McKinsey&Company

The rise and rise of private markets

McKinsey Global Private Markets Review 2018

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Introduction

The year just past was, once again, strong for private markets.[1] Even as public markets rose worldwide—the S&P 500 shot up by about 20 percent, as did other major indices—investors continued to show interest and confidence in private markets. Private asset managers raised a record sum of nearly $750 billion globally, extending a cycle that began eight years ago.

Within this tide of capital, one trend stands out: the surge of megafunds (of more than $5 billion), especially in the United States, and particularly in buyouts. Remarkably, the industry's record-setting 2017 growth is attributable to a single sub-asset class in one region. Notably too, if mega-fundraising had remained at 2016's already lofty level, total private market fundraising would have been down last year by 4 percent. Of course, this trend to ever-larger funds isn't new. Megafunds have become more common, in part as investors have realized that scale has not imposed a performance penalty; indeed, the largest funds have on average delivered the highest returns over the past decade, according to Cambridge Associates. What was interesting in 2017, however, was how an already-powerful trend accelerated, with raises for all buyout megafunds up over 90 percent year on year. For comparison, fundraising in middle-market buyouts (for funds of $500 million to $1 billion) grew by 7 percent, a healthy rate after years of solid growth.

Investors' motives for allocating to private markets remain the same, more or less: the potential for alpha, and for consistency at scale. Pension funds, still the largest group of limited partners (LPs), are pinched for returns. Endowments are already heavily allocated to private markets and do not appear keen to switch out. Meanwhile, sovereign wealth funds (SWFs) are looking to increase

their exposure to private markets, increasingly using co-investments and direct investing to boost their ability to deploy capital. Fully 90 percent of LPs said recently that private equity (PE), the largest private asset class, will continue to outperform public markets—despite academic research that suggests such outperformance has declined on average.

And so, capital keeps flowing in. Our research indicates that, in the past couple years, the industry's largest firms have begun to collect a growing share of capital, perhaps starting to consolidate a fragmented industry. Yet private asset managers did not have it all their way in 2017. The industry faced some mild headwinds investing its capital. Although the deal volume of $1.3 trillion was comparable to 2016's activity, deal count dropped for the second year in a row, this time by 8 percent. In two related effects, the average deal size grew—from $126 million in 2016 to $157 million in 2017, a 25 percent increase—and managers accrued yet more dry powder, now estimated at a record $1.8 trillion. Private markets' assets under management (AUM), which include committed capital, dry powder, and asset appreciation, surpassed $5 trillion in 2017, up 8 percent year on year.

Why did managers hesitate to pull the trigger, or struggle to find triggers to pull? One explanation is the price of acquisitions. Median PE EBITDA multiples in 2017 exceeded 10 times, a decade high and up from 9.2 times in 2016. With price tags now increasingly printed on gold foil, general partners (GPs) had to be smarter with their investment decisions and more strategic with their choices.

The byword of 2017 was scale. The way that LPs and GPs respond to the challenges and opportunities of scale will be critical to their success. LPs and GPs of all sizes will need to hard-code discipline into every part of their business system. Before long, GPs may find themselves having to choose between two models: managers capable of deploying capital at scale, and specialists operating at a smaller scale. For the first group, capital will continue to pour in, but what counts as an attractive deal may shift given that asset classes like PE are not infinitely scalable—at least not with historical levels of performance. For the second group, a strategic decision is at hand: get bigger, or stay the course. Both options can be successful, if firms clearly identify how they are differentiated and execute their strategies with the necessary rigor.

About this report

This is the 2018 edition of McKinsey's annual review of private markets. 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 conducted interviews with executives at some of the world's largest and most influential GPs and LPs. Finally, we have gathered insights from our colleagues around the world who work closely with asset owners and managers.

This report begins with a review of the industry's capital flows in 2017, including fundraising, AUM, and the deployment of capital. We then review the implications of these dynamics for the all-important relationship between LPs and GPs, and conclude with some ideas about how LPs and GPs can find continued success in this remarkable age. □

Going strong

LPs' motivations for allocating to private markets remain strong, and so fundraising continues to rise rapidly, particularly in private equity, private debt, and, despite some reports, real estate. It's no surprise then that AUM also set a new high-water mark. All this is heady stuff. But perhaps the most interesting finding in our research on capital flows is that, at last, little by little, the industry may be starting to consolidate.

The widening divide

Defined-benefit pension funds in many parts of the world are facing a massive liability gap—the difference between their assets and what they owe. Consider the situation in the United States (Exhibit 1). In the years leading up to 2008, the average funding ratio of US public pensions was just shy of 80 percent, reflecting a gap of some $1.8 trillion. During the global financial crisis, the gap then lurched significantly wider (roughly doubling from $1.8 trillion to $3.5 trillion). Since then, it has remained in the same absolute range, despite very strong growth in asset prices—particularly equities, in which most US pension funds are well invested. The gap expanded by 0.9 percent annually during 2008–17, despite annual growth in the S&P 500 of 13.4 percent over the same period, and today stands at $3.8 trillion. Many European pensions are similarly underfunded. This liability gap remains a powerful incentive for investors to seek the outsized returns that private markets have historically provided.[3]

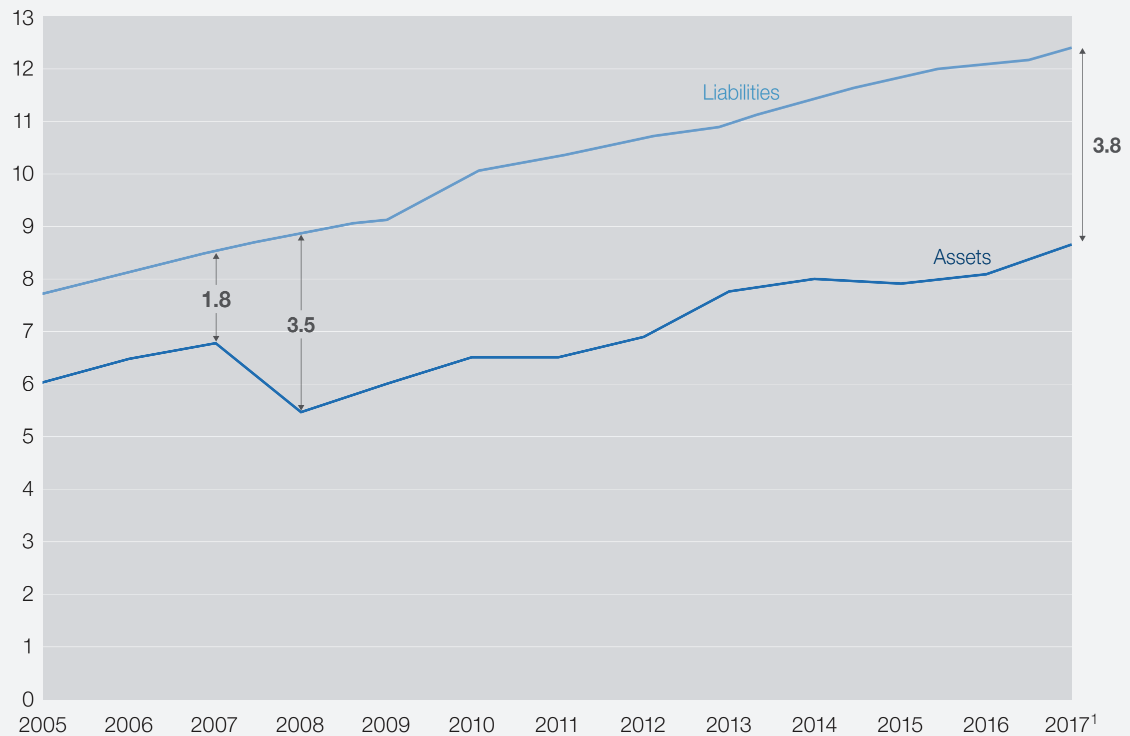
Many factors have propped open the liability gap. First, though most pensions have sizable exposure to equities, many recognized significant losses at the time of the downturn and did not reallocate with sufficient alacrity to take full advantage of the past decade's bull run. Second, US pensions have

been gradually lowering the rate of return they assume they will achieve on their investments, causing the present value of liabilities to rise. Third, many pensions have been belatedly revising mortality tables that had been in place for 15 or 20 years. As life expectancy increased by approximately two years over the period 2000–17, liabilities increased proportionately to longer expected retirements. These changes in financial and actuarial estimates have caused the reported liability gap to persist. Seen another way, the actual liability gap had been larger than reported, and the numbers have been catching up with the reality.

Other LPs also have reasons to invest in private markets. SWFs' desire for persistent performance has been increasing along with volatility in energy markets over the past several years. SWFs have been increasing their exposure to private markets, often through direct investing or co-investments alongside GPs. Endowments, on the other hand, are already heavily allocated to private markets, often earmarking nearly half their portfolio. Endowments continue to drive a lot of mid-market activity, often taking the approach that "small is beautiful" and favoring long-term relationships with managers whose strategies they believe in. That

Exhibit 1 **The US pension gap has barely changed since 2008.**

US pensions assets and liabilities, 2005–17, $ trillion



[1] Based on Q3 2017 data.

Source: Federal Reserve Statistical Release, December 2017

said, their commitments have been changing less than those of pensions and SWFs.

All told, LPs remain under substantial pressure to find returns, and it is private markets to which they have continued to turn, based on a history of outperformance. In a recent survey, 91 percent of LPs say that the various private asset classes will deliver returns above public markets. Their belief is echoed by many investment consultants who continue to predict such outperformance. This faith has been tested in recent years by several academics who have found that PE outperformance at the median level has declined.[4]

The debate about performance continues, however, in no small part because industry-level data remain incomplete at best. The quality of publicly available data may indeed be degrading over time, as assets continue to migrate from commingled pools that are often publicly reported to separately managed accounts (SMAs), which tend to operate with greater opacity. In any event, the potential if not

Exhibit 2 **Private market fundraising grew by 3.9%.**

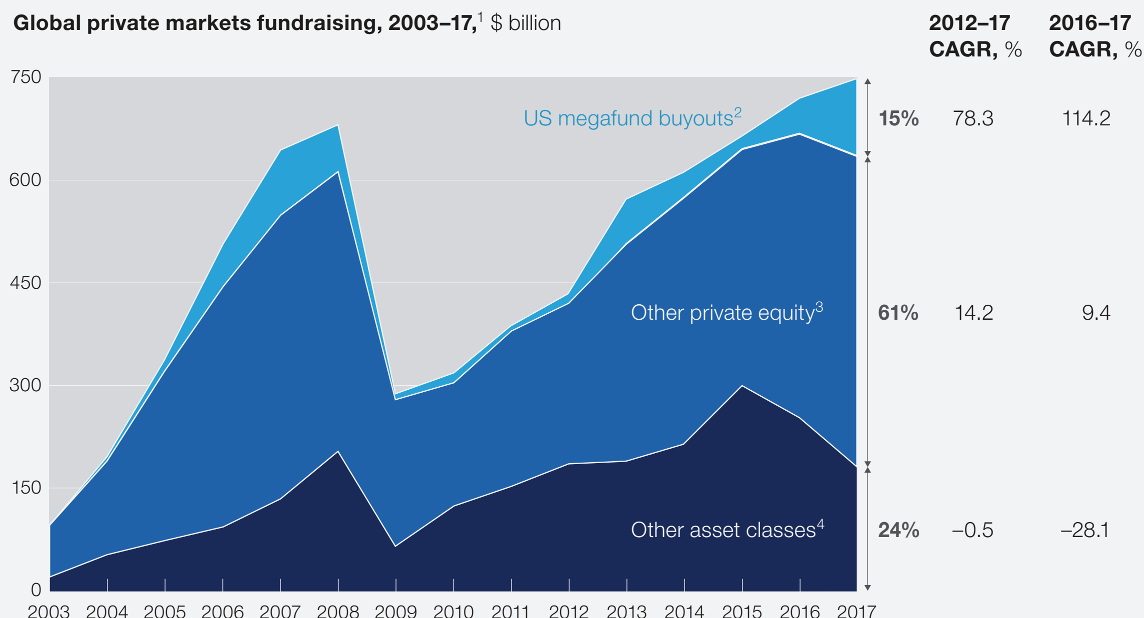
		Private equity	Closed-end real estate[1]	Private debt	Natural resources	Infrastructure	Private markets
North America	Total, $ billion	**233**	**70**	**67**	**45**	**33**	**448**
	2016–17, $ billion	+36.6	–8.4	–1.2	–12.4	+0.2	+14.9
	YoY change, %	18.6	–10.7	–1.8	–21.8	0.7	3.4
Europe	Total, $ billion	**95**	**30**	**33**	**16**	**22**	**196**
	2016–17, $ billion	+2.0	–0.8	+6.9	+9.0	+1.9	+19.0
	YoY change, %	2.1	–2.7	26.2	127.5	9.6	10.7
Asia	Total, $ billion	**60**	**9**	**6**	**1**	**2**	**78**
	2016–17, $ billion	+5.3	–2.3	+3.9	+0.4	–9.4	–2.2
	YoY change, %	9.6	–20.0	192.0	50.7	–86.1	–2.8
Rest of world	Total, $ billion	**9**	**3**	**1**	**6**	**7**	**26**
	2016–17, $ billion	–4.7	–3.5	+0.4	–0.2	+4.6	–3.4
	YoY change, %	–35.5	–56.7	55.1	–3.6	239.9	–12.2
Global	Total, $ billion	**397**	**112**	**107**	**68**	**64**	**748**
	2016–17, $ billion	+39.2	–15.1	+10	–3.3	–2.6	+28.2
	YoY change, %	11.0	–11.9	10.2	–4.6	–4.0	3.9

[1] Closed-end funds that invest in property. Includes core, core-plus, distressed, opportunistic, and value-added real estate as well as real-estate debt funds. Note that real estate as an overall asset class grew when accounting for growth in open-ended funds as well as separately managed accounts.

Source: Preqin

Exhibit 3 **US mega buyouts were a record 15 percent of all private markets fundraising in 2017.**

Global private markets fundraising, 2003–17,[1] $ billion



	2012–17 CAGR, %	2016–17 CAGR, %
15%	78.3	114.2
61%	14.2	9.4
24%	–0.5	–28.1

[1] Private markets refers to private equity, real estate private equity (i.e., closed-end funds), private debt closed-end, natural resources closed-end funds, and infrastructure closed-end funds. Secondaries and fund of funds are excluded to avoid double counting of capital fundraised.
[2] Buyout funds based in the US that closed above $5 billion.
[3] Includes venture, growth, other private equity (balanced, hybrid, private investment in public equity).
[4] Includes closed-end real estate, private debt, natural resources, infrastructure.

Source: Preqin; McKinsey analysis

the promise of considerable outperformance remains alive and well for LPs that pick their managers well.

Fundraising: Peak to peak

As Exhibit 2 shows, fundraising was positive for most asset classes and regions, with a few noteworthy exceptions. Private equity and debt enjoyed large increases (11 percent and 10 percent, respectively), while other (typically smaller) asset classes fell: natural resources by 5 percent, and infrastructure by 4 percent. It was the second year of double-digit growth for PE, after a 19 percent uptick in 2015–16. RE also grew, though as we discuss below, looking only at closed-end funds, for which data is most widely available,[5] provides an incomplete and misleading view of RE. A quick review by asset class will reveal some of the subtler dynamics within this broad-brush picture, including a substantial jump in private debt.

Private equity: Two roads diverged

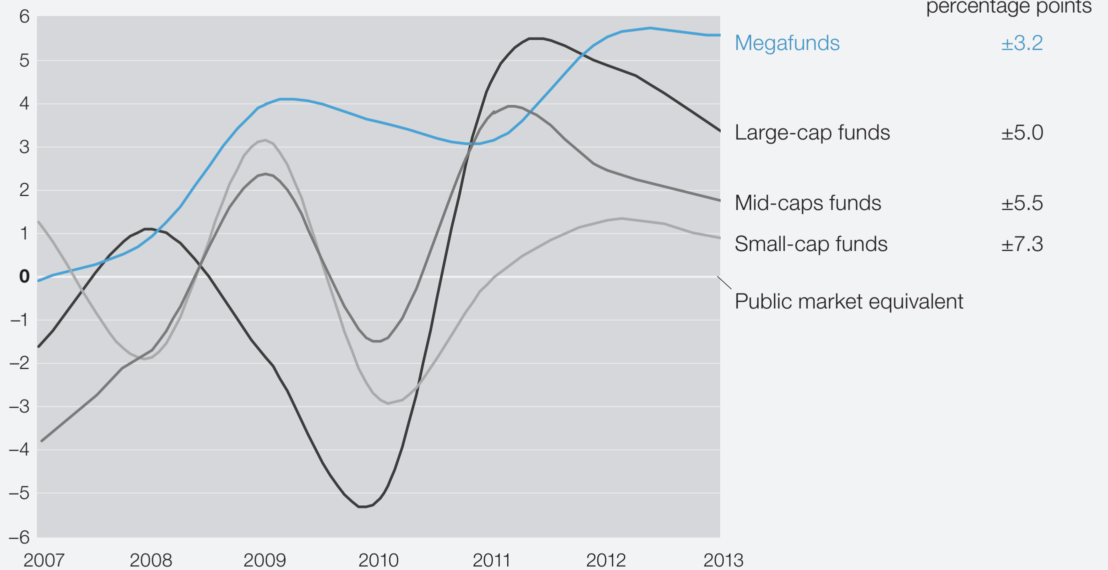
It was a record year for fundraising, but growth was overwhelmingly concentrated in just one region, sub-asset class, and fund size: US buyout megafunds (Exhibit 3). Indeed, if growth in these funds had been flat versus 2016, overall fundraising would have fallen by 4 percent. Megafunds now account for 15 percent of total fund raising, up from 7 percent

Exhibit 4

Measured by pooled returns, megafunds have outperformed since 2008.

Global private equity pooled returns by fund size relative to public market equivalent, percentage points

Top- and bottom-quartile variation from the average, percentage points



Megafunds	±3.2
Large-cap funds	±5.0
Mid-caps funds	±5.5
Small-cap funds	±7.3

Source: Cambridge Associates; Thomson One; McKinsey analysis

in 2016, having exceeded their previous peak of 14 percent in 2007.

Solid growth was also seen in the middle market. Buyout funds of between $500 million and $1 billion raised $31.8 billion globally in 2017, a 7 percent increase from 2016; funds of less than $500 million raised $29.1 billion, a 3.5 percent increase from the previous year. Middle-market fundraising was strong but was overshadowed by global megafund buyouts, which jumped 93 percent over the same period from $90.1 billion to $173.7 billion.

What's behind the growth in $5 billion-plus funds? The prevailing wisdom has long been that the "law of large numbers" might put a cap on megafund returns: the thinking runs in part that the companies on which such funds focus tend to be larger, better run, and more efficient than smaller buyout targets, thus offering fewer opportunities for operational or financial improvements. On the other hand, megafunds have also long been viewed as a safe choice by many investors because they carry a strong brand name. And that brand name has been earned: raising more than $5 billion in capital usually means the GP has delivered outperformance in the past at a smaller scale. Megafunds also make pragmatic sense to the growing class of investors that need to put billions to work quickly, as these funds are typically raised by the largest firms, which offer a strong promise that the capital will be deployed. The firm that gets the money is not always the firm that produces the best returns; sometimes, it is simply the firm

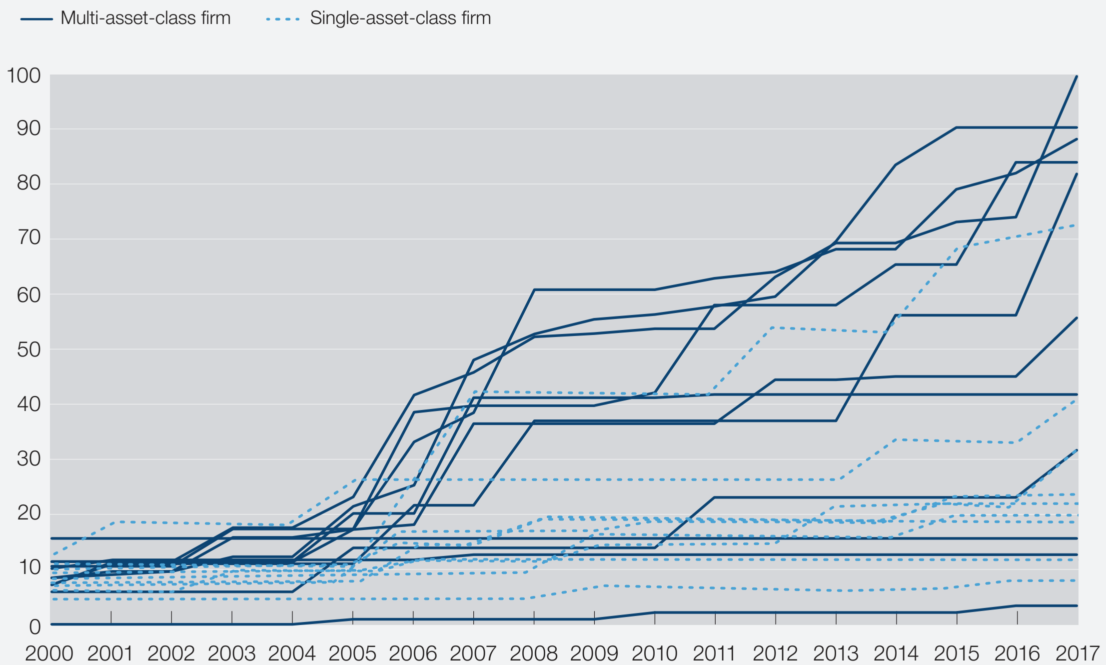
that can deploy such large amounts of capital. At the same time, some LPs have sought to rationalize their networks of external managers—which in many cases numbered hundreds of GPs, with thousands of underlying portfolio companies—creating pressure for larger individual tickets. As a result, opportunities to write a much bigger check than usual are more attractive than ever.

How do these pros and cons balance out? Can the law of large numbers be overcome? Investors have voted with their dollars and surged into megafunds. And it now appears that megafunds have also delivered superior returns on average. In other words, if there is a law of large numbers, these numbers must not yet be large enough to be held back. The data suggest that since 2008, the average megafund has outperformed other fund sizes—and also outgunned public market equivalents (Exhibit 4).

As megafund performance has given LPs comfort, the question "why allocate to a given firm?" has shifted a bit toward "why not?" for some firms in this echelon. To many sophisticated investors, however, from pensions and endowments to family offices, mid-market continues to be a beacon of performance. The spread of mid-market returns is much larger than for megafunds, such that the best funds can outperform the average IRR by a wide margin. And while mid-market entails a greater

Exhibit 5 **Large firms that diversified into other private assets have thrived.**

Cumulative private equity[1] fundraising 2000–17 for 20 largest firms as of 2000, $ billion



[1] Includes fundraising in private equity only, and includes 2 firms that are now defunct.

Source: Preqin; McKinsey analysis

level of selection risk, LPs will continue to lean on relationships with managers they trust to outperform in coming years.

More broadly, 2017 represents a rapid quickening of a long-running trend in which fund sizes have grown across private markets. Small funds of less than $500 million—36 percent of the capital raised in 2010—were down to 20 percent in 2017, while funds of more than $5 billion rose from 7 percent of 2010's total to 30 percent of 2017's. The largest GPs have raised these funds across private asset classes, extending their brands and capabilities beyond PE to meet increasing demand from LPs. While the brand name and track record of PE success clearly supports these GPs in their efforts to raise large funds in other private markets asset classes, the multi-asset class offering appears to have a positive feedback loop on PE fundraising. As Exhibit 5 suggests, the PE firms that went multi-asset class raised more money in PE; they built institutions at scale, and scale they have.

The rise of US megafunds was nearly matched in Europe, where several firms successfully closed big new funds totaling $40 billion, and in Asia, where megafunds—previously close to nonexistent—contributed more than $20 billion of the $60 billion raised in 2017. Asia megafunds too are skewing to PE buyout, rather than other asset classes.

Despite the strong showing of megafunds in Europe, however, total fundraising slowed, growing at just 2 percent in 2016–17, well below the 21 percent rate of the previous five years. Concerns over Brexit and its impact on asset prices contributed to the fundraising slowdown in Europe. As investor confidence rose in the second half of 2017, some of the void may have been filled, as North American managers turned their attention to Europe.

Private debt: Where banks fear to tread

Funds raised to invest in private debt grew by 10 percent last year, to more than $100 billion, reaching a peak last seen in 2008. Most of that growth happened in Europe (up 26 percent) and in Asia (up 200 percent, off a low base).

Several factors are at work here. The takeoff in debt indicates that private markets are increasingly seen as a good alternative to banks, particularly in India and China, where banks have been overwhelmed with nonperforming loans. Similarly, public debt markets are not deep in many parts of the world. As access to bank loans and high-yield issuance diminishes, private debt investors step in to fill the void. Funds created to lend directly (as opposed to investing in distressed or special situations, or mezzanine) raised 51 percent of all private debt capital in 2017, a sharp increase from 25 percent last year. Furthermore, many LPs see deteriorating returns in their fixed-income investments, and view private debt as having a similar risk profile with higher yield potential. Some also see private debt as a less risky way to play PE—investors get a more favorable part of companies' capital structure, and do not have to settle for substantially lower returns. Another factor, diversification, is always a consideration, and private debt offers a way for some to spread their bets.

In Europe, many PE firm leaders are excited about private debt and view it as an opportunity for their own diversification. In their mind, private debt is well positioned to fill the void in mid/small-cap financing while producing healthy returns for lenders, though lower than in PE. It's no surprise, therefore, that many LPs have asked their external managers to extend into private debt, and we expect this trend will continue.

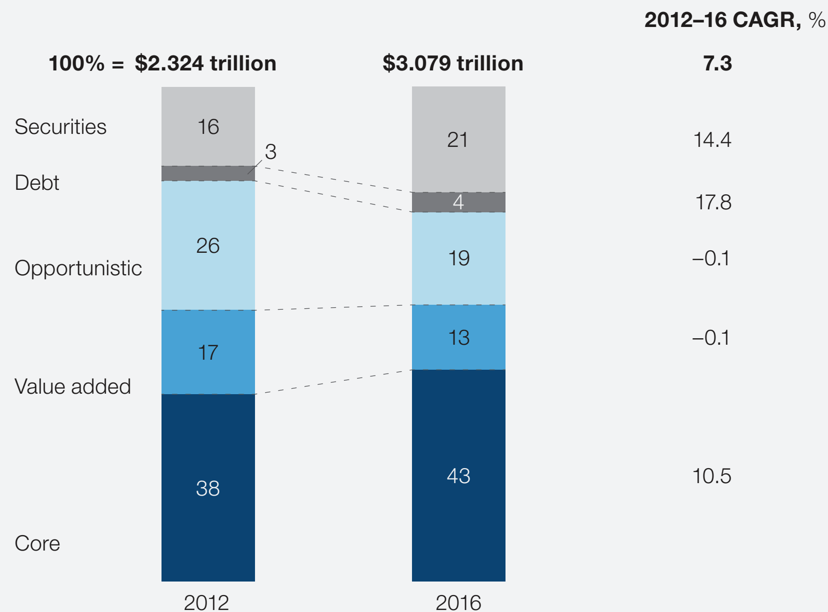
Real estate: More than meets the eye

Given its long duration and yields that have exceeded fixed income, RE is widely viewed by LPs as a particularly attractive fit with their needs. With capital surging into private markets, it is no surprise that RE has grown—even though closed-end fundraising (which we use throughout this report for the sake of consistency across asset classes) shows declines in 2016 and 2017. Given the role that RE can play in the portfolio, capital has moved out of closed-end funds and into other structures.

The big story in RE recently is a shift down the risk curve. While investors have historically viewed RE as a source of alpha, more and more are coming to see it instead as a source of income, and have adjusted their RE portfolios accordingly. Many are shifting to core, which grew 10 percent annually from 2012 to 2016, faster than most other strategies (Exhibit 6). In a yield-starved world, a less risky RE asset that produces 5 to 7 percent annual returns is compelling to many investors.

Exhibit 6 **Real estate fund flows are shifting to lower-risk strategies.**

Real estate assets under management by strategy, 2012–16, %



Note: Estimates include global institutional and retail securities under management.
Source: eVestment; IPD Global Fund Index; IREI; NFI-ODCE; Preqin; Simfund

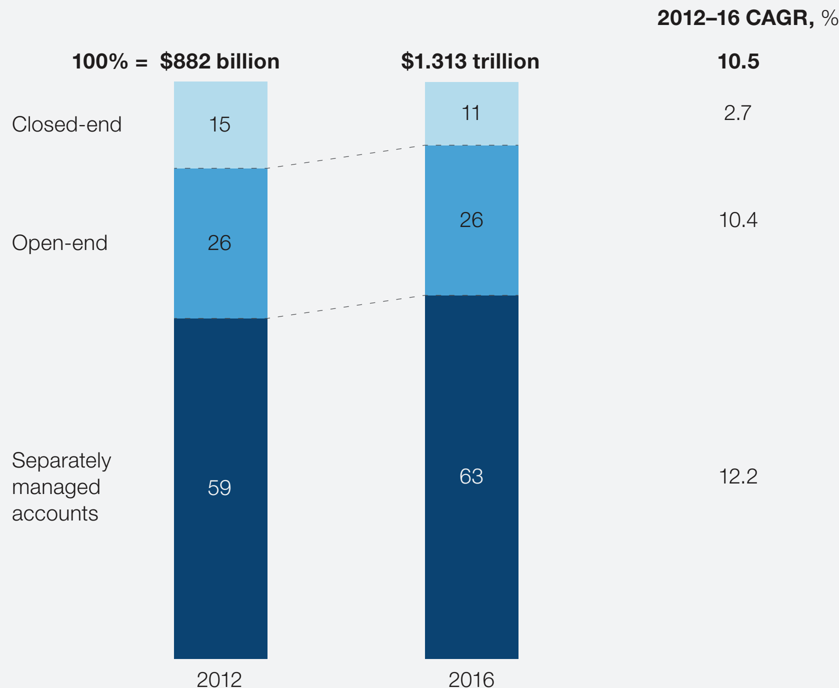
A second important theme is the growing importance of liquidity and discretion. Within core RE, for example, up to 90 percent of AUM is now held in SMAs and in open-end funds (Exhibit 7). These vehicles, which provide more liquidity and more precise choices for LPs, have driven the growth in core, the fastest growing of the traditional RE strategies. Debt funds and listed securities (REITs, traded both actively and passively) have also grown, at the expense of traditional closed-end funds.

Many GPs are now in the process of figuring out how best to match the evolving needs of their LPs. RE managers that can provide strong, less risky returns and offer liquidity in an essentially illiquid asset class will do well. Over time, we may see RE and infrastructure begin to supplant the fixed-income allocation in many investor portfolios, as those dollars shift to low-risk, core, and core-plus styles of RE investment.

PE, private debt, and RE are the three largest private asset classes. But there were interesting developments elsewhere. In infrastructure, fundraising fell in 2017, but that is misleading. Since 2016, some of the largest GPs have raised record-breaking funds for traditional, brownfield infrastructure strategies. Judging by the healthy number of funds expected to close in 2018, it is clear private infrastructure remains very appealing to investors.

Exhibit 7 **Market share of closed-end funds has decreased.**

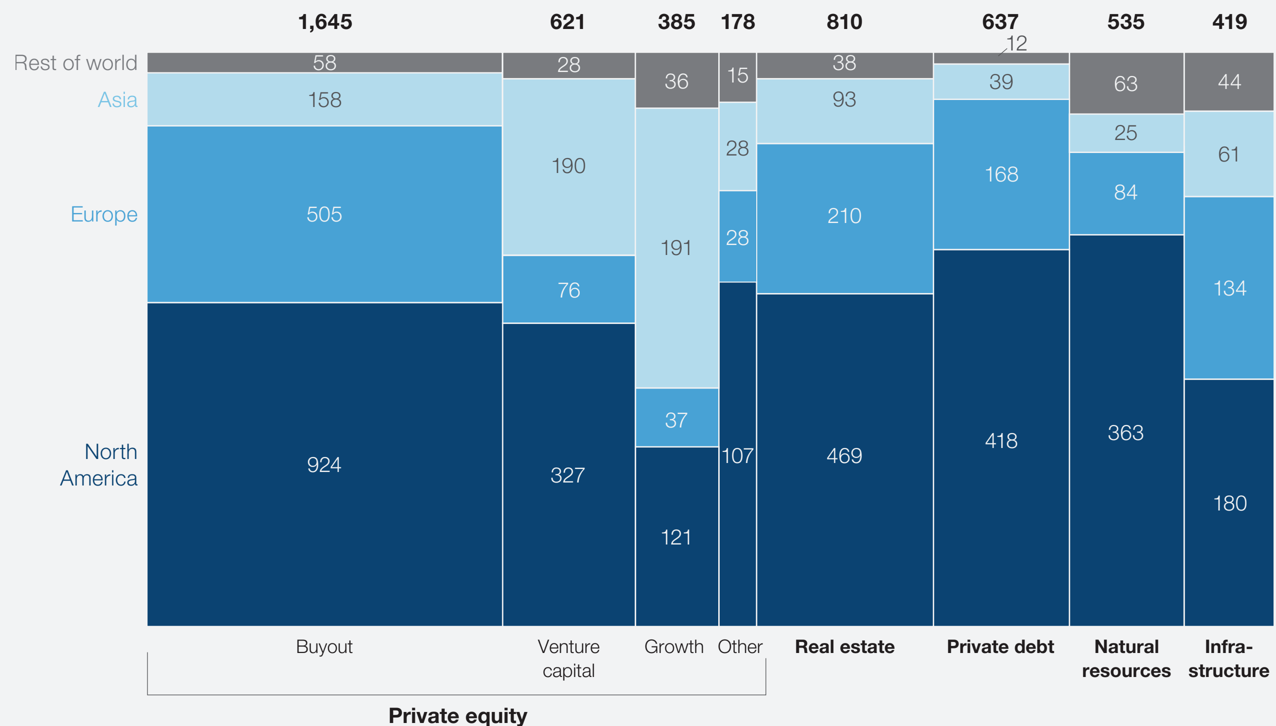
Real estate core gross assets under management by structure, 2012–16, %



Source: eVestment; IPD Global Fund Index; IREI; NFI-ODCE; Preqin; Simfund

Exhibit 8 **Assets under management now total ~$5.2 trillion.**

Private market assets under management, 2017, $ billion



Source: Preqin; McKinsey analysis

From a regional perspective, Europe and North America combined raised more than $50 billion, mostly targeting vast projects to renew and expand existing assets. In today's low-yield environment, investors will continue to seek infrastructure opportunities. The outstanding question is not demand, but supply; while many new projects are seeking investors, public–private partnerships and privatization opportunities globally are harder to find.

With fundraising so strong, private AUM also set a record. To be sure, AUM remains a somewhat abstract notion in private markets. Apart from the usual opacity of privately held companies, the industry typically does not report on so-called shadow capital, which includes LP commitments to separate accounts as well as co- and direct investments; nor does it report fully on capital deployment and exits. AUM reached a record level of $5.2 trillion in 2017, up 12 percent from 2016's $4.7 trillion (Exhibit 8). After growing gradually for many years, AUM accelerated in 2015–17, as the (much smaller) funds raised during the great recession (2008–09) cleared the cycle.

Come together

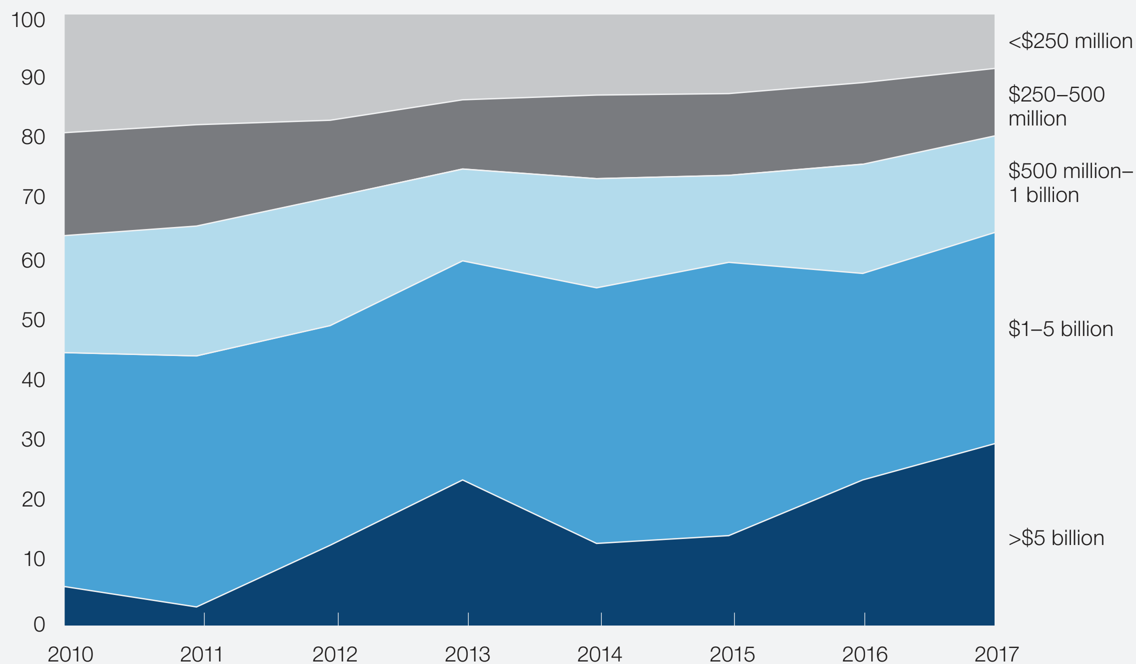
As we discussed last year, we see evidence of nascent consolidation of capital into the biggest funds, as the largest funds account for more and more of

the industry's fundraising (Exhibit 9). Logic would suggest the same would be true for firms—in other words, that the largest firms would start to collect and control more of the industry's total capital. But as of last year, we did not have sufficient evidence to make that claim. Why? We reasoned that, while the biggest firms are inarguably getting bigger, the cyclical nature of fundraising means that their growth might not show up clearly for some time, as not every big firm consistently raises a new flagship fund every year. Furthermore, the industry has a long tail of thousands of small firms; changes in the capital they absorb could obscure developments in the largest firms. And if we look instead at the number of private managers for evidence of consolidation, we won't find it, as the number of firms grows every year.

However, the latest data suggest the beginnings of consolidation of capital, not only in PE, but across private asset classes. Exhibit 10 shows that, though the share of fundraising that goes to the top 20 private markets firms has been in steady decline for years, it has risen sharply since 2015, coinciding with the rise of megafunds. Two years do not make a trend, but this could be the start of a longer-term shift.

Exhibit 9 **Large funds continue to absorb a greater share of funds raised.**

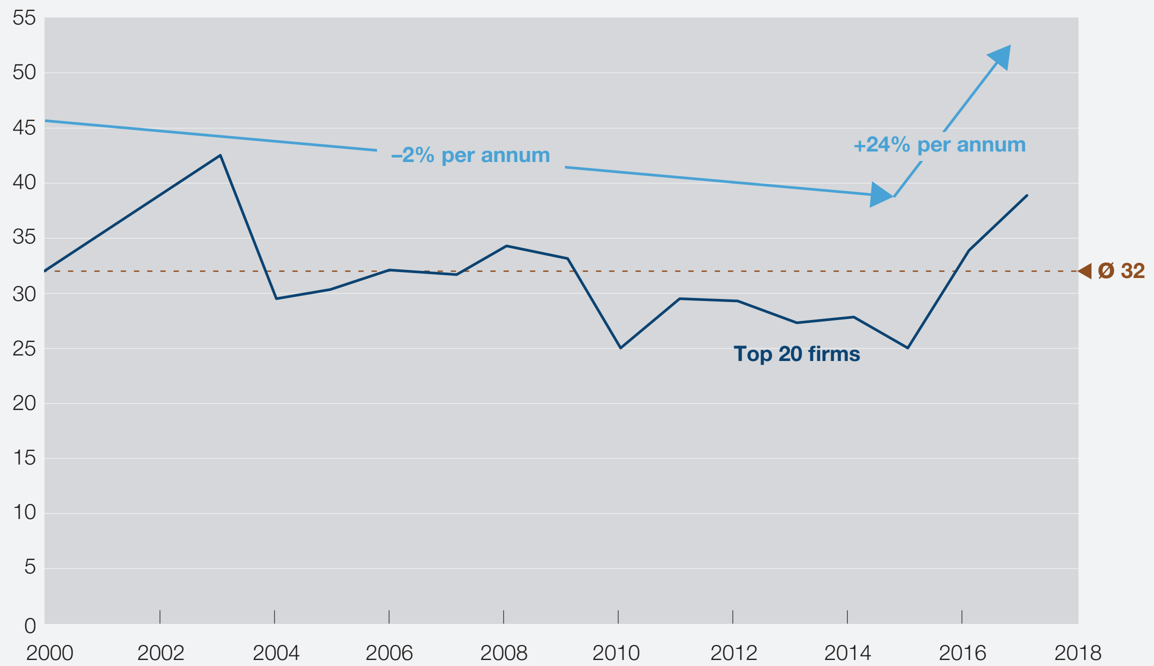
Global private markets[1] fundraising by fund size and year, % of total in-year fundraising amount



[1] Private equity, real-estate private equity (ie, closed-end funds), private debt closed-end, natural resources closed-end funds, and infrastructure closed-end funds. Secondaries and fund of funds are excluded to avoid double counting of capital fundraised.

Source: Preqin; McKinsey analysis

Exhibit 10 **Big firms' share of fundraising has increased since 2015.**



Source: Preqin; McKinsey analysis

And while data on shadow capital is limited, it is safe to assume that the largest firms are also capturing a disproportionate share of these funds. If the top 20 firms account for more blind pool capital than at any point in the past 15 years, and they're also raising most of the shadow capital (a trend that was in its infancy 15 years ago), then it follows that assets are starting to consolidate at the top of the league table.

Consider this from another angle. Over the past five years, most of the top publicly listed alternatives managers have expanded their fee-earning AUM faster than private markets overall. While not a comprehensive analysis, it offers another piece of evidence that private market funds are beginning to concentrate into fewer hands. ☐

Now comes the hard part

So far, so good for private markets. The industry has a record amount of capital. But what to do with it? On that front, some signs of strain materialized in 2017. Deal multiples continued their steady climb, while GPs came under pressure from LPs to use some of their vast stocks of dry powder. Research suggests that today's record levels of dry powder may not be the problem some suggest—but if deal activity continues to stagnate, as it has for two years now, it might soon be.

Deal activity: Getting choosy

In 2017, deal activity was mixed. Take PE, where global deal volume increased 14 percent, surpassing $1.2 trillion (Exhibit 11). Asia led the charge: deal volume there jumped 96 percent, to $110 billion. This dramatic growth is not surprising for the region's maturing PE industry and reflects several larger deals in China, Korea, and Japan, many involving B2B companies. Europe grew impressively, at 30 percent. North American deal volume barely budged, rising 1 percent, to $641 billion, again led by deals in the B2B sector.

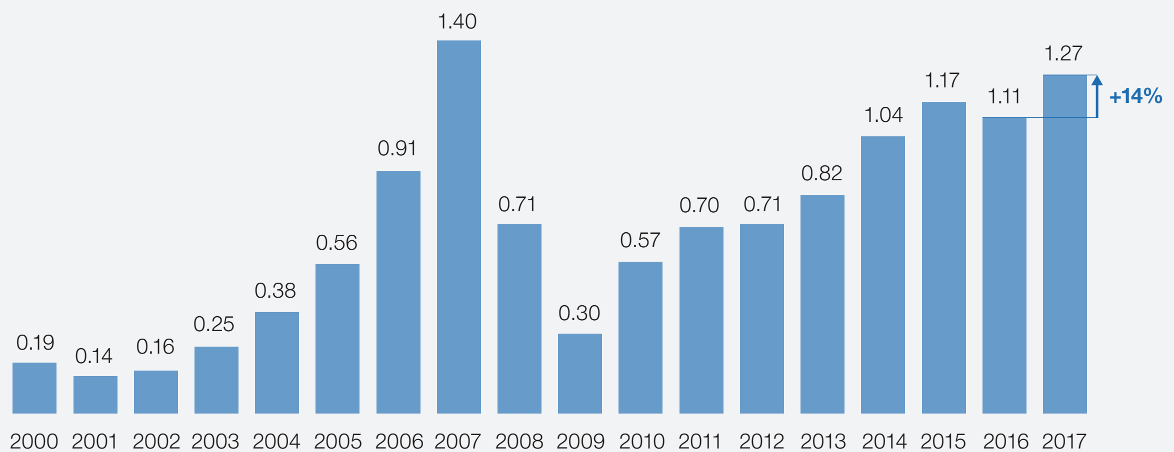
At the same time, however, global deal count declined 8 percent, to about 8,000. This marks a second consecutive year of decline in the number of PE deals. Every region suffered, although mileage varied. In the United States, deal count dropped by 6 percent, continuing a decline that began in 2015. Europe experienced a sharper decline, with deals falling 11 percent. Asia fell slightly, by 4 percent, but the largest fall was in Africa and Latin America, which fell 14 percent, to about 390 deals.

Among specific sectors, energy experienced the largest drop in deal count, falling by 30 percent, reflecting uncertainty about commodity prices

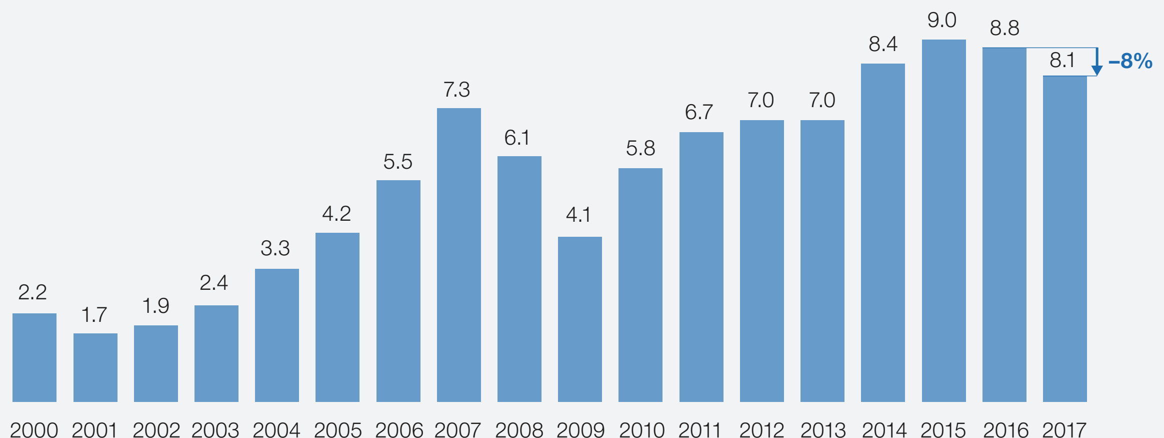
and the resilience of US fracking. B2B and B2C deals were not far behind, falling 12 percent and 14 percent, respectively, as PE firms ceded some ground to strategic investors that reached down to acquire smaller companies. Further, we witnessed a number of corporate carve-outs at the end of 2017, driving more capital through fewer deals. Healthcare declined slightly, about 5 percent. Several big deals took place in home care and healthcare services, driving total value higher, but the sector had fewer deals overall. Information technology ticked up sharply, increasing 10 percent as more and more companies appreciated the step-change in performance afforded by digital transformations.

Exhibit 11 **Private equity deal volume was flat, but deal count declined in 2017.**

Global private equity deal volume, 2000–17, $ trillion



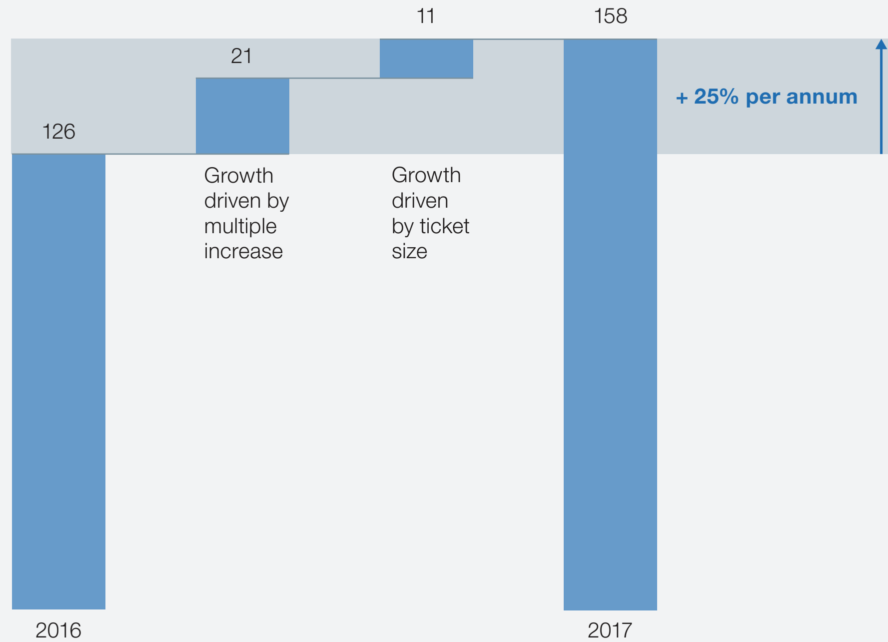
Global private equity deal count, 2000–17, thousands



Source: PitchBook

Exhibit 12 **Average deal size increased 25% in 2017.**

Global private equity average deal size, 2016–17, $ million



Source: PitchBook; McKinsey analysis

The falling deal count reflects a few factors. First, deal size has increased, driven mostly by multiples, making each deal a more significant commitment for GPs. Second, targets are harder to find and some (though not all) GPs are more cautious, pursuing only those deals where they think they can realistically achieve attractive IRRs. Many GPs recall the lessons of the last PE boom, when too much capital was deployed at too-rich multiples over too brief a time—now investors are trying to balance the pressure to deploy capital with the goals to remain disciplined in valuation and rigorous in process. And in some regions, such as Europe, a growing number of PE-sponsored IPOs could be displacing sponsor-to-sponsor sales.

Multiples: Ever higher

With deal volume increasing and deal count dropping, average deal size has risen—by 25 percent this year. About two-thirds of this increase is due to growing multiples (Exhibit 12); the remaining third might be said to be organic, as it is explained by acquisitions of larger targets that generate higher EBITDA.

As Exhibit 13 shows, multiples are on the rise—for several reasons. Start with public market comparables. Although private assets are used to diversify from public markets, they are not unconnected. The public markets are hot—some recent wobbles notwithstanding—and that's been driving comparables' valuations to new heights. Further, private buyouts

are a small fraction of total M&A, whose dynamics are heavily shaped by strategic investors. The low-cost debt environment of the past decade encouraged strategics to open their pocketbooks and quickly expand through inorganic growth. In so doing, they are competing directly with PE for deals and pushing multiples ever higher. Another factor: within private markets, record fundraising means there's more competition for good deals. Finally, the ongoing availability of cheap debt is driving up leverage levels.

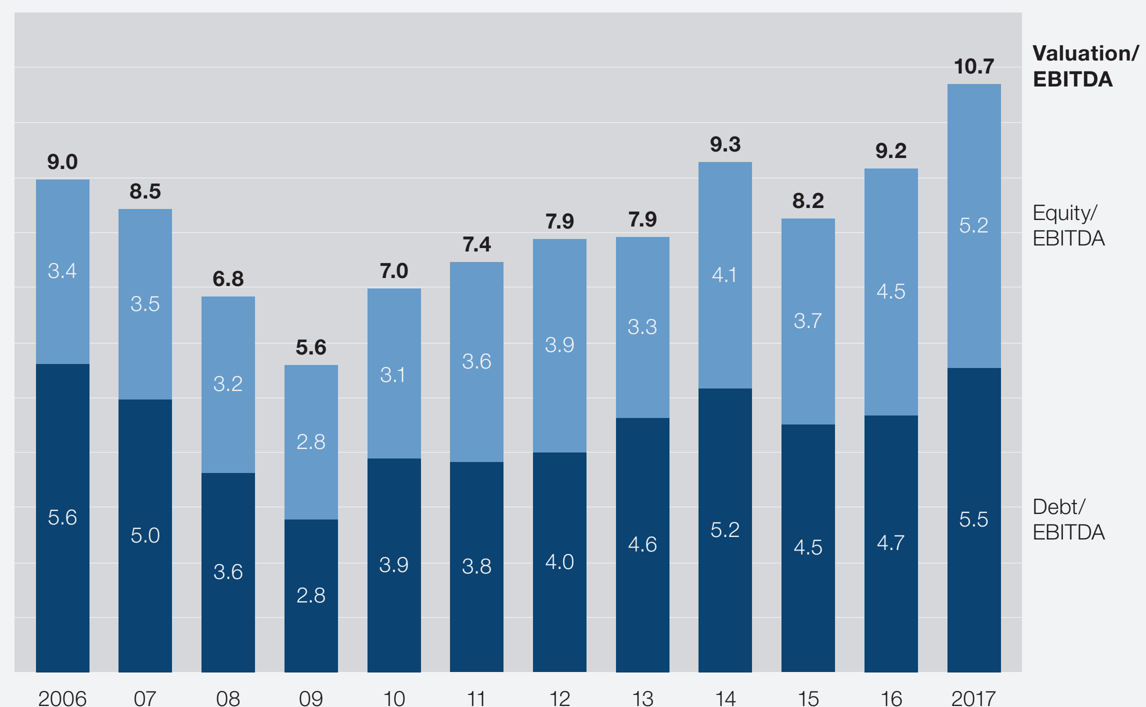
The difficult environment has concentrated minds. GPs are making fewer investment choices, zeroing in on targets where they can still earn an attractive IRR—though what constitutes attractive is undergoing revision, as many firms lower their hurdle rates. Our discussions with industry leaders suggest that these are companies in which the GP has subject-matter expertise, opportunities to extract synergies, or strong conviction about market upside potential.

Dry powder: How much is too much?

With competition rising and deals hard to find, GPs' stocks of uncommitted capital, or dry powder, reached a record high of $1.8 trillion in 2017 (Exhibit 14). That was up 9 percent year on year;

Exhibit 13 **Private equity deal multiples continue to rise.**

Global median private equity EBITDA multiples, 2006–17



Source: PitchBook

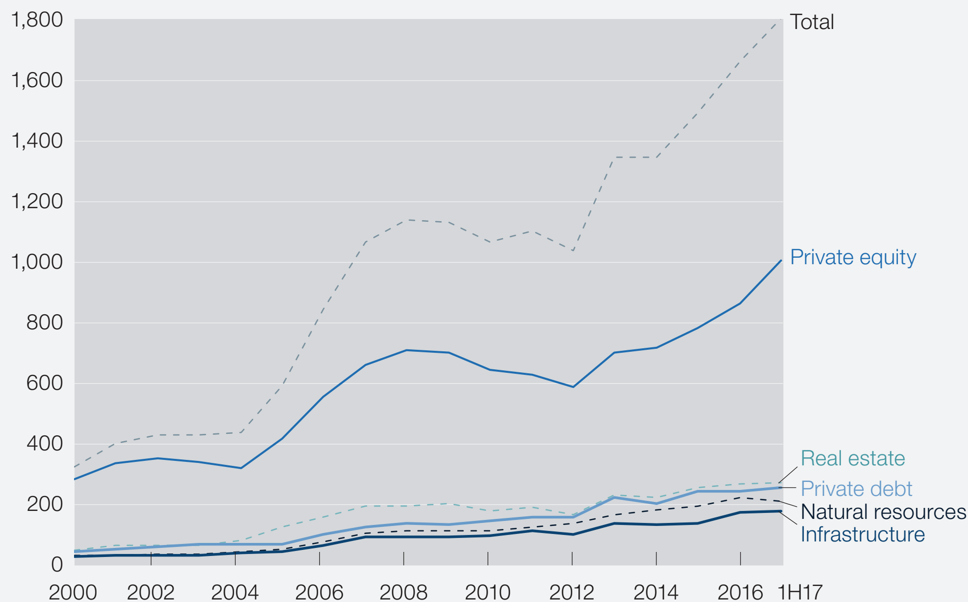
indeed, dry powder has grown by 10 percent on average every year since 2012.

Does the industry have too much capital? Probably not, or at least not yet. If we compare dry powder to other measures, such as funds raised and AUM, "stocks" of capital available for investment have changed little over the past few years vis-à-vis the size of the industry. Dry powder as a percentage of in-year fundraising has been between 220 and 280 percent for the past six years. As a percentage of AUM, dry powder has been similarly consistent, at 30 to 34 percent. Nor are there any significant variations among asset classes, suggesting that GPs are finding adequate opportunities in every field.

Furthermore, by the metric we introduced in the 2017 edition of this report, years of PE inventory on hand, dry powder still seems adequate to deal flow. If we divide dry powder by deal volume on a seven-year trailing basis, the industry seems to have cycled through its capital in a stable way for the past several years (Exhibit 15).

Exhibit 14 **General partners' stocks of dry powder reached a new high.**

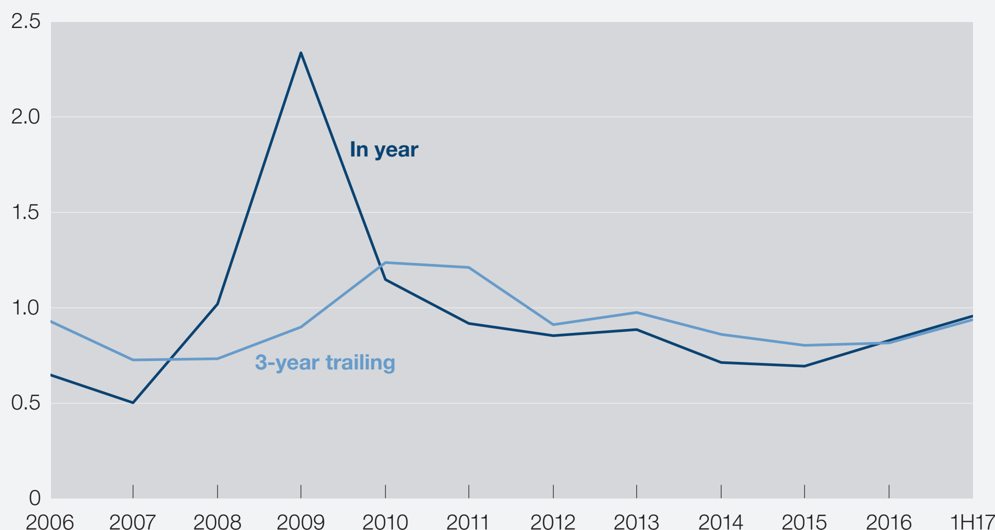
Capital committed and not deployed, 2000–1H17,[1] $ billion



[1] Data not available for full 2017 year.
Source: Preqin

Exhibit 15 **Inventories of dry powder continue to appear stable.**

Years of private equity inventory on hand,[1] turns



[1] Capital committed but not deployed, divided by deal volume.
Source: PitchBook; Preqin; McKinsey analysis

Nevertheless, the metric ticked higher in the past year, given the continuing growth of dry powder combined with the softening of deal activity. A continuation of this trend over the coming years would be troubling and could force many GPs to further reduce hurdle rates as well as deploy capital in situations they otherwise would not. Furthermore, if we factor in leverage on the dry powder accumulated, the numbers begin to reach eye-catching proportions. While the industry has managed inventory quite well so far, we may reach a point where the sheer magnitude of capital that has to find deals becomes an issue.

Exits: Go time?

No discussion of deployment would be complete without a word on exits. With multiples high, exits have been relatively painless, so GPs have taken advantage of the environment to sell. Continuing the trend that started in 2011, distributions to LPs exceeded capital calls; in the first half of 2017, GPs returned $100 billion more to LPs than they called in (about 30 percent more returned than called in).

And yet, total value of exits in 2017 was nearly flat, while the number of global PE exits continued to decline (Exhibit 16)—the same dynamics we saw in acquisitions.

Again, like acquisitions, average exit values were higher in 2017, putting pressure on owners to sell and capitalize on the frothy environment. In response, North American GPs are increasingly

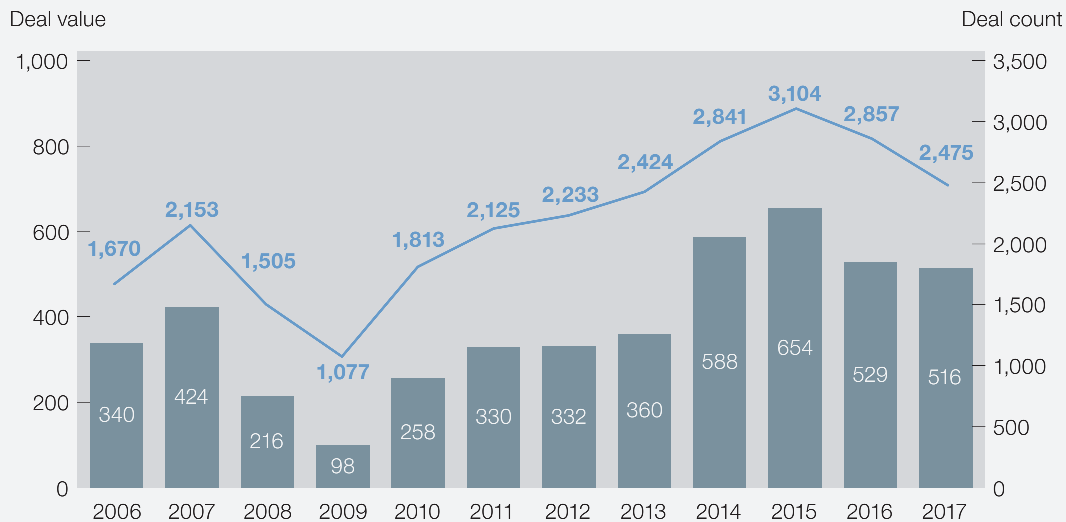
mimicking their European counterparts by conducting vendor due diligence, in which sellers seek to better understand and communicate their company's value and growth potential to buyers, in an effort to leave less money on the table.

Some GPs we've spoken to wish to shorten their hold periods and exit quickly. Broad industry data does not yet reveal this trend, possibly because it takes time to appear, or because some managers are choosing to hold assets for longer than the traditional four to five years.

More simply, the decline in exits might be a product of cyclicality. During the crisis, exits nearly came to a halt. To avoid realizing a loss or a low IRR, owners put off sales until the market recovered. Portfolios swelled, and the pent-up pressure was released in 2014–15. With that, 2016–17 deal counts declined to more sustainable levels. □

Exhibit 16 **Value of private equity–backed exits was roughly flat; the number of exits fell.**

Global private equity–backed exits, $ billion, number of exits



Source: PitchBook

The march of progress

What's next for this rapidly growing industry and for the vital relationship between GPs and LPs? Our experience and discussions with both sides suggest that the relationship is healthy, but also changing as allocations expand. As GPs build more discipline, structure, and scale into their processes (part of what we call a firm's "organizational spine"), they are building a foundation that, among other things, can accommodate massive capital inflows.

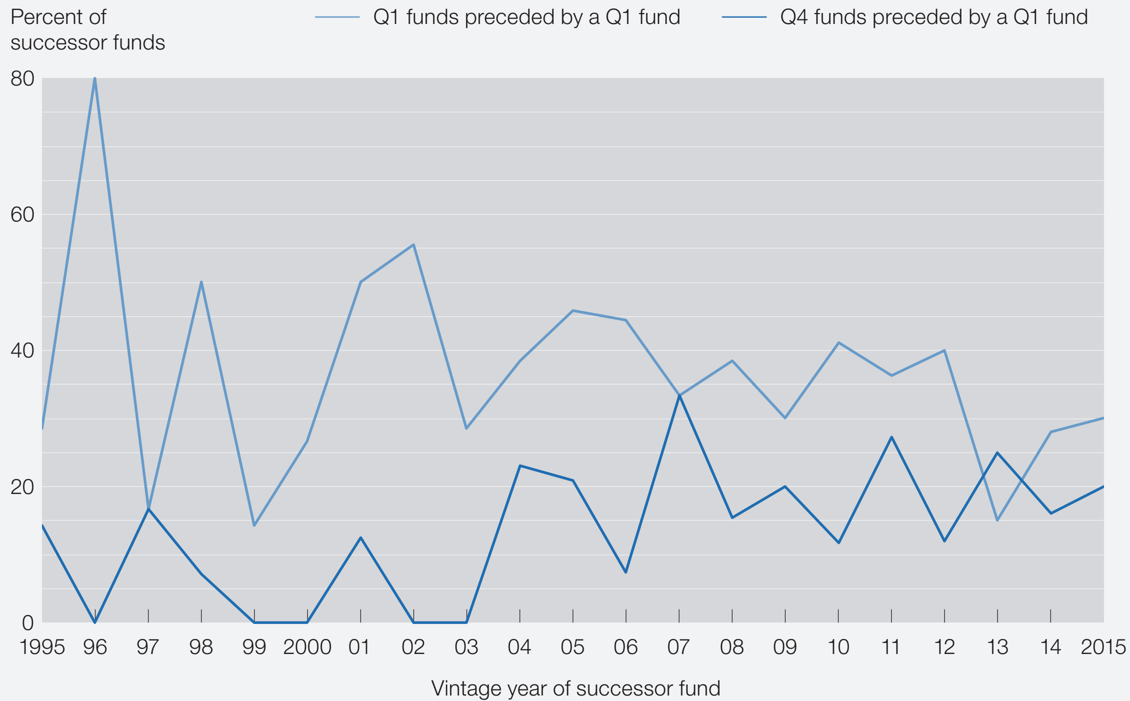
Changing dynamics and ten-figure mandates

As LPs vet external managers, persistency of performance has emerged as an important topic to consider, as it has weakened since the 1990s. Previously, a successor fund to a fund that performed in the top quartile had on average a 40 percent chance of replicating the feat. New data, while not definitive, suggest that number has declined to an average of 30 percent in recent years. Moreover, the likelihood of a successor fund dropping to bottom quartile has quadrupled over the same time (Exhibit 17). Indeed, follow-on performance is converging towards the 25 percent mark—that is, random distribution—but hasn't reached that point yet. These are early signs and are not conclusive—but are suggestive of a challenge for both camps, particularly for LPs and the process of manager selection. It is also, to the earlier point on megafund growth, a new wrinkle in LPs' long-standing practice of choosing large, brand-name funds. Anecdotally, some savvy LPs believe that even where firm persistence has declined, persistence of performance among individual dealmakers is still quite strong.

At the same time, LPs have continued interest in building co-investment and direct investing capabilities, as a way to reduce cost and deploy capital. In McKinsey's recent LP survey, over 70 percent of LPs

Exhibit 17 **Convergence in outcomes of successor funds suggests persistency is falling.**

Private equity funds' quartile performance relative to immediate predecessor, %



Source: Preqin; McKinsey analysis

stated an intention to build these capabilities.[6] However, making this shift can be challenging, and success depends on LPs' governance model, capabilities, size, and risk tolerance. The data show that, while LPs have increased their co-investment activity, few have become true direct investors. The value of co-investment deals has more than doubled since 2012 (totaling $104 billion in 2017), but direct investment has remained essentially flat, at around $10 billion (Exhibit 18). A recent survey finds something similar: the number of LPs making co-investments in PE rose from 42 percent to 55 percent over the past five years, while the proportion of direct-investing LPs barely grew, from 30 to 31 percent. Both LPs and GPs have found that co-investment has its challenges. For LPs, not only are co-investments hard to scale, but academic research shows significant variance in returns, which can make it difficult to get approval from investment committees for these fast-moving transactions. For GPs, the resulting slow pace of decision making is frustrating, and the speed of deployment of commingled funds has slowed commensurately.

So how are LPs and GPs tackling the challenges of scale? One approach growing in popularity has been increasingly large SMAs, sometimes called

strategic partnerships. Gradually, inexorably, and—given their private nature—somewhat opaquely, SMAs account every year for a larger share of private markets' capital under management.

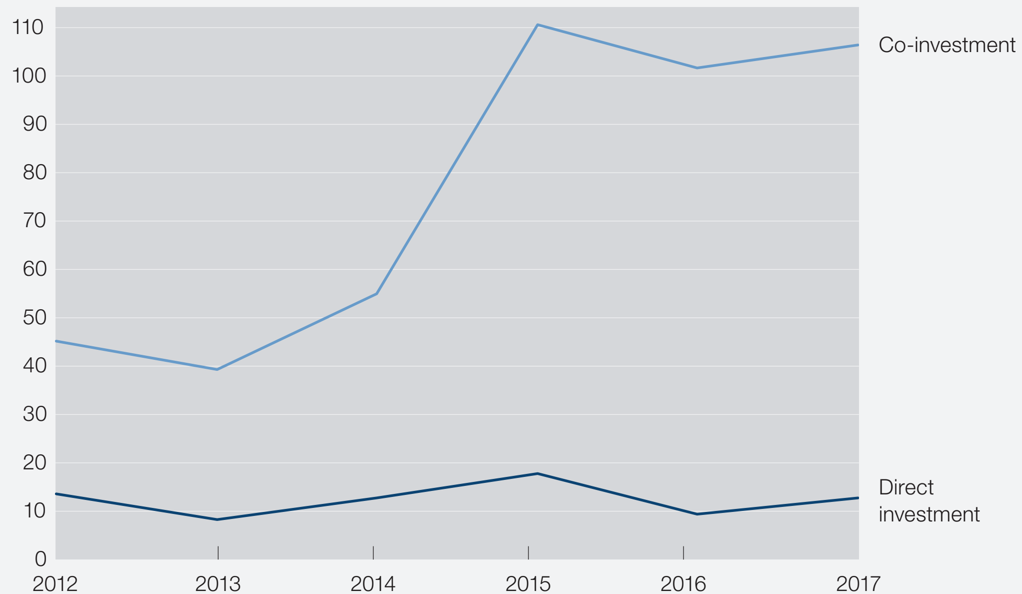
One notable recent development is the super-sizing of these SMAs, as LPs seek broader, deeper, more strategic relationships with a smaller number of trusted managers. These partnerships tend to be characterized by larger allocations, "most favored" fees, and increasingly, terms that reflect performance across the entire relationship rather than in individual transactions or asset classes. More of these relationships now also feature longer-term (or even "permanent") capital; higher levels of mutual transparency and collaboration, especially in the context of co-investment; and in some cases, a mix of commingled structures, SMAs, co-investment, and even some exposure to GP economics.

The LPs in these relationships are typically larger pensions or SWFs seeking a streamlined way to deploy capital at scale, and to develop or extend their internal capabilities through training opportunities for staff, access to the GP's sector or regional experts, detailed market views, regular access to investors and executives, and even in some cases in-depth bespoke research.

For GPs, the calculus involved in these mega-mandates is usually more complex than just attracting

Exhibit 18 **Co-investment has increased significantly.**

Limited partner co-investment deal value,[1] $ billion



[1] Defined as deals involving at least 1 LP and 1 GP.

Source: PitchBook; McKinsey analysis

a bigger check at lower fees. One attractive feature for GPs is the potential to reduce fundraising costs by eliminating the friction of returning and reallocating capital every few years. The relative certainty of managing a set amount of capital is especially enticing to publicly traded managers with volatile fee streams. Those with more predictable income tend to trade at higher multiples. These benefits are enhanced if capital automatically recycles back into the partnership. No less important to GPs contemplating such relationships is the benefit of having a reliable "anchor tenant" for new investment products, which improves their marketability, particularly if the LP is influential with its peers.

Large strategic partnerships are still in their relative infancy. Since 2011, several institutional investors have structured such partnerships with a number of private managers—in some cases, publicly announcing the relationships, in others avoiding publicity. Some partnerships have been very broad—covering multiple asset classes, with innovative fee terms and detailed capability-building provisions—while others have effectively just been mammoth SMAs.

The overall impact has been twofold. First, the rise of strategic partnerships has accelerated the industry's shift away from the commingled fund as the default organizing structure for external management. The blind pool is far from finished, but especially for larger LPs, it is now less often the presumed approach. Second, strategic partnerships—and billion-dollar-plus SMAs more generally—are redefining what it means to be among a GP's "most favored" investors. At many GPs, the days are long gone when simply writing a larger check and committing to a fund sooner meant an LP could ensure preferential treatment. Effectively, an elite scale that once topped out at gold now has platinum and diamond tiers. As these relationships multiply and scale rapidly (with some LPs now contemplating mandates in the tens of billions of dollars), the industry should expect these effects to reverberate.

Organizing at scale

A second trend among both GPs and LPs is to strengthen what we call their organizational spine—a shift that takes activities once done as a sideline by busy founders and professionalizes them, creating a modern and efficient institution. Fundraising, AUM, and dry powder are at record levels, producing at least heightened deliberation if not discomfort among both GPs and LPs. Both are taking a hard look at the ways they work, to make sure that the processes and approaches that succeeded in what was, in many ways, a cottage industry will remain suitable in an era of scale. Adding controls to processes cannot guarantee high returns and cannot by itself lead to blockbuster transactions. In this people-driven business, it remains impossible to legislate success. But greater process discipline can help cut off the lower side of the returns distribution, enabling investors to avoid the failures of care that, for instance, held back net performance of many GPs in the vintages of the last PE boom.

Billion-dollar-plus SMAs are redefining what it means to be among a GP's "most favored" investors.

Among other things, GPs are enhancing their spine by trimming bloated back offices; formalizing succession plans; better integrating analytics, digital, and big data tools; and rethinking recruitment of analysts and associates. Even better, many are sharpening their risk-management processes, which can protect firms from macroeconomic downside, including a possible slowdown of global growth as well as rising interest rates. 2017 may not have been that year—far from it—but the most forward-thinking firms are always looking years ahead at obstacles unknown, and limiting the potential for careless investing behavior.

Riding the wave

Strategic partnerships and the emergence of the organizational spine are two steps forward for the industry. But GPs in particular should consider further moves, at every step in the deal cycle—sourcing, diligence, operations, and exits—as they seek to future-proof their deal-making for the age of scale.

Next-gen sourcing. Attempts to improve sourcing with analytics have been rare thus far, but early signs are encouraging. Practitioners of analytics-driven sourcing told us that they have found such methods effective in industries such as consumer technology, where users' posts may be a decent predictor of a target's attractiveness. Analytics can also be used to comb company financials across sectors to identify markers of untapped operational upside. In general, they enhance rather than replace the human process.

But analytics is not the only way for GPs to bring discipline to sourcing. Instead of casting a wide net to find opportunities—and coming up with only a few that match their investment thesis—GPs can instead make things happen by finding companies whose potential well matches their playbook. That is, GPs can identify broad themes, sometimes macroeconomic in nature, and through portfolio construction, gain exposure to and place bets on those themes. For example, a firm that foresaw growth in freight on a certain trade route might acquire a stake in airlines that sell belly capacity on that route. Or consider the real-estate strategies that underpin several PE firms' retail investments.

A third way to improve sourcing is to anticipate economic and demographic shifts up and down a business system. It's possible to know, for example, just when an emerging middle class will upgrade its grocery purchases from basics to more expensive fare.

Win at diligence. At current valuations, GPs increasingly find themselves having to assess ex ante their ability to improve the economics of the target, if they are to exceed their hurdles. Operations-focused diligence has become more common as a way for GPs to gain confidence to underwrite these oppor-

tunities, in effect making a bet on both ends of the industry's J-curve. GPs exploit ops-focused diligences as a new way to assess from the outside the potential to improve a company's operations, in procurement, SG&A reduction, pricing, and other areas. Some are even finding ways to apply clean-sheet budgeting to estimate cost savings, without much knowledge of what a company actually spends. Deep operations expertise helps, obviously, not only in such assessments, but also in developing conviction about the certainty of capturing these gains. Such conviction can make all the difference in assigning probabilities to the typical scenarios of base case/upside/downside—and thus to placing a winning bid.

Traditional commercial due diligence, like sourcing, is also finding new efficiencies through technology, particularly for consumer targets. Web-scraping tools not only piece together the historical evolution of product pricing over time, as an input to growth models, but can also conduct brand-sentiment analysis on social-media posts. For assets with a significant online presence, new tools can assess the effectiveness of digital marketing spend and even the rate of customer conversion on e-commerce sites. Perhaps most importantly, these analyses can all be conducted from the outside in.

Get serious about operational improvement. With multiples at record highs, investors have two options: pay the current price and hope for even higher multiples at exit, or pay a lower effective multiple by underwriting specific expectations for operational value add. The latter method is attractive in theory to many GPs but difficult to execute in practice. Some managers have proven reliably able to enhance portfolio company economics, but most are still searching for a successful formula. They should not be discouraged by their mixed track record—in fact, they should redouble their efforts, since if multiples remain high, operational value creation will be all the more necessary.

They can start by looking for value within their own portfolios. Too often, GPs hold on to underperforming portfolio companies long past their originally intended exit date, hoping for a reversal of fortune. Yet a concerted effort to turn such companies around, especially with new approaches such as digital-first transformation, can yield rapid success, as we have seen recently with several portfolio companies in consumer-packaged goods and retail.

A second approach for GPs—and a more important one to debate—is whether to build internal operating groups or hire externally. Certainly, some internal operating groups have delivered strong value, particularly at firms with strong specialties in industries or certain asset classes. However, when firms venture off their turf by exploring a less familiar industry or function, their specialized skills are less valuable. The same holds true when firms expand rapidly; experts have only so much time in the day. And when firms attempt large-scale operational projects such as overhauling legacy systems or digitizing or outsourcing big pieces of the company, again internal capacity is often exhausted. Moreover, some of the largest internal operations teams have been scaled back, because they were a large fixed cost or ultimately too far below scale to have sufficiently specialized expertise. Leading firms supplement their operating capabilities with help from outside, and thus bring to bear a far greater range of operational expertise than could be accomplished within a leaner internal group.

The tough get going. Exiting a company with strong ongoing potential can be frustrating for a GP beholden to the holding period norms imposed by most commingled fund structures. Often, GPs strongly believe that a given investment will continue to prosper beyond the normal holding period but feel compelled to sell to meet the demands of LPs, or other needs. In today's climate, obeying these rules may not yield maximum value. GPs may adapt

their processes to highlight the value of retaining control of some investments—for example, calculating an optimal "handoff period" in which the investment can move from its original fund to a second fund with a lower expected IRR but also lower fees charged to contributing LPs. We expect demand will emerge for this type of investment vehicle, as it becomes clear to investors that older investments, particularly infrastructural ones such as power plants, continue to have value-creating potential. Alternatively, some GPs are experimenting with partial exits, selling much of the portfolio company to LPs while retaining a sizable stake.

Exit cycles will begin to diverge from tradition. The average global buyout holding period is around five to six years, and, barring a significant downturn in valuations, this average is unlikely to move significantly (it has held more or less stable since 2010). However, longer tails at both ends will likely emerge. On one end, exit cycles for investments purchased at high multiples may reduce to as little as two years, as firms cash in on multiple growth early (especially if they anticipate multiples will decline). On the other end, GPs investing in assets naturally suited to longer holding periods (real assets such as infrastructure, natural resources, and RE) may place them in evergreen funds, to create maximum value for LPs that understand the benefits of extending holding cycles for such investments.

As a wise man once said, a billion here and a billion there, and pretty soon you're talking about real money. Private markets are awash in real money—and the challenges that come with rapid growth. We hope that this report provides useful ideas for private investors to take advantage of today's benign environment, and build their defenses should fortunes suddenly shift. ■

[1] We define private markets as closed-end funds investing in PE, real estate, private debt, infrastructure, or natural resources, as well as related secondaries and funds of funds. We exclude hedge funds and publicly traded or open-end funds.

[2] Data cited in this report were produced by McKinsey and by Cambridge Associates, Capital IQ, CEM, Coller Capital, Dealogic, PitchBook, and Preqin.

[3] "Why investors are flooding private markets," September 2017, mckinsey.com.

[4] See Robert S. Harris, Tim Jenkinson, and Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, Darden Business School working paper, number 2597259, April 2015, ssrn.com.

[5] This report focuses on closed-end funds, or blind pools.

[6] "A routinely exceptional year for private equity," February 2017, mckinsey.com.

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