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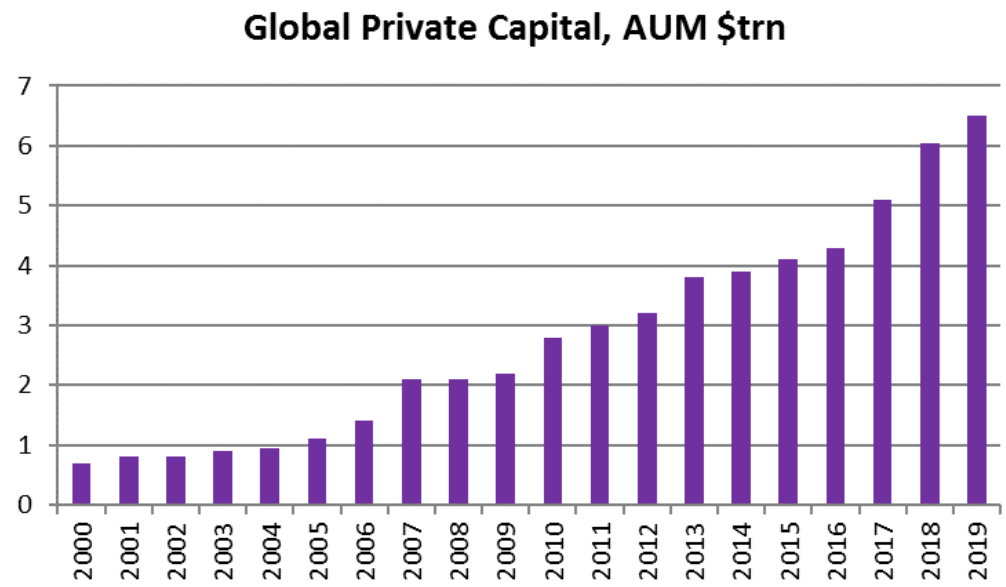
The going-private movement

Private markets consist of all the investments that are not traded on a public exchange or market. They can encompass a wide array of underlying assets, from securities to properties and everything in between. In this note, 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. For further understanding on private equity please refer to "what is private equity?".

Active management lives on

In one of our previous focus pieces[1] we looked at the seismic shift in investor preference from active to passive fund management over the past decade. While everyone talks about the impressive growth of the exchange traded fund (ETF) market, the real show stealer (in terms of asset growth) is the private realm. According to McKinsey Global Private Markets Review 2020[2], total AUM across private markets has hit another all-time high of $6.5 trillion as investors continue to shift capital from public asset classes in search of more upside. According to JPMorgan, pools of private capital grew by 44% in the five years to the end of 2019. A different way to capture the scale of the private party is to look at the quartet of Wall Street firms that specialize in managing private investments for clients—Apollo, Blackstone, Carlyle and KKR. Their total managed assets have risen by 76% in the past five years, to $1.3trn.



Source: Preqin & McKinsey

While passive investment is not (yet?) feasible in private assets, it is worth understanding that private markets have been growing at twice the pace of ETFs. In essence, those who fear that the end of active management is in sight (relative to the growth in ETF vs. traditional funds) should understand that active ownership is alive and kicking as the main engine of performance for private assets. In private equity, for instance, it's commonly accepted that 60% of returns are driven by active ownership, achieved through asset improvement.

Why are more companies giving preference to being private?

In observing financial markets, the broad expansion of private assets is visible through the fact that companies remain private for longer and the fact that it the delisting of public companies (to go private) is becoming more common[3]. By staying private, companies can embark on long-term, innovative, and sometimes high-risk, high-return ventures. They aren't bound by the pressures of quarterly results, meaning they can take a longer term view. Running a public company can be an arduous task. The rules and regulations that govern operations and disclosure requirements have become increasingly complex over the years and the corresponding expenses to stay compliant are considerable.

With the number of new listings in decline and an increasing number of firms quitting the stock market to go private, the proportion of publicly listed companies should continue to fall. Between 2000 and 2018, the number of private equity-backed companies in the US rose from around 2,000 to around 8,000. At the same time, the number of publicly listed companies fell from 7,000 to roughly 4,000. Albeit, those listed firms are still worth more than ten times the private-equity backed ones (due to their bigger size, on average).

Considering
that there are half as many public companies as there were two decades ago, everyday investors are left with fewer places to store their money.

According
to The Economist, a large and growing share of assets allocated by big pension funds, endowments and sovereign-wealth funds is being redirected into private markets. Across a panel of 10 of the
world's largest funds examined, the median share has reached 23%.

Private assets are now an integral feature of capital markets

It's becoming
clear that private assets are now a core feature of the investment landscape for investors and entrepreneurs and they are here to stay. A generation ago, a promising startup would typically aim for an initial public offering (IPO) within some years. Now, the remaining active investors in public markets are less willing to take a punt on small firms. Midsized companies are not big enough or liquid enough to fall under the umbrella of passive investing. While private asset management is the antithesis of passive management, the growth in both of these areas is feeding some sort of self-reinforcing rationale.

While private
investments were once considered as hard to access, opaque, complex and niche, they are now valued and accepted as an

attractive way to diversify an investment portfolio and achieve enhanced long-term return potential; clearly this underpins the strong appetite shown by high net worth and institutional investors.

Key drivers behind the rise of PE

Regulation is also altering the playing field. After the financial crisis of 2007-09 new rules made it costlier for banks to lend. The biggest banks were incentivized to lend to consumers and blue-chip firms at the detriment of midsized firms: The gap in corporate credit has been filled by private assets funds. Early June, the US administration paved the way for ordinary savers to invest in private equity funds through their employer-sponsored retirement accounts. The US labour department, which governs 401(k) retirement accounts, said private equity could be used within the professionally managed funds on offer to savers. The new rule will level the playing field for ordinary investors vs. institutional investors, helping to democratize access to private assets.

Some intellectual evolution is also at play among investors. The redirection of the endowments of large and well-established American universities during the '80s towards having a larger exposure to private assets has been followed by a larger band of investors. A 2014 study[4] found that venture and buy-out funds on average did better than the S&P500 index by around 3% a year after fees (with considerable dispersion around winners and losers and without accounting for leverage). But as cautioned by one of the authors, "what private equity is going to do going forward, God only knows".

Depressed interest rate levels around the globe (often described as financial repression) mean that the earnings for savers are entrenched below the level of inflation. This is a strong driver behind flows into the private realm. The quest for low correlations in portfolio construction is also at play. While listed equity indexes disconnect regularly from fundamental perspectives, an increasing number of investors are holding cash, remaining skeptical of public market dynamics. While doing the necessary research is not

an easy task, more and more investors are willing to take their chances with private debt and equity.

Private equity has a sulfurous reputation of cold-blooded capitalism, somewhat illustrated by Danny De Vito's character of "Larry the Liquidator" in the '90s movie, "Other People's Money". The asset stripping and job cutting[5] is a biased perspective about a single part of the broader picture. While takeovers of public companies by PE firms are, from media coverage, associated with restructuring and job losses, Larry the Liquidator is long gone and has been replaced by less colourful but more efficient corporate players. Private equity funds were previously considered as raiders, stone-cold financiers, gaining control of a company through a leveraged buyout (LBO) to dismantle it by selling its most profitable elements while scarifying whatever remained (i.e. human capital). These days this is not the reality, cash is abundant and private equity practitioners are adopting buy-and-build mentalities, while fighting obsolescence. Private equity is also more than LBO. Private equity takeovers of listed companies are only a small part of the scope. A far greater part of private equity activity is related to takeovers of non-public companies, not to mention venture capital, which is helping build tomorrow's disruptors.

Is there a downside?

Let's be realistic, the smoothed returns of private equity understate the true economic risk and are an artifact of the lack of mark-to-market for illiquid assets. In short, although PE has low reported risk, it is economically riskier and has higher exposure to the equity risk premium than public equities. But looking through the glass-half-full perspective, if the growing interest in private equity before the current pandemic was supposed to drive richening valuations, a headwind for future returns edge over public equity, the ongoing context is a reasonable opportunity for new joiners. As stated by AQR[6], "the full risk of PE is most likely to materialize in prolonged bear markets, not in a relatively fast one" (nor a short one).

Conventional wisdom is that you should receive an additional premium for holding illiquid assets. But what if this illiquidity is perceived as a "feature and not a bug"[7]? Knowing that we are all suffer from behavioral biases, sometimes detrimental to our investment ambitions, illiquidity could mean that the madness of crowds associated with market timing is out of reach. Keep in mind that for euro-based investors, negative interest rates also mean that time value is upside down. Liquidity, as such, could also be upside down. Counter-intuitive, but illiquidity could do more positive than negative for some investors. It will not be inconceivable to face illiquidity-discounted expected returns.

The shape of PE in a post-Corona future

The Covid-19 pandemic has majorly disrupted economic activity and private equity. The extent or duration of disruption is unknown at present, hence, forecasting demand and short term cash flow is difficult. We are reassured that private equity activity has the innovative capabilities and resilience to work through this unprecedented moment. Clearly, some transactions have been disrupted or put on hold. Pricing assets is also challenged by the long list of uncertainties and this will take more than a couple of weeks to resolve. But the industry is supported by various factors. Prior to Covid-19, it was well documented that dry power waiting to be invested was pilling up. Funds nearing the end of their predefined duration could find it tricky to exit investments. Those funds are likely to increase their holding period and work through the crisis to sell in better times, as long as they have the ability to do so. On the other hand, new buyouts may need a bigger investment than they have been used to secure financing but private equity is also likely to benefit from borrowing at historically low interest rates while seizing opportunities at discounted valuations. According to Bloomberg calculations, the private equity M&A market share proportionally increased since the pandemic erupted to reach roughly 30% of all M&A volume in 2020. From the same source, "private equity buyout volume is also on the rise. $101.3 billion in proposed, pending, and completed private equity buyouts have been announced in the U.S. this year, which represents a 15% increase from the same period last year". While private equity may not see the "extreme money-making" of past years, the industry is continuing to make deals and is poised to seize upon targets with lower multiples; cheap acquisitions could be

sowing the seeds of a great vintage year down the line.

Real estate

The
Covid-19 pandemic is also accentuating existing trends. For private real estate, lower rents and expected income streams could push values down, but the fall in interest rates will also buffer the effects of this through lower discount rates. At the end of the day, the real estate risk premium required today would have to be larger given the higher level of uncertainty. Having a significant pipeline with many pre-identified assets may not be attractive to investors anymore, not only because of the anticipated adjustments in asset values, but also because of the changing tenant demands that should impact longer-term price trends in the real estate sector - structural trends were already quite visible before the pandemic.

The office market in aggregate entered the crisis in good shape. A limited pipeline and low vacancy rates are still at play even if some occupiers are suffering, and some will go out of business. Furthermore, the rise of home working will reshuffle the office market. Remote working could ultimately erode tenants' demand for traditional office space and dampen overall occupancy and rent levels in the market. At the same time, the experience of the pandemic may change corporate behavior, and if social distancing becomes the norm, employers may have to grant more personal space to employees than is currently standard. The battle between the out-of-office model and the need for creativity and interactions around the coffee machine is at play.

But working
from home is not new. The development of remote-working capabilities started years ago, as companies began to focus on improving their employees' work flexibility and work-life balance, while reducing real estate costs. While location has always been paramount in real estate, office space in prime locations is likely to appreciate. Just consider that some businesses reduce the number of their workforce who work in the office, they might prefer to have the select few move to more central and prestigious locations. There will also be a heightened demand for healthy buildings with enhanced air and water quality. The structural trend to obtain social and green certifications for office buildings will continue to gain traction.

Retail real
estate is another segment in which the pandemic is exacerbating prior difficulties, with a significant oversupply and a shift to online shopping. The misfortune of retail is the strength of the logistics sector. The acceleration of online sales will likely boost demand for logistics facilities, though there won't be immunity to economic cyclicality. While the current
pandemic is affecting
companies' capacity and willingness to pay contractual rents, we expect landlords to feel the impact. Nevertheless, S&P Global Ratings estimates that office landlords will not see rents decline by more than 5% in 2020. At the same time, weak economies and remote working pose longer-term threats to the demand for office space. This compares favorably with S&P's assumption of a 15%-20% drop in rental growth for European retail landlords in 2020.

The residential
sector will suffer from the recession shock as many tenants went into the crisis with fragile balance sheets. While difficult to gauge if the boom of larger houses in the countryside is a short-term phenomenon, the 'operating procedures' for elderly housing are likely to be amended in the wake of the crisis but the demographic trend of an aging population will remain.

Finally, infrastructure investment has been resilient during previous crises, but the severity of the current economic shock is a significant litmus test for the asset class. In our view, some sectors of infrastructure investment will face structural challenges and others, structural opportunities. Airports are confronted by the stress of airline companies and passenger traffic.

Oil and gas faced the supply glut and the energy transition. On the other hand, infrastructure related to datacenters, telecommunication, renewable energies are gaining traction.

Conclusions

Private assets, like any other asset, are currently finding a new equilibrium. If history is a guide, previous crises offered attractive investment opportunities to private market investors. Nevertheless, investors should understand that Covid-19 is very different from previous crises and will impact private markets very differently than other crises have done over the past 40 years. Private assets are not uniform. Drivers of returns vary significantly. An understanding of the nature of cash-flows in underlying business models, the level of leverage and the duration of debts are essential.

As of today, no-one has certainty as to capital injections. What we know for sure is that any new capital injections will dilute the holdings of existing investors, while presenting a potentially attractive opportunity for new investors to lock-in attractive valuations. In a recent interview with the FT[8],

Joe Bae from KKR explained that the firm is currently "capitalising on the unprecedented level of volatility and dislocation in the markets to buy high-quality businesses at attractive prices". The same article goes on, quoting one adviser to KKR, saying that he has "taken out the playbook and is using every chapter on how to deploy capital" during the crisis. "It's auction processes, it's proprietary deals, it's public, private, control, single-percentage minority, carve outs, it's all sectors… there's no rock unturned."

The bottom-lines in real estate will stay unchanged. These are typically anchored on real assets, often backed by long-term leases. Office landlords with the longest leases are better protected against the risks of tenant exits and negative re-leasing spreads over the coming quarters amid the current uncertainty around market rents. The scarcity of prime-quality assets and low vacancy rates should partly mitigate a potential fall in demand in the major office markets this year. The "value-add" strategy which aims to create value at each acquired estate level, is best suited to mitigate market uncertainties and to manage investment downside risk(s). Going forward, health issues, ESG issues and technological induced changes will hasten existing assets obsolescence and drive further value-add strategies and investment. Asset "sustainability" and qualitative certifications have evolved from being "nice to have" to being must-haves.

We believe private assets are long term investments that offer superior returns for investors looking through the cycle. While the jury is still out as to how the recovery will look, private assets have historically been a good diversifier to traditional asset classes with low correlation. With lower valuations come buying opportunities as shown by the vintage years born of previous crises. Resilience in some long life assets should ultimately help to maximize debt recoveries. Acknowledging trends towards sustainability, ESG and energy transition is vital for private assets. Investment towards private assets provide the most direct pathway to generating impact outcomes for both the environment and social challenges with tangible solutions, creating intentional and positive outcomes.

[1] BIL Investment Insights: Active versus passive: Are efficient markets make believe? https://www.bilinvestmentinsights.com/active-versus-passive-are-efficient-markets-make-believe/

[2] "A new decade for private markets" McKinsey Global Private Markets Review 2020

[3] According to Dealogic, deals involving public companies being taken private by domestic private equity sponsors increased more than 27% from 2018 to 2019

[4] "Private Equity Performance: What Do We Know?" ROBERT S. HARRIS TIM JENKINSON STEVEN N. KAPLAN

[5] See for instance FT: "Private equity takeovers of listed companies hit jobs hardest, study finds" October 2019 https://www.ft.com/content/dfe3d4f4-e821-11e9-a240-3b065ef5fc55

[6] Demystifying Illiquid Assets: Expected Returns for Private Equity, Antti Ilmanen, Swati Chandra, and Nicholas McQuinn

[7] AQR – The illiquidity premium https://www.aqr.com/Insights/Perspectives/The-Illiquidity-Discount

[8] FT: "Private equity steps in where others fear to tread during pandemic"

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