.

Unsurprisingly, closed-end real estate fund performance declined year over year, driven by weak performance in the first quarter. Over the trailing 12 months ending September 30, closed-end real estate returned -0.8 percent (Exhibit 23). It is clear that the pandemic-driven performance decline in 2020 has hurt nearer-term returns, but real estate remains the second-highest-performing private markets asset class over the last decade, trailing only PE and producing a ten-year-horizon IRR of 10 percent.

Open-end funds

Open-end core and core-plus vehicles fared better in 2020 than their value-add and opportunistic counterparts.¹⁷ As represented by the National Council of Real Estate Investment Fiduciaries

Open End Equity (NFI-OE), which includes large, diversified US core and core-plus funds (\$271.2 billion in NAV), gross contributions through 2020 fell 28.9 percent year over year. Yet with the exception of a few noteworthy funds that faced outsize distributions, investors largely stayed the course, and distributions and redemptions fell 19.4 percent through 2020 relative to 2019. In total, net distributions as a share of beginning NAV fell just 0.4 percent, and the total value within this large and representative fund group finished the year up 2.9 percent in total NAV.

NFI-OE funds returned 1.4 percent in 2020 and 6.1 percent per annum over the trailing five-year period net of fees. As is sometimes the case, public real estate investment trust (REIT) returns, influenced by supply and demand for shares as well as the free cash flow generated by the underlying properties, disconnected from private real estate returns in 2020. Whereas private market funds mark at NAV, public REIT valuations can trade at a premium or discount to NAV, and total return for investors does not always match the performance of the underlying holdings. The NAREIT All Equity REIT index returned -5 percent in 2020.¹⁸

AUM

Within closed-end funds, AUM growth was surprisingly sturdy, despite the decline in fundraising and stifled returns. Some of this growth can be explained by growing dry powder stock and a reluctance among GPs to sell assets while valuations are down. Further, uncertainty over future inflows from large institutional investors during the height of pandemic-driven uncertainty resulted in many real estate investment managers choosing not to make any meaningful shifts or commitments. Globally, closed-end AUM grew by 4.6 percent in the first half of 2020, with strong growth in funds investing across emerging markets. In North America and Europe, AUM grew by

¹⁷ Core strategies typically are viewed as relatively low risk and most often include acquisitions of assets with stable occupancy and cash flow.

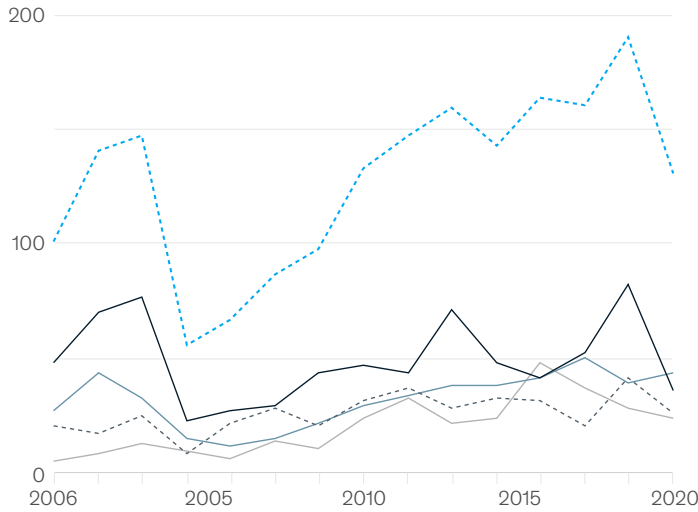
Core-plus investments indicate greater risk relative to core, whether due to cash flow stability, use of leverage, or other factors

¹⁸ "FTSE Nareit US real estate indexes," FTSE Russell, ftserussell.com.

Exhibit 22

Global fundraising in closed-end vehicles fell 32 percent year over year, but the decline was not uniform among investment strategies.

Global closed-end real estate fundraising by asset subclass,¹
\$ billion



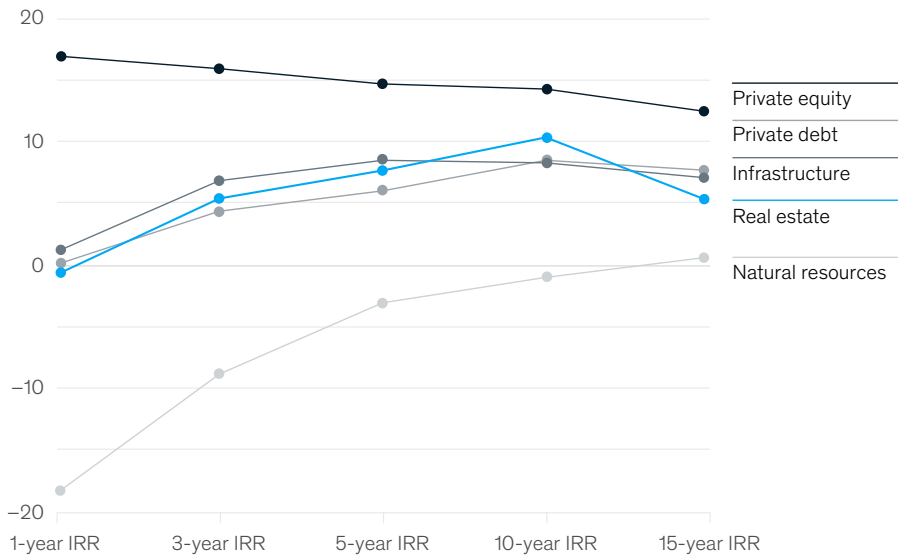
	2015–20 CAGR, ² %	2019–20 growth, ² %
Grand total	-4.0	-31.7
Value added	2.9	12.0
Opportunistic	-12.6	-56.1
Other real estate ³	-1.6	-35.9
Debt	1.7	-14.8

¹Excludes secondaries, funds of funds, and co-investment vehicles to avoid double counting of capital raised.
²Compound annual growth rate.
³Includes real estate core, core-plus, and distressed.
 Source: Preqin

Exhibit 23

Real estate underperformed, but long-horizon returns are strong.

Global fund performance over 2000–20 by asset class for global funds raised in 2000–17,¹
IRR² for 2000–17 vintage funds as of Sept 30, 2020, %



¹Fund performance assessed using IRR calculated by grouping performance of 2000–17 vintage funds during 2000–20. Some data not available for certain periods.
²Internal rate of return.
 Source: Burgiss

3.0 percent and 5.2 percent respectively. With these two regions constituting the vast majority of closed-end AUM, weaker performance there eclipsed double-digit growth in Asia and the rest of the world. The impact of these figures is perhaps lessened by a continuing trend: open-end core and core-plus vehicles capturing a growing share of assets under management. Over the last seven years through the end of 2019, global real estate AUM (excluding REITs and securities) has grown 8.0 percent per annum (Exhibit 24).

The fact that fundraising in open-end funds fell by less than fundraising in closed-end vehicles continues a longer-term trend of open-end vehicles taking share (Exhibit 25). There are three factors that may help explain this shift in investor preferences. First, the overlap between risk preference and vehicle type has created a tailwind: late in the cycle, investors rotated into lower-risk strategies, which tend to be open end (more on this below). Second, investors prefer control over the

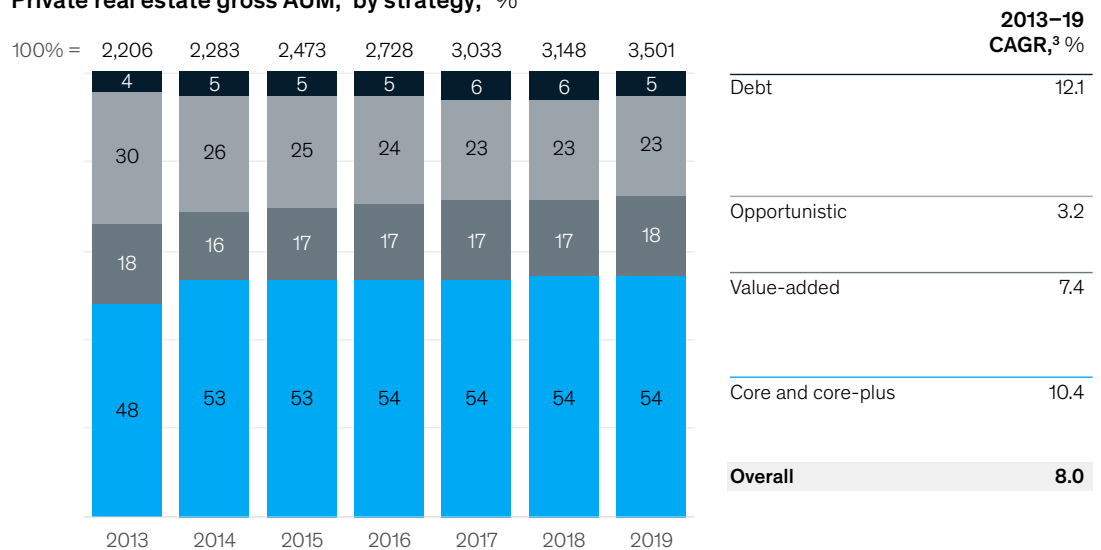
timing of their cash flows, and open-end funds allow LPs to add dollars and take distributions at their discretion, an option that includes hold periods well beyond the duration of a traditional closed-end vehicle. For investors trying to maintain long-term exposure to a less-correlated asset class, open-end vehicles are a more efficient way to do so. Finally, open-end funds offer investors a deeper understanding of their commitments, particularly for mature vehicles. As such, open-end vehicles offer a level of transparency that closed-end funds, which typically feature blind-pool investing, cannot match.

Market conditions in 2020 highlighted the key risk for GPs in managing open-end vehicles: that LPs can redeem shares when they need liquidity, similar to dynamics in the hedge fund space. This risk came to fruition for some managers in 2020, when some managers were forced to “gate” investors seeking redemptions. Still, on the whole, the open-end market seems to have weathered the storm

Exhibit 24

Private real estate fund flows have been shifting to lower-risk strategies.

Private real estate gross AUM,¹ by strategy,² %

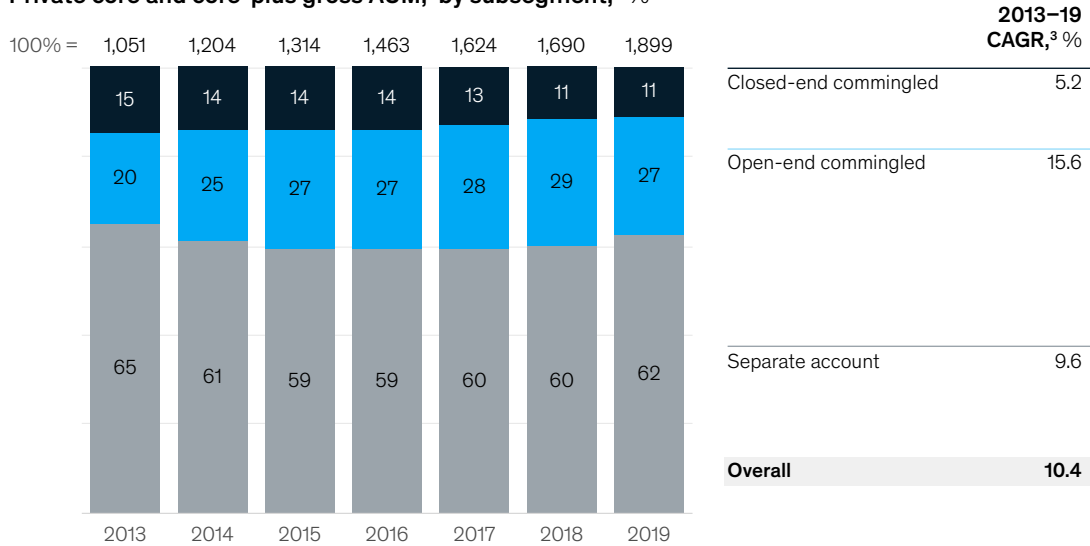


¹Assets under management.
²Excludes real estate investment trusts.
³Compound annual growth rate.
Source: Preqin; IREI; NCREIF; MSCI

Exhibit 25

Within core, capital has shifted toward open end.

Private core and core-plus gross AUM,¹ by subsegment,² %



¹Assets under management.
²Excludes real estate investment trusts.
³Compound annual growth rate.
 Source: Preqin; IREI; NCREIF, MSCI

relatively intact. Unlike in the GFC, no liquidity crisis erupted, and mass redemptions have yet to materialize.

Deal volume

Real estate suffered a precipitous decline in deal volume over the course of 2020, with global totals decreasing 26.4 percent year over year to \$833 billion, per CBRE Research (Exhibit 26). This was largely brought about by a substantial drop in the Americas, where deal volume fell 33.9 percent year over year, with declines of 16.9 percent in Europe, the Middle East, and Africa and 21.3 percent in Asia–Pacific. While the impacts of the pandemic were felt most heavily in the second and third quarters, volume rebounded strongly in the fourth

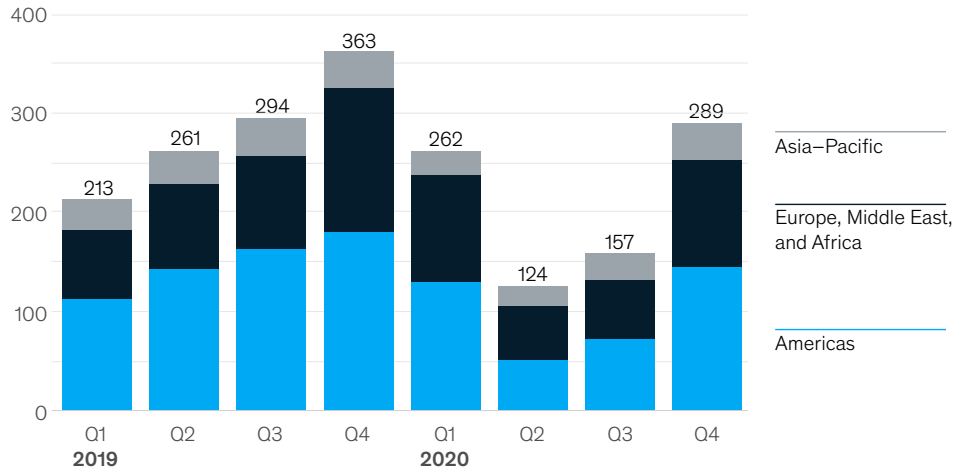
quarter. Despite record levels of dry powder and many GPs looking for relative bargains, most were unable to do so, as sellers held assets rather than transact at newly lower prices.

The pandemic’s effects on deal volume were not uniform across sectors. In the United States, for example, office transactions suffered the greatest decline from the first quarter to the second, dropping 67.8 percent (Exhibit 27). Retail transaction volume similarly dropped in 2020, falling less dramatically than office volume but also recovering less quickly. Multifamily transaction volume saw both a steep reduction from the first quarter to the second and a sharp recovery in the second half, while deal volume in industrial proved relatively resilient through the year.

Exhibit 26

Commercial real estate deal volume suffered during the pandemic.

Global commercial real estate deal volume,¹ \$ billion

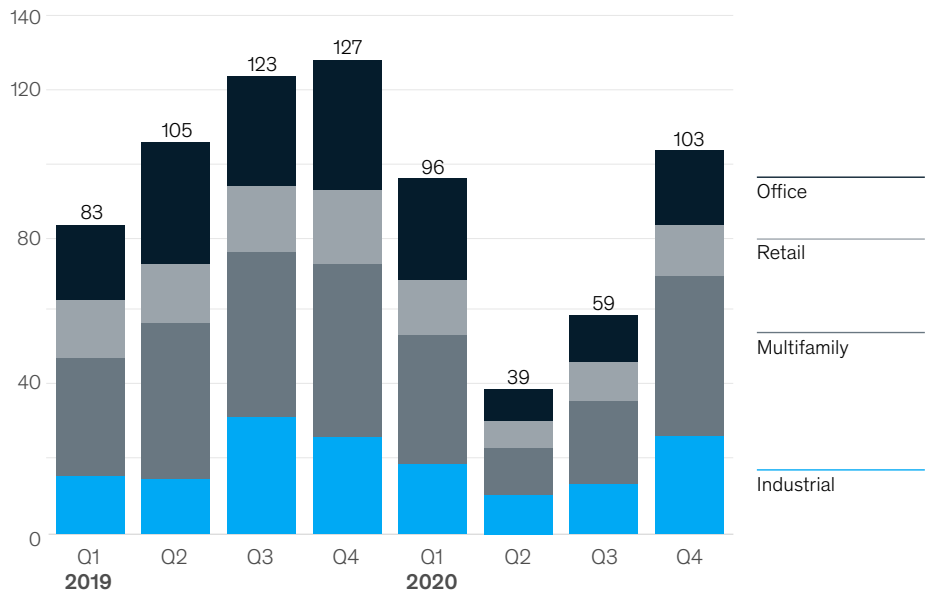


¹Values include entity-level transactions and exclude development sites. Fixed exchange rate, using most recent quarterly foreign-exchange rates of Q2 2020. Source: CBRE Research; Real Capital Analytics

Exhibit 27

Deal activity in industrial properties proved more resilient than in retail and office properties.

US commercial real estate deal volume,¹ \$ billion



Source: CoStar

Spotlight: In US real estate, dramatic divergence between sectors

Viewing real estate at the asset class level masks some of the most interesting and potentially durable shifts that occurred in 2020. Among the four major sectors in US real estate—industrial, office, retail, and multifamily—the pandemic-driven outcomes in 2020 and the forward-looking view differ meaningfully. Industrial properties largely sustained value, buoyed by a rapid shift to e-commerce and demands for shorter delivery times, which increased the demand for modern warehousing, while the other three major sectors declined. In all, it was a turbulent year that seems certain to reshape the physical and investment landscape for years to come.

Hybrid work takes hold

In-year office performance at the property level was remarkably steady in 2020, with rents coming in at about 95 percent of normal throughout the year, and delinquencies of 30 days or more holding below 3 percent each month. Despite extended closures, most tenants continued to pay rent, and owners continued to pay their lenders. Yet notwithstanding this steadiness in rent collection, uncertain demand has driven down valuations. Green Street reports that office REITs have lost 20 percent in unlevered value from the pre-pandemic market peak.

The pandemic caused a worldwide shift for knowledge workers to the remote workplace—an unplanned experiment that has gone better than many would have expected. Knowledge workers have broadly reported that they have enjoyed the experience. In a December survey of US office workers, 72 percent agreed with the statement “I love working from home.” Though that number remains high, it was even higher earlier in the year: in April, 80 percent agreed with the statement. Equally important, 68 percent of knowledge workers believe that they are *at least as* productive when working from home, a number that remained steady through 2020 (Exhibit 28).

Many employers are excited about the upside in increased levels of remote work, including greater talent access, heightened ability to collaborate across geographies, improved digitally enabled processes, and greater cost efficiencies. To be sure, the experiment has not proven positive for all participants. There are early indications that relationship building, community, mental health, and innovation have struggled during this new era of remote interaction. A year or so into the experiment, signs of employee burnout are becoming more apparent. A recent global study by the *Harvard Business Review* notes that 56 percent of those surveyed said that their job demands have increased. And beyond the demands of work, home life has suffered, in large part due to homeschooling. Strikingly, just 23 percent rated their well-being as good or excellent.¹⁹

Many organizations are now entering a new phase of the experiment with a greater focus on hybrid work. Remote and hybrid work are distinct. The efficacy of many learned practices established during the pandemic may wane when some employees are in the office while others are not. For knowledge workers, hybrid is likely to be the norm. In a recent survey, 46 percent of workers say they worked full-time in the office in January 2020, but just 30 percent anticipate doing so beyond the pandemic period (that is, after full vaccine distribution).

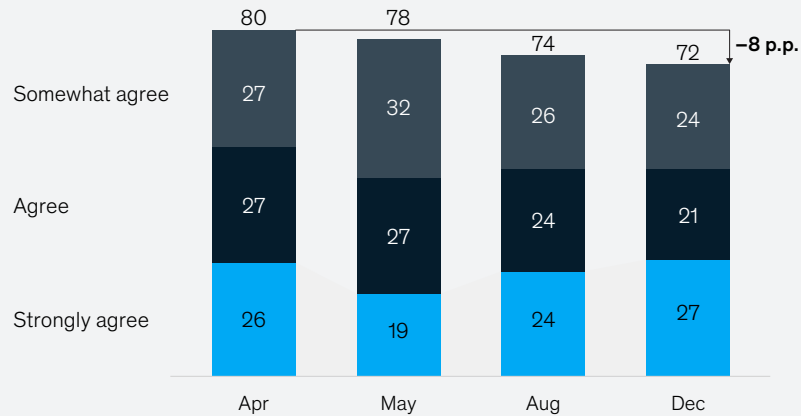
The future of the office is nuanced. Even some of those companies that have announced permanent work-from-home options are simultaneously signing major leases or building new headquarters. Organizations are seeking to combine the best elements of their historical operations with their most positive learnings from the pandemic. This reflection will lead companies to identify the moments that matter enough to require physical presence, which include collaboration, alignment, and community. Investors in the office space are eager to learn more about the optimal frequency of

¹⁹ Jennifer Moss, “Beyond burned out,” *Harvard Business Review*, February 10, 2021, hbr.org.

Exhibit 28

Majority of employees continue to believe they are productive at home, though that sentiment may be declining slowly.

How strongly do you agree or disagree with the following statement? I love working from home
 % of respondents working from home in the last 2 weeks



Source: McKinsey 2020 consumer survey, Apr 15–17 (n = 338), May 15–18 (n = 338); Aug 5–7 (n = 515); Dec (n = 556)

those moments—daily, weekly, monthly—for different types of businesses and employees, as the answer will impact the amount of space that office tenants need going forward. The answer will be unique to each company and to each role, so the volume of space required remains uncertain.

The office product will need to look and feel different going forward. Companies are increasingly recognizing a need for a seamless model of “work from anywhere” across office, home, coworking stations, and other places of work. Physical spaces must adapt to focus on the moments that matter, including greater demand for collaboration spaces rather than individual offices and cubicles. The company office experience must be sufficiently exciting to entice employees to leave the home office, and innovations need to emerge that can delight employees—for example, experiences,

amenities, food and beverages. Upon employees’ return, digital is expected to play an increasing role in the office experience, including room bookings, food ordering, concierge services, and facilitating health, safety, and wellness.

Office owners and operators may do well to start thinking of themselves more as solution providers, collaborating with their clients rather than focusing on negotiating standard lease terms. More flexibility is now required, both in lease structure and duration; few tenants are anxious to sign long-term leases for fixed spaces during this period of heightened uncertainty. Winning landlords will rethink their tenant strategy, focusing on physical spaces and amenities that will attract and retain highly desirable tenants. Collaborating with those tenants will enhance stickiness.

In total, there may be an oversupply of current spaces built for a pre-pandemic office environment, but there is also likely a scarcity of spaces and experiences purpose-built for the new hybrid world. Winning office investors and owners will have to adapt quickly.

Omnichannel shopping shifts the US retail and industrial landscape

The pandemic's impact on retail real estate was immediate and severely negative during 2020. Amid retail business closures and dramatically reduced foot traffic, in-person retail sales fell sharply, and tenants and landlords debated appropriate rent collection during full or partial lockdowns. Rents fell sharply in April and May before gradually recovering during the rest of the year. In US shopping centers, a particularly hard-hit subsector, rent collection fell to 49 percent of typical collections in May and had recovered to just 82 percent by September.²⁰ Thirty-day delinquencies across US retail jumped from 3.7 percent in April to 18 percent. As of December, 30-day delinquencies in retail remained just below 13 percent. Many have argued that the United States was already over-retailed, and the pandemic accelerated trends expected over the next two to three years. Over 30 prominent retailers filed for bankruptcy in 2020,²¹ with many using bankruptcy protection to exit unproductive leases or renegotiate terms. Some of these exits drove a cascading set of co-tenancy concerns for landlords, whereby other tenants can gain the contractual right to trigger alternative minimum rents or renegotiate leases altogether.

At a time when many shoppers could not go into their favorite stores, there was a considerable pickup in e-commerce penetration. According to credit card data from Earnest Research (Exhibit 29), the overall e-commerce penetration for leading retailers rapidly increased from about 25

percent in January–March 2020 to approximately 35 percent in April–May, a significant shift that represents years of e-commerce acceleration in just a few months.²²

Another consumer phenomenon in 2020 was the emergence of new shopping behaviors that blend the physical and digital. According to McKinsey's recent COVID-19 US Consumer Pulse Survey, more than 75 percent of Americans have tried a new shopping behavior during the crisis, and more than 70 percent overall intend to continue those behaviors. The kinds of new behaviors consumers will sustain and the final impact of that change on retail real estate will vary substantially by geography, specific location, property quality (such as A malls versus B malls), category (such as apparel), and brand. For example, Exhibit 30 shows the likelihood of consumers continuing behaviors for food purchases. Across categories, buying online with pickup in store (BOPIS) and curbside pickup are likely to become permanent fixtures of the shopping experience. New store formats that focus on experiences and enable omnichannel engagement will accelerate, which imply a different store network and a different box size for many retailers.

Finally, heightened demand for same-day delivery is causing retailers to rethink their supply chain and pushing demand for last-mile industrial. Whereas other sectors struggled, industrial rent collection sustained at 97 percent of normal or higher through the midsummer depths of uncertainty, and 30-day delinquencies across industrial assets remained below 2 percent. Entering the year with near all-time lows in vacancy rates and buoyed by e-commerce-driven demand, market rents grew for the vast majority of the top 50 US industrial markets.²³ Green Street estimates that RevPAF, a combined measure of occupancy and rent, grew 3 percent year over year, a slowdown of growth over the last

²⁰ "REIT industry September 2020 rent collections," NAREIT, September 23, 2020, reit.com.

²¹ Deborah Weinswig, *US and UK store openings and closures tracker, 2021 week 3*, Coresight Research, January 2021, coresight.com.

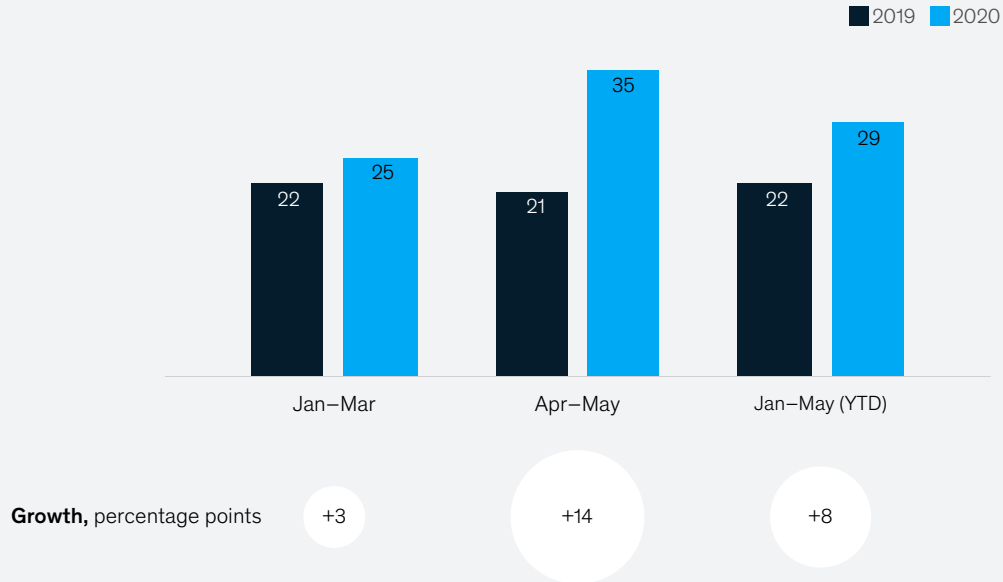
²² Earnest Research transaction data, including consumer credit/debit card and checking account transactions for a consistent subset of more than one million anonymous US consumers; excludes cash, SNAP, and check transactions; international tourist transactions; wholesale and B2B transactions; transactions made outside the United States; unbanked population (estimated 6.5 percent of US households, according to 2017 FDIC survey); and store card transactions (small proportion of overall sales manifested as balance paydowns, versus single POS transactions).

²³ Eric Frankel, Nick Fromm, and Ashleigh Clock, *U.S. industrial outlook*, Green Street Real Estate Analytics, January 2021, greenstreet.com.

Exhibit 29

Average retail e-commerce penetration

Average retail e-commerce penetration,¹
online transactions as % of total²



¹Retail defined as 540+ merchants in Earnest coverage. Selection leans more heavily on larger retailers and represents a smaller percentage of small and medium-size enterprises, with a significant portion of grocery and general-merchandise retailers.

²Based on Earnest Research transaction data, including consumer credit/debit card and checking account transactions for a consistent subset of >1 million anonymous US consumers; excludes cash, SNAP, and check transactions; international tourist transactions; wholesale and B2B transactions; transactions made outside the United States; unbanked population (estimated 6.5% of US households, according to 2017 FDIC survey); and store card transactions (small proportion of overall sales manifested as balance paydowns vs single POS transactions).

Source: Earnest Research

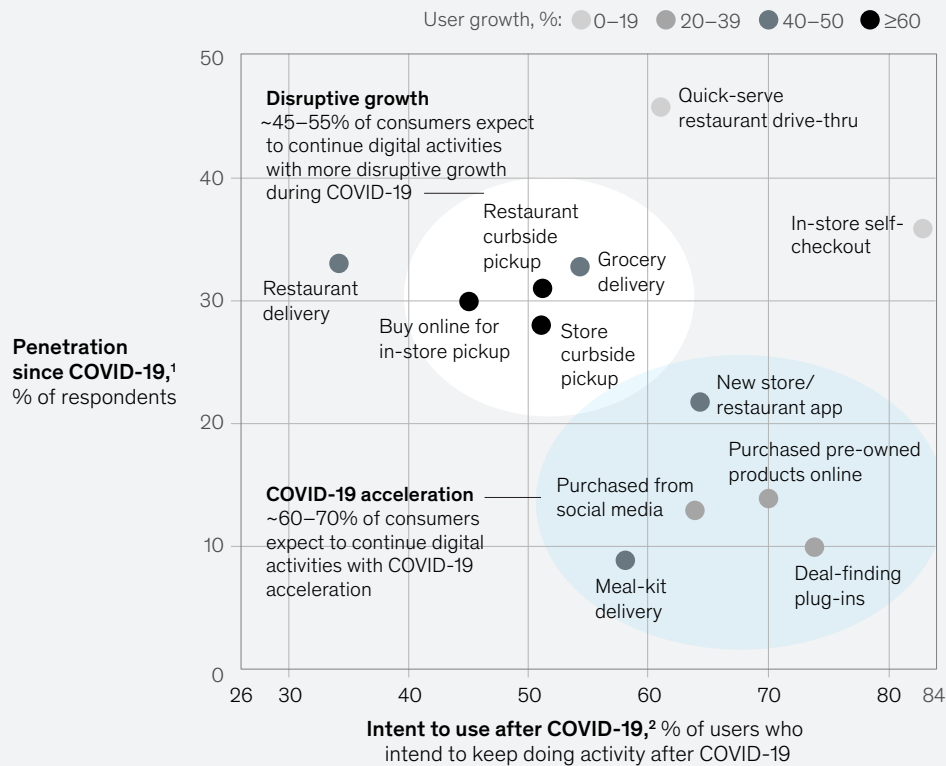
seven years but a highlight relative to other real estate sectors. In total, Green Street estimates that industrial property values fell just 2 percent on an unlevered basis from February 21 through January 4, 2021, making industrial the strongest-performing major real estate sector.

Despite a moderate slowdown in growth, industrial market participants have reason to believe in sustained demand, in part due to the impact of the shift to e-commerce and the shift to omnichannel. More space close to major population centers will be

required to enable last-mile distribution and to keep pace with online sales/e-commerce. CBRE estimates that every \$1 billion in incremental e-commerce sales will generate 1.25 million square feet of warehouse space, and JLL estimates that demand for industrial real estate could reach an additional one billion square feet by 2025.

Beyond simply *more* space, *different* industrial space is required to facilitate the current trends. By number, traditional warehouses and distribution centers built for pallet loading may lose share in

Consumers say most food-related pickup and delivery habits work for now; just over half report intending to continue after COVID-19.



¹Q: Which best describes when you have done or used each of these items? Possible answers included: "just started using since coronavirus started"; "using more since coronavirus started"; "using less since coronavirus started" or "using about the same since coronavirus started." Possible answers not included: "not using."
²Q: Compared to now, will you do or use the following more, less, or not at all, once the coronavirus (COVID-19) crisis subsides (ie, once there is herd immunity)? Possible answers: "will stop this"; "will reduce this"; "will keep doing what I am doing now"; "will increase this." Number indicates respondents who chose "will keep doing what I am doing now" and "will increase this" among new or increased users.
 Source: McKinsey & Company COVID-19 US Consumer Pulse Survey 2/18–2/22/2021, n = 2,076, sampled and weighted to match the US general population 18+ years

favor of micro distribution centers enabling pick-and-pack of single selling units optimized for rapid direct-to-consumer delivery. In addition, demand for industrial space will shift from more rural, low-labor-cost locations to property in close proximity to urban centers. Strong relationships with tenants—including large manufacturers, distributors, and third-party logistics operators—have always been critical to sourcing and executing accretive industrial opportunities, and that reality has only been exacerbated by the uncertain environment ahead. Industry and tenant selection are now even more critical.

Some assets will be successful, while many others will not. Investors and developers will need to be creative about space and look for redevelopment opportunities across asset classes (self-storage, multifamily, etc.) for unused space. The use of advanced analytics and nontraditional data (for example, mobile geolocation, credit card spend, COVID-19 impacts at the micro level) can be invaluable in helping to avoid properties destined for obsolescence and to invest behind the inevitable tailwinds that will arise.



4 Private debt: A port in the storm

Fundraising

Perhaps unsurprisingly, private debt proved to be the most resilient asset class in terms of 2020 fundraising. Global fundraising declined just 6.7 percent from 2019 levels, marking the sixth straight year that the asset class has garnered more than \$100 billion in commitments, after averaging just \$60 billion annually over the prior five-year period (Exhibit 31). Growth in private debt continues to be fueled by long-term secular trends—in

particular, the disintermediation of bank lending channels due to regulatory developments in the wake of the GFC, as well as sustained low interest rates on traditional fixed-income securities due to accommodating monetary policy.

In 2020, fundraising was also propelled by substantial appetite for credit strategies targeting the COVID-driven market dislocation. This was particularly true in North America, which saw

private debt fundraising increase by 15.8 percent over 2019 on the back of a strong second-quarter haul. While fundraising declined for direct lending strategies, which make up the largest portion of the private debt market, fundraising for distressed and special-situations strategies was resurgent. Second-quarter fundraising was partly fueled by “trigger” funds, in which institutional investors pre-commit capital to a fund strategy that is triggered upon a market dislocation. These structures facilitate timely deployment of capital toward investment opportunities that may prove short-lived. While overall fundraising dropped sharply in the third quarter, it rebounded in the fourth, which saw the raising of an \$11 billion mezzanine fund that is one of the largest in our data set since the GFC.

The outlook for private debt fundraising, furthermore, remains strong, with the number of active fundraises and total capital being targeted both at all-time highs in early 2021. The trend is amplified not only by continued secular growth in direct lending strategies but also by efforts to capitalize on opportunities that may arise as the crisis works its way through additional sectors of the economy. Investor interest in special-situations

funds doubled over 2019, according to Preqin, while interest in distressed strategies was up 20 percent.

AUM

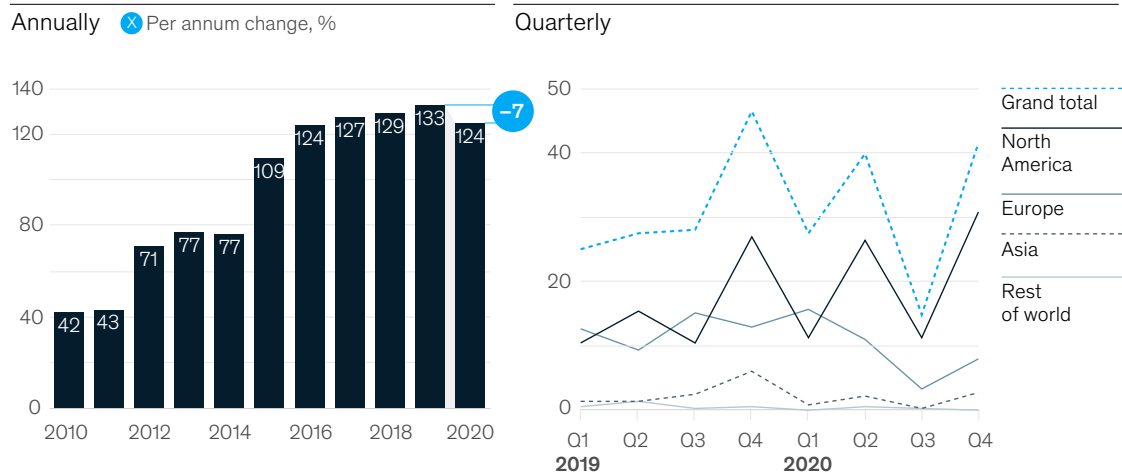
Private debt AUM grew just over 5 percent in the first half of 2020 and has now grown at a 12.8 percent CAGR since 2015. North America AUM still represents the lion’s share of global dollars (60.5 percent of total private debt AUM) and also grew the fastest last year (7.9 percent), but long-term growth has been highest in Asia (17.4 percent CAGR since 2015).

While it’s still early, the pandemic does not appear to have had the sobering impact on deployment trends in the space that might have been expected. Unlike during the GFC, when a near-complete shutdown of financing channels paralyzed deal making for months, credit markets in 2020 roared back in the third and fourth quarters of 2020. Both syndicated and direct channels finished 2020 in full “risk-on” territory, with deal making at a frenetic pace, leverage at all-time highs, and borrower-friendly covenant-light loans again becoming more common.

Exhibit 31

Global private debt fundraising declined 7 percent from 2019 levels.

Global private-debt fundraising by region,¹ \$ billion



¹Excludes secondaries, funds of funds, and co-investment vehicles to avoid double counting of capital raised.
Source: Preqin



5 Natural resources and infrastructure

Fundraising

Natural resources and infrastructure fundraising fell to just over \$100 billion globally in 2020, a decline of 19.1 percent year over year.²⁴ Fundraising in Asia was relatively stable, declining 3.9 percent, while fundraising in North America and Europe fell 17.6 percent and 25 percent, respectively. Taking a

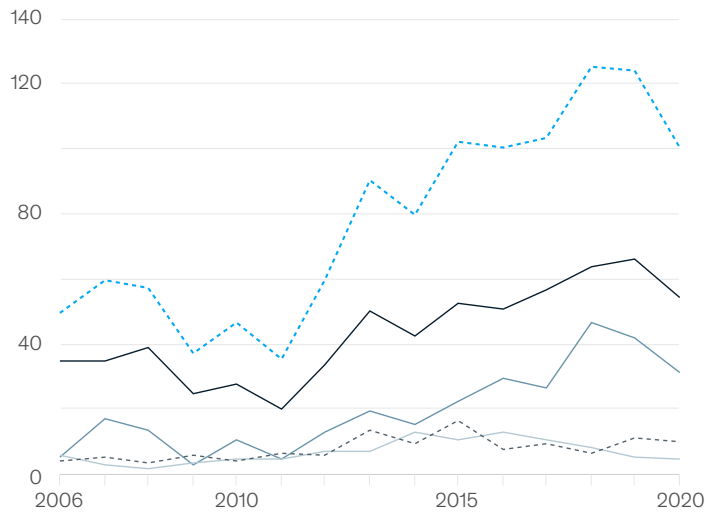
longer view, fundraising this year was in line with the five-year average, and the decline in 2020 was to an all-time high in 2018 and 2019 of approximately \$125 billion. Even after a relative down year, infrastructure and natural resources managers globally have now raised \$100 billion or more per year for six consecutive years (Exhibit 32).

²⁴ Natural resources and infrastructure are two distinct asset classes. However, the two overlap: fundraising and AUM data are usually kept aggregated, as most funds fall into both natural resources and infrastructure categories (Preqin categorization), with only a handful of funds truly differentiated.

Natural resources and infrastructure fundraising fell to just over \$100 billion globally in 2020.

Global infrastructure and natural resources fundraising by focus region,¹

\$ billion



	2015–20 CAGR, ² %	2019–20 CAGR, ² %
Grand total	-0.3	-19.1
North America	0.7	-17.6
Europe	6.9	-25.0
Rest of world	-9.9	-13.2
Asia	-14.9	-3.9

¹Excludes secondaries, funds of funds, and co-investment vehicles to avoid double counting of capital raised.
²Compound annual growth rate.
 Source: Preqin

Fundraising in natural resources and infrastructure has increasingly accrued to large firms and large funds. The five largest natural resources and infrastructure funds have all been raised in the last five vintage years. All five funds are energy focused with exposure to North America (one primarily invests in Europe) with three targeting value-added strategies, while the remaining two are split between core and core-plus. And while the top five firms in 2015 had raised 15 percent of funds over the trailing five-year period, that share reached 24 percent in 2020, suggesting moderate consolidation of the asset class.

AUM

Infrastructure and natural resources assets under management grew 1.9 percent in the first half of 2020 and have now grown 10.9 percent per annum since 2015. Another strong year in fundraising,

despite the year-over-year decline, was mitigated by declining net asset values, driven in part by energy price contraction. Growth was strongest in Europe, where AUM grew 6.9 percent in the first half of 2020 and has grown 20.3 percent per annum since 2015. Conversely, AUM declined in North America and Asia, shrinking 0.5 percent and 3.0 percent, respectively, in the first half of 2020. Growth was not consistent across sectors; funds with significant exposure to transportation or conventional energy saw valuations decline over the year as the pandemic drove uncertainty around travel and energy usage.

Performance

In considering performance,²⁵ we differentiate between natural resources funds and infrastructure funds, as the respective return patterns have diverged. With oil prices falling dramatically in the

²⁵ Methodology: Median IRR was calculated by taking the average of median IRRs for funds within each vintage year. Quartile IRR was calculated by taking the average of quartile IRRs for funds within each vintage year.

first half of 2020, natural-resources funds suffered. The longer-term story is similar: four of the last six years produced in-year losses, and that string of returns has caused long-term underperformance.

Infrastructure fund performance has been meaningfully better. Longer-term performance remains relatively strong, and every vintage of the last two decades has produced a positive IRR. The median IRR for infrastructure funds in vintages 2007 through 2017 is now 7.5 percent, roughly in line with performance of real estate and private debt.

Energy transition accelerates

A key structural shift impacting both infrastructure and natural resources is the ongoing energy transition, which accelerated in 2020 as investors increasingly sought opportunities in renewables and clean energy. The transition, of course, predates 2020, but the economic shock delivered by the pandemic increased the focus on the shift away from fossil fuels. More specifically, the government response to the pandemic included funding energy transition programs as a form of economic stimulus. From 1998 to 2014, LPs and investors responded to a largely bullish energy market by pouring money into oil and gas funds. Those investments were largely rewarded, as pooled IRRs for O&G-specific funds vintage 2000–10 had actually exceeded buyout funds of comparative vintage as of the fourth quarter of 2014.²⁶ The collapse of commodity prices in 2014 followed by the Paris Agreement in December 2015 changed both realized and expected returns in the asset class. The shift mirrors that in public markets: for example, energy companies represented 7 percent of the S&P 500 in 2015 (by weighting); by 2020, that share had fallen to about 2 percent. Similarly, private markets investors have reallocated capital from underperforming oil/gas exploration and production focused investments into other sectors, such as power, utilities, and renewables.

Against this backdrop, the first quarter of 2020 created further performance trouble for strategies tied to traditional energy prices, as minimal economic activity and travel drove down oil prices. Investor sentiment toward the conventional energy market, already waning, may have fallen further still. At the same time, several large institutional investors publicly announced deeper commitments to ESG investing, with a focus on decreasing exposure to fossil fuels.

In this context, greener strategies have taken share. As a short-term example, of the 16 natural-resources funds closed in the third quarter of 2020, 11 were energy sector specific (and renewables driven). Four of the five largest funds closed in the quarter had affiliations with the UN Principles for Responsible Investment (UNPRI), signaling ESG commitments.²⁷ And in infrastructure, deal activity for transport and conventional energy was down 45 percent and 44 percent year over year, respectively, while renewable sector activity was down only 13 percent.²⁸

The energy transition will remain a tailwind for those investing in the sustainability trend. McKinsey estimates that the energy transition will require \$3 trillion to \$5 trillion per year in capital expenditures by 2030, a total far above current capital invested. However, if PE is to play its part in this transition, firms may need to develop new skill sets. Historically, investors in the sector have been focused on picking great management teams that understand the innovations driving the business (for example, shale, deepwater, hydraulic fracturing, horizontal drilling) and are skilled at public market exits. Going forward, investors may need to refocus on developing their own understanding of technology and on identifying business builders.

²⁶ Burgiss.

²⁷ *Preqin Quarterly Update: Natural resources, Q3 2020*, Preqin, October 2020, preqin.com.

²⁸ *Preqin Quarterly Update: Infrastructure, Q3 2020*, Preqin, October 2020, preqin.com.



6 Advancing diversity in private markets

In 2020, the pandemic drastically changed ways of life and work for billions of people. In May, the death of George Floyd produced another seismic shift in cultural awareness of systemic racism—in particular in the US—and set in motion urgent calls for racial equity on a global basis. There is an increasing recognition that against this backdrop, the private markets industry has the ability and imperative to improve diversity, equity, and

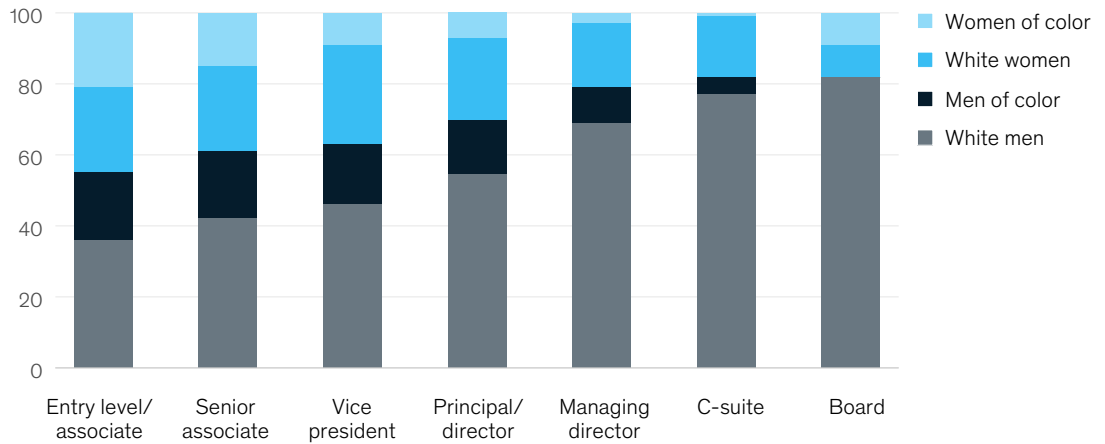
inclusion (DE&I) in the workplace. It turns out that doing so may provide additional levers for financial outperformance. Our long-running research on diversity across industries shows that companies with greater diversity in leadership ranks are more likely than those with less diverse leadership to perform better than the industry average on margin growth.²⁹ Applying this analysis to PE suggests an additional lever for value creation

²⁹ Sundiatu Dixon-Fyle, Kevin Dolan, Vivian Hunt, and Sara Prince, "Diversity wins: How inclusion matters," May 2020, McKinsey.com.

Exhibit 33

Gender and racial diversity in North American private equity decrease with career advancement.

Private equity employees by level,¹ 2019, %



¹Survey covered 11 PE firms in Canada and the United States.
Source: *Women in the Workplace 2020* data set

within firms' portfolios. Not only will improving DE&I provide an additional opportunity for financial outperformance, but DE&I commitments may also help firms raise capital.

Given the strengthening business case for DE&I and investors' growing interest in doing good, it seems evident that PE firms that want to raise larger funds faster and see outsize returns need to get serious about embracing DE&I in how they manage their own firm as well as their portfolio companies. By prioritizing DE&I, the PE industry can create more equitable and inclusive places to work, attract better talent, redefine corporate culture, and set a standard for businesses across sectors.

The opportunity for PE

PE firms have an outsize ability to influence the status quo of the business community. Globally, about 8,300 PE firms manage more than

\$4.5 trillion in assets.³⁰ In North America alone, about 4,700 firms back more than 18,800 companies.³¹ If PE firms were to continue to reduce gender and racial inequalities across the companies they invest in, they could change the face of business.

McKinsey and LeanIn.org's report, *Women in the Workplace 2020*, confirms that PE lags corporate America on gender and diversity in senior ranks. Our analysis presents overall trends and averages for the industry, and we fully recognize that some PE firms have made advancements on DE&I. On the whole, gender and racial diversity at PE firms is stronger in entry-level positions than at the top. To date, at the start of 2020, about 20 percent of senior leaders (managing-director level) on PE investment teams were women, while the share of women on executive teams in the rest of corporate America was about 30 percent³² (Exhibit 33).

³⁰ PitchBook Data, October 2020, pitchbook.com.

³¹ Ibid.

³² *Women in the Workplace 2020*, a joint report from Lean In and McKinsey, September 2020, womenintheworkplace.com.

PE also trails on ethnic diversity. In 2020, investment deal teams were about 1 to 2 percent Black in the United States,³³ with other people of color constituting the remaining 11 to 12 percent of diversity at the managing-director level.³⁴ Public companies do better, with approximately 13 percent Black and Latinx executives.³⁵ But that's still far below the US demographic composition (about 30 percent Black and Latinx in 2019) and also lags behind the ethnic-minority population that holds a graduate degree (about 23 percent of the total workforce with relevant graduate degrees in 2019). PE portfolio companies' management teams and boards of directors represent a further area of opportunity.

How PE can catalyze DE&I advancements

Over the past five years, McKinsey has studied the strengthening business case for gender and ethnic diversity: greater diversity within

corporate leadership teams correlates to stronger financial results. Companies in the top quartile for gender diversity were 25 percent more likely to outperform industry-median growth in earnings before interest and taxes (EBIT) than bottom-quartile companies. Similarly, executive teams in the top quartile of ethnic diversity were 36 percent more likely to financially outperform the industry median.

If this business case were to hold for PE-backed companies, beyond the increased likelihood of financial outperformance for the portfolio company itself, a PE fund focused on driving significant change across the portfolio would itself produce significant enterprise value. While it is still early days for PE on improving diversity, and the correlation remains to be validated for privately held companies, the scale of potential value creation demands attention.

³³ Based on active members in the 2020 McKinsey Black Investor Professionals Forum Database. Weighted average of active members as a percentage of all investment professionals in the more than 150 North American firms represented in the database.

³⁴ Figures from Women in the Workplace 2020 dataset

³⁵ Ibid.



25%

Greater diversity within corporate leadership teams correlates to stronger financial results. Companies in the top quartile for gender diversity were 25 percent more likely to outperform industry-median EBIT growth than bottom-quartile companies.

Firms are already moving ahead. Since May 2020, we have seen a sharp increase in the number of PE firms focused on DE&I. Much of that is because the energy gathering around gender and racial equity is raising expectations for employers to respond. But institutional investors and other limited partners are also beginning to bring DE&I criteria into their thinking as they allocate funds to general partners. Furthermore, as the data show, the push for increased DE&I could also make financial sense for PE firms. The Diversity and Inclusion Roadmap, spearheaded by the Institutional Limited Partners Association (ILPA), has already garnered over 100 signatories among GPs—firms committing to make certain changes—with many more expected to follow suit.

While the standard tactics to improve DE&I—including early recruitment and interview preparation for underrepresented minorities, unconscious-bias training, and inclusivity surveys—are helpful to any company, many PE firms are aware that they can do more. A set of tailored and unique actions can help GPs and their portfolio companies improve DE&I in their organizations and lead across the business community. Here's a small sample of those actions.

PE firms can do the following:

- **Make a clear commitment.** Firms can, for example, establish an internal council on DE&I for themselves and their portfolio, with a C-level chair to signal that this matters. The council can develop metrics, set goals, and monitor progress on targets for both the firm and the portfolio.
- **Conduct diversity assessments of targets.** Firms can include DE&I throughout the deal life cycle. Building DE&I criteria into due diligence of targets and investment-committee reviews can help not only to assess risk but also to understand the value-creation opportunity inherent from improving DE&I. Once targets

are acquired, owners can include DE&I in the 100-day value-creation plan. And they can revisit DE&I as one of the value-creation levers highlighted for buyers upon exit.

- **Focus on diversity performance.** Leadership can review firm and portfolio-company diversity metrics at all partner meetings, and even link a portion of compensation to deal teams' or portfolio companies' performance on these DE&I metrics.

Within portfolio companies, advancing DE&I includes the following steps:

- **Set diversity targets for boards.** PE firms have seats on the boards of most of their investments. They can use those to position qualified, diverse candidates; they can also add seats to create a diverse board of directors with relevant skill sets for their companies.
- **Establish diverse management teams.** Firms can review the diversity of each portfolio company's workforce and management and identify areas where increased DE&I could lead to improved culture and performance.
- **Remove structural racism from all corporate policies portfolio-wide.** Firms can examine current benefits and corporate policies and restructure them as needed to improve retention and promote equity in advancement of underrepresented minorities.

These levers are not exhaustive; they are a few of the tangible ways that global PE firms can lead in the creation of a more diverse, equitable, and inclusive workplace.

It is increasingly clear that PE's push on DE&I in this moment can serve as a catalyst, with outsize impact across the business community, while also increasing the likelihood of outperformance for early adopters.



7 A new commitment to ESG

ESG matters to stakeholders

More institutional investors are beginning to recognize environmental, social, and governance (ESG) factors as drivers of value. Public interest and LP pressure to take ESG factors into account in investing have soared, prompting greater transparency on ESG policies and performance as well as a rise in dedicated “impact funds.” Managers are increasingly attributing importance to ESG and are finding that these factors are positive (or neutral)

in achieving strong performance. In the private markets, topics of ESG have now reached an inflection point, becoming increasingly crucial for a variety of stakeholders including regulators, LPs, consumers, and employees:

- *Limited partners.* By 2018, 33 percent of investments of the largest investment funds (across all asset classes, not just private markets) were allocated to companies in

accordance with ESG criteria, amounting to some \$31 trillion. The issuance of sustainable debt instruments saw a 53 percent increase between 2013 and 2020, with a record \$732 billion issued in 2020. To date, investors with \$15 trillion in AUM have committed to divesting fossil fuels.

- **Employees.** As the talent at private markets firms shifts increasingly to the millennial generation, ESG factors are rising in importance as a factor in choosing employers. Surveys of the broader US workforce indicate more than half of employees consider the social and environmental responsibility of an employer when choosing where to work.
- **Consumers.** McKinsey's Gen Z and Millennial Survey reveals that 26 percent of millennials and 31 percent of Gen Zers (expected to possess about 60 percent or about \$40 trillion of spending power by 2030) are willing to pay a premium for products that have the least negative impact on the environment , and 76 percent of consumers are willing to reject products or services for ethical reasons.
- **Regulators and policy makers.** Global ESG regulations and laws have grown by 90 percent since 2016, and 2020 saw efforts to standardize the various frameworks and taxonomies, the best example being a report published in September 2020 on establishing a common set of ESG metrics and consistent nonfinancial disclosure standards supported by 120 of the world's largest companies. With EU regulation already pushing companies in this direction and comparable legislation widely expected in the United States, it is broadly acknowledged that the regulatory environment is shifting, and PE firms and investors are working quickly to adapt.

Capital is flowing to ESG strategies

Capital flowing into ESG-related investment strategies saw unprecedented growth in 2020: nearly \$400 billion in cumulative ESG-focused

private capital was raised from 2015 to 2020, with over a quarter (about \$100 billion) being raised in 2020 alone. These investments include both funds focusing on ESG themes and funds committed to ESG principles (funds that are signatories to ESG agreements such as the UN Principles for Responsible Investing). Among strategies committed to ESG principles, there are a variety of approaches to ESG filtering which vary by application, starting with negative screening through to a fully embedded model where ESG considerations are thoroughly integrated into the investment processes.

With regard to growth, all classes of private capital, including infrastructure, private equity and debt, real estate, and venture capital, saw increases in capital flows from 2015 to 2020.

- **Infrastructure.** ESG-related capital grew by 28 percent per annum in infrastructure with a majority of growth focused on funds committed to ESG principles. A large part of the increase was due to a flow of infrastructure fundraising into sustainability-related strategies. For example, a Bay Area infrastructure fund raised \$1 billion for clean-tech infrastructure.
- **Private debt.** ESG-related capital in private debt grew by 23 percent per annum. Recent news has seen traditional investment and banking firms leverage sustainability or diversity targets as a means to embed ESG principles into their debt issuance. For example, large asset managers have tied interest rates on multibillion-dollar credit lines to board diversity, while global banks have linked lower interest rates to corporate improvements in ESG ratings among industrials borrowers. Corporates also joined in on ESG private debt issuance, with tech firms announcing billion-dollar sustainability/ESG bonds in the past several years.
- **Private equity.** ESG-related capital grew rapidly in private equity, increasing by over 30 percent per annum from 2015 to 2020. Last year saw a wide range of PE firms announce ESG, climate-related, or impact

Capital flowing into ESG-related investment strategies saw unprecedented growth in 2020: nearly \$400 billion in cumulative ESG-focused private capital was raised from 2015 to 2020, with over a quarter being raised in 2020 alone.

funds. As discussed above, 2020 also saw a significant influx of capital into SPACs, with over two dozen transactions focused on cleantech transactions in electric, hydrogen, and hybrid auto; electric-vehicle charging infrastructure; battery tech; and renewables.

- **Real estate.** ESG-related capital grew modestly in real estate at 3 percent per annum, with additional growth expected due to increasing importance of environmental climate risk on global real estate assets.
- **Venture capital.** ESG-related capital grew by nearly 30 percent per annum in venture capital, with a majority of growth affecting funds that are focused on sustainability or ESG themes. A variety of new funds have been launched in the last five years, many focused on climate/cleantech or on investing in and supporting diverse and minority founders.

ESG deals are getting done

With the managers of trillions of dollars in capital now embedding some ESG factors in their decision making, and with rising billions in funds being raised, it is now more widely accepted that most managed assets will eventually integrate some form of impact mandate. Historically, many

observers have tended to categorize deals in a binary manner as ESG focused or not—green or not green. In fact, the distinction is not binary but rather exists on a gradient where most deals are ESG focused in some ways but not others. We have found three main archetypes of such deals: ESG growth, ESG transition, and ESG improvement deals.

ESG growth transactions are investments intended to help scale companies with an ESG-centric business model. For example, an injection of growth capital into a battery producer or a company focused on alternative proteins would fit this archetype. More often than not, these investments tend to be more VC-like in nature. Often, these transactions are in emissions-intense sectors, such as energy, transportation, agriculture, or heavy industry, and the deal thesis rests disproportionately on making a positive difference in environmental factors. Companies like these tend to be placing bets on secular change in a given sector, so they seek investors able to infuse both growth capital and sector expertise to help them gain scale and share rapidly.

In an ESG transition deal, the thesis focuses on shifting a company's business model to favor better performance on ESG factors, typically in expectation that improvement in these factors will

also favor strong financial returns. For example, such deals would include investments aimed at helping a company in the energy space shift away from fossil fuels and toward renewables (say, fleet internal combustion engines to electric vehicles, gas stations to electric-vehicle charging infrastructure). To accelerate the shift to an ESG-focused business model, these deals often involve M&A development of new capabilities or rely on partnerships or M&A to help catalyze a shift in direction.

The third archetype is the ESG improvement deal, where companies do not have a business model focused on ESG yet are open to executing on select ESG improvements. Such deals are increasingly common, representing a material value-creation opportunity for many or even most private markets assets. One example would be the packaging company that shifts to biodegradable packaging alternatives or greater use of recyclable materials. Another would be the food brand that considers setting up a more locally oriented supply chain to reduce its carbon footprint. These deals require identifying material ESG factors to address for driving value creation, typically involving activities such as baselining, assessing the potential ESG improvement and setting targets, identifying key improvement levers, and increasing ESG performance to realize financial value. Often, these deals may impel sponsors to consider externalities as well, even absent any link to the bottom line.

ESG factors' relationship to financial performance remains unclear

The relationship between ESG factors and company financial performance is an area of ongoing research. While it is too soon to draw firm conclusions, there is increasing evidence that ESG factors and financial performance may correlate in some areas. Thus far, using commercially available data, McKinsey's research on public companies appears to suggest no strong correlation between top-quartile ESG performance and total return to

shareholders (TRS). However, the emerging data do suggest a strong correlation between degree of improvement (or decline) in ESG performance with improvement in TRS. We expect to see increasing focus on this topic as the research deepens.

The evolving emphasis on ESG is raising the bar for capabilities

For both GPs and corporates, the rise in attention paid to ESG is requiring the rapid development of new capabilities across the entire enterprise. For private market players, integrating ESG across the investment life cycle will require building capabilities in data aggregation and reporting, diligence and underwriting, portfolio diagnostic and transformation capabilities, and crafting compelling narratives.

Data and analysis. A differentiated ability to source, organize, analyze, and report ESG data will be important for investment firms hoping to play a leading role in the space. ESG data are still nascent, and it is likely that some degree of aggregation from multiple sources will be needed for a complete view of the ESG performance or value at stake in a target or portfolio company. These sources run the gamut from internal (for example, self-reported data from portfolio companies, survey data, questionnaires) to external (for example, third-party vendor data; natural-language processing of corporate sustainability reports; scrapeable public data such as social media, blog posts, consumer and employee reviews, and press), and they vary widely in quality and depth.

Reporting to LPs at the company or portfolio level and picking which set of standards to follow are also increasingly important for establishing accountability and transparency and in some cases for fulfilling compliance obligations.

Diligence and underwriting. ESG's role in the due diligence process is beginning to shift from being what many investors have considered a check-the-box exercise in risk mitigation to

something seen as a potential driver of value. In the future, due diligence embedded with ESG principles will be more quantitative, will likely be understood and governed by deal teams, and over time will focus more on what is assessed to be “material” for a given target’s sub-sector. The concept of materiality will be increasingly important for tailoring the diligence and underwriting approach to each potential asset, as key ESG dimensions can vary widely across and even within sectors.

Diagnostic and improvement. To understand the ESG performance of investor portfolios and to improve the performance of ESG “laggards,”

GPs must develop capabilities to perform holistic portfolio diagnostics, assess the full potential of an asset from a risk and opportunities perspective, and implement meaningful change programs. The diagnostic and potential assessment steps will involve using external ESG data and internal data to benchmark portfolio companies to peers (both private and public) and to understand potential areas of improvement with associated value at stake from executing prioritized ESG levers. ESG improvement will require setting and monitoring targets and working with operating partners and management teams to improve the most material ESG factors for that asset.



8 The pandemic's lasting impact on private markets

Based on the numbers alone, one might conclude that the pandemic's impact on private markets may prove relatively short-lived. After all, fundraising, deal activity, and performance have proven more resilient than many expected. Yet the pandemic's most durable impact on private markets may be in how it has changed the way business is done.

The imperative for remote working throughout 2020 upended established industry practices based on in-person interactions. These analog approaches were hastily replaced with their digital equivalents in the second quarter as lockdowns hit. As the year wore on, market participants settled in to a "new normal" of remote work. The majority of market participants are still operating in a fully remote manner as of March 2021. As vaccinations

While the “remote working revolution” that was discussed during the early phases of COVID-19 may not quite come to pass, it seems likely that at least some of the digital practices that grew out of the crisis will persist.

accelerate in some large markets, a return to prior ways of working may technically be feasible in mere months. What might that “next normal” look like?

GPs find some upsides to remote work

The majority of a GP’s business activities—fundraising, sourcing, due diligence, portfolio oversight, and so on—have traditionally been structured to a considerable extent around in-person meetings and site visits. For a single acquisition, for instance, members of a GP deal team might have had five or more on-site meetings with a given target from origination to closing. Fundraising was similarly dependent on in-person interactions, not just for IR professionals but also for product experts, deal leads, and GP management. These meetings, and the time spent traveling to them, were viewed as meaningful but unavoidable costs of doing business, essential to secure an LP’s commitment, build trust with a management team, accurately assess the risks of a potential investment, or create camaraderie among colleagues.

When the pandemic led to lockdowns across much of the globe, these in-person modes of interaction became impossible. GPs, like many

other businesses, scrambled to adopt and adapt to virtual alternatives such as videoconferencing. Despite initial growing pains, most firms transitioned to the remote working environment quickly and fairly fluidly. As the year wore on and the pandemic’s impact endured, many firms started to recognize the inherent advantages of virtual engagement models. Valuable hours spent previously in a car or on a plane could now be spent sourcing a potential deal or aligning with a management team. These efficiencies are likely reflected to some extent by the rebound in deal activity: in North America, more PE buyouts closed in the fourth quarter of 2020 than in the same quarter of 2019.

Other perceived benefits may begin to emerge as well. The potential talent pool may grow with the promise (or at least possibility) of more flexible working arrangements. Firms may narrow their use of in-office space—for instance, optimizing for collaboration and meetings, while roles demanding less in-person presence shift virtual. Some firms have already begun to consider the potential for cost savings opportunities in real estate (via an optimized office footprint) or labor (via location arbitrage), which may prove material given that private markets firms are disproportionately based in high-cost locations.

Conversely, some factors may push GPs back toward prior ways of doing business when offices reopen and travel becomes safer. The industry is as competitive as ever: if there is an advantage to be gained through in-person interactions with potential investors or management teams, many GPs will take it. Furthermore, while many employees laud the flexibility of remote work, the reality of fewer in-person interactions may have implications for talent development and corporate culture. And greater “efficiency” may have a different meaning to a senior professional working from a summer home than to an analyst working from a studio apartment. The sustainability of remote working models, especially for certain roles, has yet to be tested over the long term.

As the virus persists in the first half of 2021, digital communication is expected to remain the predominant form of interaction across the private markets in most geographies. But the nature of the next normal remains uncertain. While the “remote working revolution” that was discussed during the early phases of COVID-19 may not quite come to pass, it does seem likely that at least some of the digital practices that grew out of the crisis will persist.

LPs discover they can commit without meeting face-to-face

Like their GP counterparts, LPs faced growing pains when first transitioning to a remote working model early last year. Amid the uncertainty of the

first weeks and months of the pandemic, new commitments declined precipitously: in North America, fundraising for the month of May was down nearly 70 percent versus 2019. In-person GP visits were considered to be an irreplaceable component of the diligence process; without them the majority of LPs were uncomfortable committing capital. As it became clear that remote work was likely to endure for some time, LPs gradually warmed to the idea of virtual engagement. By the fourth quarter, the pace of LP commitments had rebounded substantially. While there is undoubtedly still a preference for in-person vetting, a survey by PEI found that over 90 percent of LPs would take a first GP meeting virtually, and over half would commit to a new manager without ever meeting face-to-face.

It remains to be seen whether these practices among LPs will persist when they are no longer a necessity. Should remote work persist in the next normal, one interesting area to watch will be the impact on LPs’ ability to attract talent. Unlike GPs that deliberately locate their offices near robust talent pools, the majority of LPs are tied to a specific geographic area related to their capital base. Greater flexibility on location could meaningfully impact their ability to attract and retain top talent.

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