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Prime time for private markets:

The new value creation playbook

Introduction

Top level sport is back, though not as we know it. There are no spectators. Physical contact is strictly restricted. Some teams even have to live together in bio-secure bubbles to guard against COVID-19 infection. But at least the rules of the game are the same. Just imagine if the contestants had returned to find hoops raised, goals narrowed or the bats halved in size. Teams would need a whole new playbook.

As a private markets manager, you now face just this kind of disruptive challenge. The prizes continue to be immense; dry powder is abundant. But the rules of the game have changed. The pandemic has underlined the vital importance of resilience. Value is also no longer simply a matter of financial returns. This was an emerging truth before the pandemic and has come into sharp relief since. Environmental, social and governance (ESG) priorities in areas such as health, sustainability, labour rights and social inclusion are increasingly critical to investors. They want their money to have an impact but also want excellent financial returns.

Taking a lead on ESG and making it more of a central, rather than additive, feature of what your organisation does could therefore reframe public perceptions, cultivate closer affinity with investors and generate new forms of value. Impact turnaround opportunities might include acquiring businesses with a poor environmental record and moving them towards cleaner, 'net-zero' production. Private markets managers might be better positioned than their public markets counterparts to do this because they have more resources, better return potential and a more hands-on approach to creating value, especially as asset managers grapple with the immediate challenges of the economic downturn. Private markets businesses could also support turnaround and generate value in the current environment by bridging the funding gap for innovative growth businesses and supporting infrastructure investment to help drive recovery.

But to navigate this new value ecosystem successfully, especially amid the economic downturn resulting from COVID-19, you'll need a more intensive, interventionist and innovative playbook. Traditional value levers, such as financial engineering and cost reduction, are still useful but are no longer enough. The new playbook will need to focus more closely on strategic positioning, operational excellence and capital efficiency in both your business and the portfolios you manage.

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What do we mean by private markets?
For the purposes of this report, *private markets* brings together four primarily illiquid asset classes: private equity (including venture capital), infrastructure, real estate and private credit.

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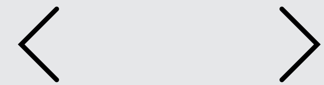

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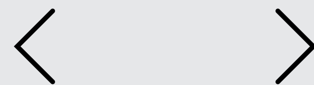
Before we look at how to sustain success, it's important to look more closely at why a new playbook is needed. Even with the rollout of COVID-19 vaccines, economic conditions are extremely tough. And as we've already outlined, the definition of value is becoming more complex all the time. These circumstances are clearly challenging, but they also present an opportunity for driving innovation, differentiation and value creation.

Returns are harder to find

Downturns can increase opportunities for private markets managers, particularly when it comes to acquiring companies, infrastructure or real estate assets at reduced cost. In the current situation, small- and medium-sized firms could benefit from funding from private credit firms.

But these openings might not be enough on their own to help managers deliver target returns. COVID-19 has upended economies in broad ways, disrupting supply chains and depleting incomes. Entry multiples are high, a problem that could be exacerbated by the fact that a lot of companies have capital they're looking to put to work. So, managers need to find other ways to boost returns and create new types of value. There's evidence from the global recession of 2008–09 that dedicating resources to value creation pays off. Private equity firms with value creation teams experienced a better average rate of return across funds (23%) compared to those without dedicated teams (19%), according to data provided by Preqin.



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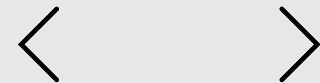
Dedicating resources to value creation pays off. The average internal rate of return for funds with dedicated value creation teams was 23% during the 2019-13 recession era. By contrast, funds without value creation teams averaged a 19% rate of return during the same period.

Stakeholder attitudes are moving the goalposts

Investors are the main reason that ESG has become more than a tick-box exercise in fund due diligence. Regulators are also pushing, especially in the EU—although other governmental agencies, notably the US Department of Labor, insist that financial considerations should continue to take priority over ESG. Many politicians and civic groups want COVID-19 to be a catalyst for a fairer and greener economy. Campaigns such as #MeToo and Black Lives Matter have also put a spotlight on diversity, equity and inclusion. And importantly, some investors are coming to see ESG as a key source of value preservation and generation, rather than simply being an altruistic or reputational priority.



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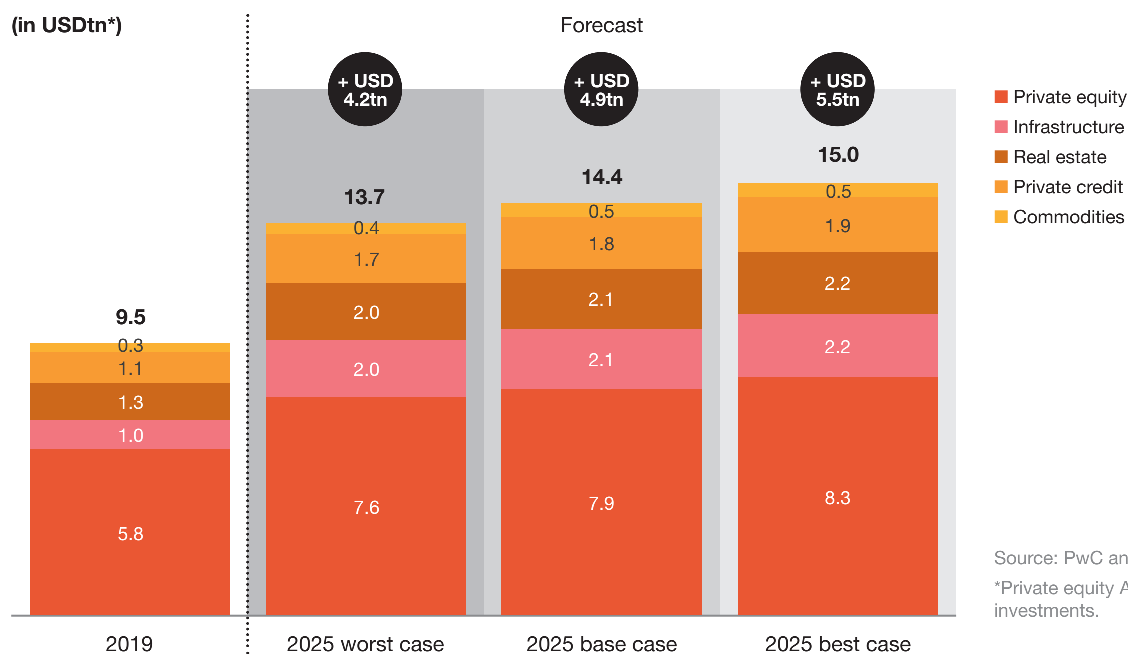
There's still growth to seize

Investors continue to look to private markets to deliver the yields that lower-risk and more liquid asset classes struggle to match. As a result, we expect assets under management (AuM) in private markets to expand by between US$4.2tn and US$5.5tn by 2025, to reach between US$13.7tn and US$15.0tn, depending on the trajectory of economic recovery in the years ahead. Under the base-case scenario, private markets would make up more than 10% of global AuM by 2025, constituting a small but fast-growing and high-impact slice of the capital markets.

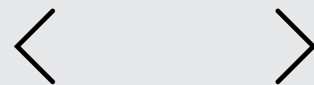
We expect assets under management (AuM) in private markets to expand by between US$4.2tn and US$5.5tn by 2025, to reach between US$13.7tn and US$15.0tn

Exhibit 1: Projected growth in asset management industry AuM



Source: PwC analysis

*Private equity AuM does not include direct investments.



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There's not a significant difference between the recovery scenarios, which underlines how resilient private markets are. Even in the worst-case scenario, we project AuM growth of almost 50% from 2019 to 2025.

The slowdown in the economy will prolong low interest rates, which will encourage institutional investors to seek out the higher yields and returns offered in private markets. Even though it will still be challenging for private markets managers to deliver substantial alpha in a highly competitive environment, we believe they could still significantly outperform managers in traditional asset classes. These same factors could also attract much more retail investment into private markets.

However, regulators might also allow some direct investment. For example, private equity investment is now allowed in US 401(k) retirement funds via professionally managed funds. The US Securities and Exchange Commission is also exploring the possibility of expanding access, though only through an intermediary and as part of a diversified pool (fund of funds).

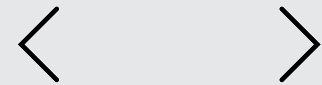
Big firms are dominating, but specialists can still drive alpha

Private markets are becoming increasingly competitive and concentrated. Institutional investors' shift to multi-asset mandates is making it difficult for smaller, single asset–focused managers to compete with big, diversified rivals. And because of the costs and complexities of due diligence, some investors are also restricting their commitments to fewer firms.

The leading firms are increasingly dominant. A clear sign of this is their ability to raise larger mega-funds. In private equity by 2019, there were 15 funds of US$5bn or larger, compared with eight in 2014 and three in 2009. There's still room, though, for specialised players with the right capabilities. The firms that are most vulnerable are those that have neither scale nor specialisation. They risk being squeezed out of the picture.

Brand strength and AuM growth are strongly correlated, and market shares of strongly branded names are constantly increasing. Today's turbulent times have reinforced the advantage that big players have. In a recent example, data from capital markets company Preqin shows that real estate mega-funds took in 75% of the aggregate capital raised in the second quarter of 2020, compared with 59% during the less volatile second quarter of 2019. Likely drivers included strong historical performances and the ability to communicate strengths and strategies effectively.

The move to diversified multi-asset strategies also highlights the connectivity within private markets. For instance, there's crossover between asset classes in the increased allocations of private equity funds to credit opportunities, growing private equity investment in real estate, and a focus on infrastructure in real asset regeneration. Other signs of connectivity include the upsurge in collaboration as firms seek out partners to provide specialist expertise in a new asset class or to market products through third-party platforms.



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How private markets can continue to outperform

You'll want to go beyond a few small tweaks to your playbook in order to respond sufficiently to the changing value ecosystem. Here are some of the moves we think you'll need to consider.

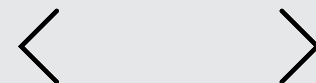
Deliver a plan for how you'll navigate the new value ecosystem

Our research underlines the importance of putting strategic plans in place early and tracking progress and returns rigorously. It's not enough just to have a plan. You'll need to embed a value creation mindset across your organisation and among those who manage your companies, properties and other assets. That mindset should be characterised by ruthless prioritisation and tracking of value generation.

For instance, you should assess and measure the impact of entering new markets and delivering on planned operational efficiencies. Tracking will not only help you gauge return on investment but also will allow for course correction and intervention. Remember, you can and should take the long view. In fact, one of the big advantages of private over public markets is that it's easier for private managers to execute value creation strategies over the longer term because they don't face constant pressure to deliver quarterly earnings.

For example, there's a growing trend of private markets investors accessing insurance reserves as a form of AuM. Doing this has been an attractive option, as many types of insurance capital are longer-term in nature and generate fee income. Performance of insurance as an asset class (e.g., insurance-linked securities) has generally also been less correlated with broader financial markets, which makes it more diversified. However, this type of expansion of AuM tends to be complicated due to regulation, legal structures and talent needs.

If ESG is a real priority, it's important to think about how you can ensure that it's integral to your investment strategy and product development. This means looking at all your operations through an ESG lens, modifying your investment philosophy and promoting ESG awareness across your organisation. Support this effort by building ESG into individual performance objectives and incentives. And remember that ESG includes areas such as diversity and inclusion.



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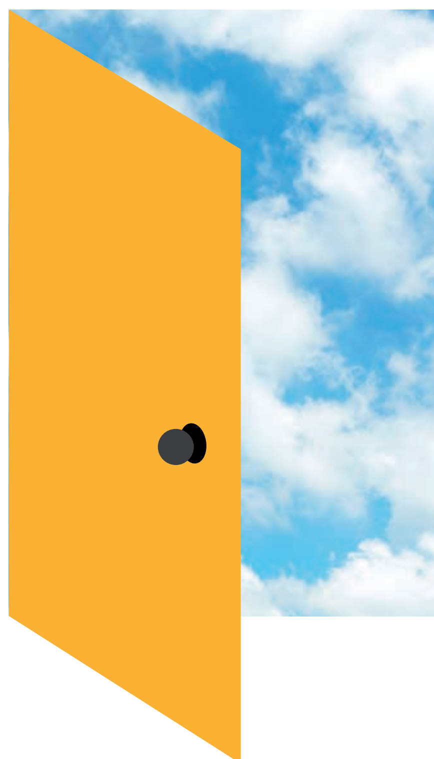
Firms with a more limited brand presence should look at how to articulate and communicate their purpose and performance to help establish their credentials and stand out from the pack.

From a capital efficiency perspective, it's important to consider how your strategic positioning and operational plans would affect tax, pensions, working capital and other balance sheet items. Ask yourself how working capital optimisation could help you release cash and reduce debt within portfolio companies, for example. Or ask how you could eliminate tax leakages and establish a tax-efficient supply chain. Further considerations include optimising your real estate footprint in your business and your portfolio companies, as remote work becomes the norm.

Dedicating resources to this effort will likely allow you to reap returns and help you raise more capital after the downturn. A team that is focused on applying a value creation lens to all that your company does might initiate a series of immediate repairs, for instance, such as stabilising returns in portfolio companies by helping them find alternative suppliers or by switching from physical to digital distribution. A value creation team might next focus on helping portfolio companies reconfigure to achieve net-zero production or move to service-led models in real estate. We could even see an impact turnaround in which 'dirty' production facilities are turned green.

More intensive restructuring and revenue enhancement strategies could provide further impetus for longer-hold and 'permanent capital' models. The potential advantages of these models include allowing you to avoid the drain of successive rounds of capital raising and the constraints of generating returns within a fixed time frame. These models also appeal to investors who are looking to secure long-term returns, such as insurers, pension funds and sovereign wealth funds.

And compliance and regulation are ever increasing. It might be time to rethink your compliance strategy rather than simply adding more costly and complex fixes.



Make sure you have the talent you'll need

Demand for specialist expertise is increasing, both in terms of investment expertise—including ESG investment—and the high-end tech skills needed to perform the data analysis that informs and supports your investment strategy. Increasing the diversity of your talent pool will also improve your ability to understand changing stakeholder expectations and steer through disruption.

But with finite resources, you can't afford to keep paying more and more for top talent. It's therefore important to step up progress on developing talent from within your workforce. It's also important to make the most of collaborative platforms and the gig economy to help drive innovation and reduce fixed costs.

Our own experience of digital upskilling at PwC has demonstrated that it's important to let people learn in the way that best suits them. It's also important to offer people opportunities to apply their new skills—for example, by using their training in analytics and visualisation to help tailor investment products and investor experience more effectively. Inevitably, there will be some resistance to change. It's therefore important to explain to your employees what's in it for them and foster a culture that embraces innovation and change as opportunities.

Use technology to gain a competitive advantage

The foundation for creating value in the new ecosystem will be an integrated technology platform that manages all activities, including investments, distribution, valuation, reporting, operations, tax and regulatory compliance. You don't have to develop it yourself; there are opportunities to redefine your outsourcing model by taking advantage of external firms' new capabilities and refocusing on your core competencies. Whether you build, buy or borrow it, such a platform will enhance efficiency and cut costs—and help you differentiate your firm from competitors.

In private equity, for example, developments in data analytics are making it possible to perform a detailed upfront evaluation of value levers and the value potential in deals, and then scrutinise performance against objectives. Analytics and AI could also enable private credit funds to profile borrowers, assign them credit scores and proactively target them. In real estate, an example of a tech-enabled value play is the deployment of sensors to monitor in real time how a space is used and to detect and deal with environmental and maintenance issues.

At least some element of digital automation is essential in freeing up time and making it possible to scale and flex your business. Flexibility and interoperability between applications and external parties are also important for collaborative and interconnected operations in the private markets network.

To strengthen the consistency of decision-making and support operational integration across functions, it's important to have a single 'golden source' of information for use by all functions. To strengthen data quality and governance, it's also important to assign data owners or stewards.

Pick your spot—specialise or diversify?

Scaling your business and offering a range of asset classes will put you in the best position to attract large capital allocations and tackle complex investment opportunities. Pouring your resources into technology, talent acquisition and workforce upskilling will also enable your business to diversify and differentiate asset sourcing, investor engagement, management and monetisation capabilities while engaging potential clients across multiple channels and strengthening your brand's visibility.

However, resource and talent constraints mean that only a limited number of managers can develop the necessary depth. The other option is to offer a genuinely differentiated area of investment specialisation. Either directly or working with larger players, you can market the expertise that others may lack. By staying smaller, you could also have greater agility in moving in and out of opportunities.

If you decide to go for scale, you'll have to decide whether to build capabilities, buy them or borrow them via strategic relationships and alliances. Building takes time and therefore won't bridge gaps that need to be addressed now. In the long run, however, developing in-house teams to address a broad array of asset classes can give you an edge in creating value. Reconfiguring your in-house core could also cover areas such as ESG or digital transformation.

The key advantage of buying is that you can acquire multi-asset capabilities and the supporting talent and technology quickly. However, amidst fears over being caught in a 'squeezed middle,' buyers—both private and traditional—might go on the acquisition trail. And midsized businesses that try to scale could still be vulnerable if their capabilities remain substandard or their strategy lacks clarity.

Partnering offers the same speedy capabilities boost as acquisition, without the inherent costs or deal risks. The challenges, though, include finding partners that are prepared to share capabilities, especially in core areas such as asset specialisation or portfolio management.

Most strategies are likely to include a blend of build, buy and borrow. It's therefore important to think what the best mix would be for your business.

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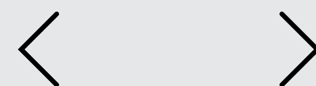

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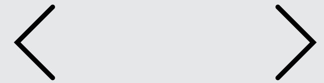
In this section of our report, we offer our projections through 2025 across all the private markets asset classes.



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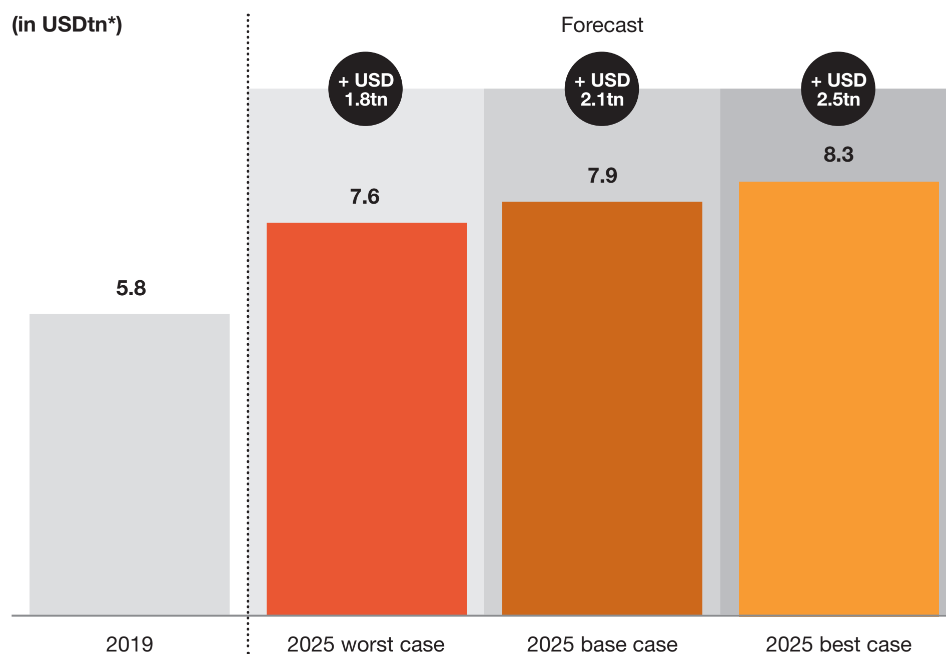
Private equity is the 'asset class of the moment,' as opportunities for acquisition and corporate turnaround increase.

Although private equity is likely to have the lowest CAGR of the four asset classes between now and 2025 (6% to 7.7%), it will remain the largest asset class and is growing by the greatest amount in absolute terms. The secondary market could see especially fast growth. This development reinforces private equity growth opportunities, as it improves liquidity in this classically illiquid market.

A shift from public to private markets is also driving fund expansion, though the change is being offset by growth in special purpose acquisition companies, through which several private companies have gone public again. These parallel developments, though they seem to conflict, attest to a rapid evolution in ownership and investment strategies, with private equity at the heart of both.

Exhibit 2: Private equity AuM growth projection



Sources: PwC Global Market Research Centre, Preqin, PwC analysis
*Private equity AuM does not include direct investments.

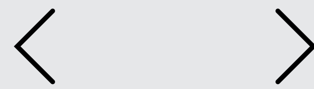


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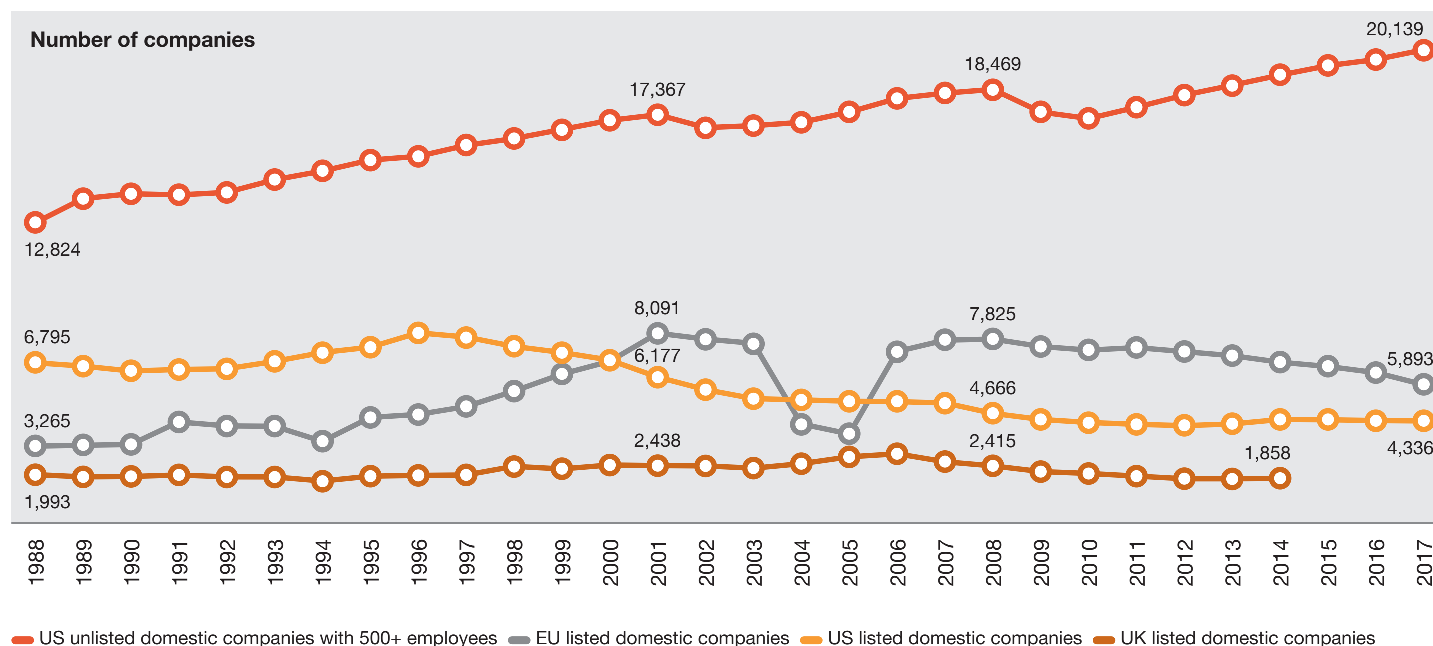
Exhibit 3: Shift from public to private markets



Note: UK listed company data not available for 2015, 2016 and 2017.
Source: World Bank, US Census

Strong fundraising has heightened pressure to put dry powder to work and has therefore inflated valuations in the market. Prices for potential targets listed in the public markets have also remained higher than many would have expected given the state of the global economy. These high acquisition prices increase the need for managers to boost returns. According to PwC analysis, enterprise value multiples reached a peak of 12.9x in the first quarter of 2020.

These circumstances underline the need for an active value creation approach all the way through from deal strategy to exit planning. The shock of the pandemic has highlighted the importance of expertise in liquidity and crisis management, in particular. As we move to recovery and longer-term turnaround, we're also likely to see a growing focus on value levers that traditionally have been viewed as overly complex or difficult to control. These levers include strategic repositioning, maximising top-line growth, and developing the engagement, incentives and cultural understanding needed to retain and motivate key talent.

Portfolio management priorities include addressing changing demands accelerated by COVID-19, including changing customer behaviour, the growing importance of digital engagement and rising expectations regarding ESG. It's therefore important to revisit portfolios and operations to verify whether they're aligned to these customer expectations.

The challenges of delivering financial outperformance will have managers looking for new ways to create value, including through ESG. Indeed, ESG has moved from being a differentiator to being a core imperative for private equity. It will need to be integrated fully into deal strategies, portfolio management and performance evaluation.

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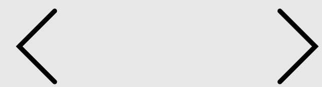
Real estate



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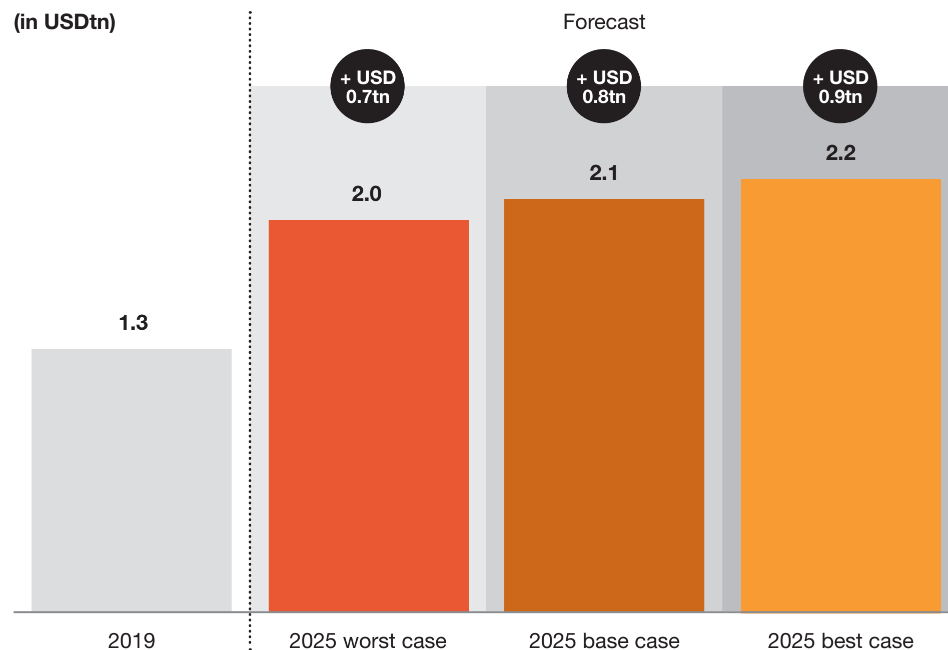
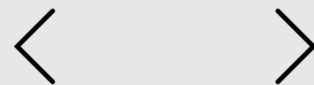
COVID-19 has reduced retail footfall and led to widespread deferment of rental income. In the longer term, the pandemic is likely to accelerate remote work and online shopping, potentially leading to a rise in empty office and retail space. However, investment and growth potential remain strong, in part because these trends present investment opportunities in other areas such as warehouses, distribution centres and tech.

Fundraising dropped off in the first quarter of 2020 but bounced back in the second quarter, with a 7% year-on-year increase. Appetite is holding up especially well for both prime office space and growth assets such as warehousing. And there's growing demand for flexible offices (e.g., space on demand) with high ESG, health and well-being credentials. These sustainability trends are largely tenant-driven but could eventually be reinforced by regulation. Deal activity should begin to pick up with the economic recovery, when we'll see greater certainty over tenant sentiment and market prices.

Exhibit 4: Real estate AuM growth projection



Sources: PwC Global Market Research Centre, Preqin, PwC analysis



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We could also see a focus on brand development as companies strive to connect more closely with customers and increase their influence over planners and policymakers.

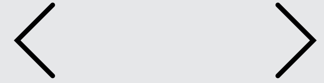
Potential innovations in real estate include leases tied to the quality of services in a building rather than to a specific length of time. The growth in remote working could also provide openings for technology companies to develop hybrid physical and virtual workplace models. Social responsibility and sustainability will extend beyond the energy and environmental design of a development to the relative inclusiveness of its tenant profile and its contribution to community life and cohesion.

To keep pace with these developments, managers will have to determine what tenants want and how to adapt accordingly, which will require a closer and more collaborative partnership with tenants. And managers will need to learn about more than just the space that tenants want to rent, including the services they expect, such as deep cleaning, environmental monitoring, tech connectivity and amenities that help them enjoy their experience in the space.

This more service-led and customer-attuned value proposition will require managers to staff their companies with new and different talent. For instance, companies will need people with expertise in sustainability, and they might need brand development professionals or psychologists to help understand and address public concerns about returning to shops and offices. Technology will also be critical in helping you deliver on your evolving strategy, especially in offering new and enhanced customer services.

Craig Hughes
Global Real Estate Leader
Partner, PwC UK

Infrastructure



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COVID-19 has effected little change in some subsectors of infrastructure, such as energy, but it has caused sharp decreases in revenue from once-stable sources of return such as airports. Some assets, such as fibre optics, are now moving into the central core.

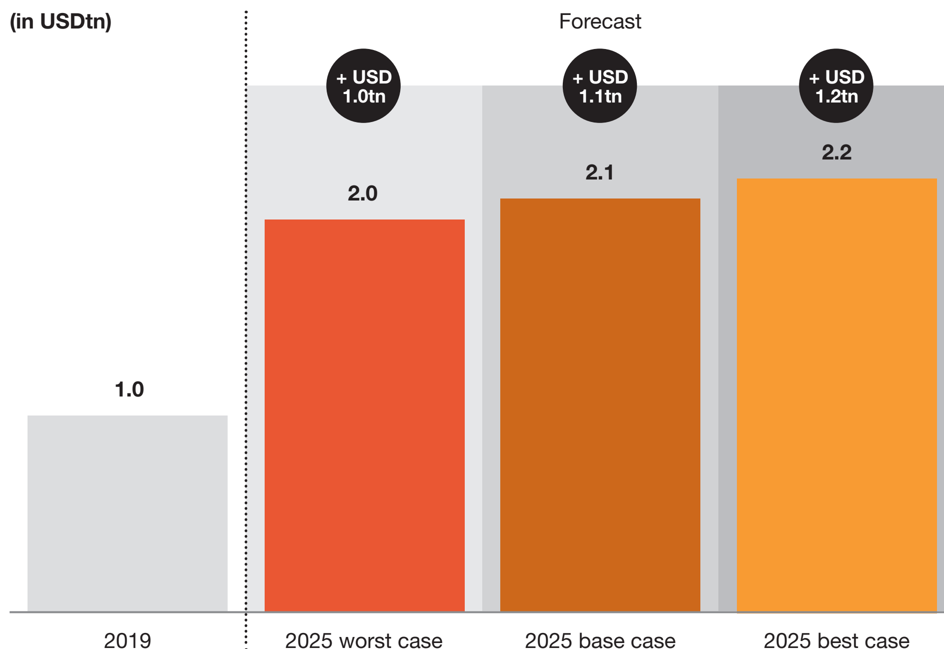
To preserve value, fund managers have had to be hands-on in dealing with the impact of COVID-19 across multiple asset classes. Managers who have real-time information and strong asset management capabilities have found this to be easier.

COVID-19 has highlighted a digital divide, which points to investment opportunities in areas such as fibre optics and broadband. In developed markets, there are considerable opportunities to renew old infrastructure such as roads, rails and hospitals, and to accelerate technologies such as 5G and renewable energy. In emerging markets, the need for investment in both traditional and digital infrastructure is greatest. As a result, we expect AuM in infrastructure funds to double by 2025.

COVID-19 disruption has underlined the importance of active management and ensuring you have the real-time data and analytics—and people—to support it. Infrastructure managers also face increased scrutiny of both their ESG commitment and their delivery of life essentials that now include broadband in addition to water and electricity.

Making these plays will require you to reconfigure your strategies and capabilities, but doing so will give you the chance to drive more value.

Exhibit 5: Infrastructure AuM projected to double even in worst case



Sources: PwC Global Market Research Centre, Preqin, PwC analysis

We expect AuM in infrastructure funds to double by 2025.

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Global Capital Projects and Infrastructure Leader
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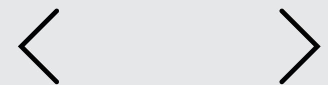

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Nonbank lending expanded rapidly after the global recession of 2008–09 and now exceeds bank lending in advanced economies, even in Europe.

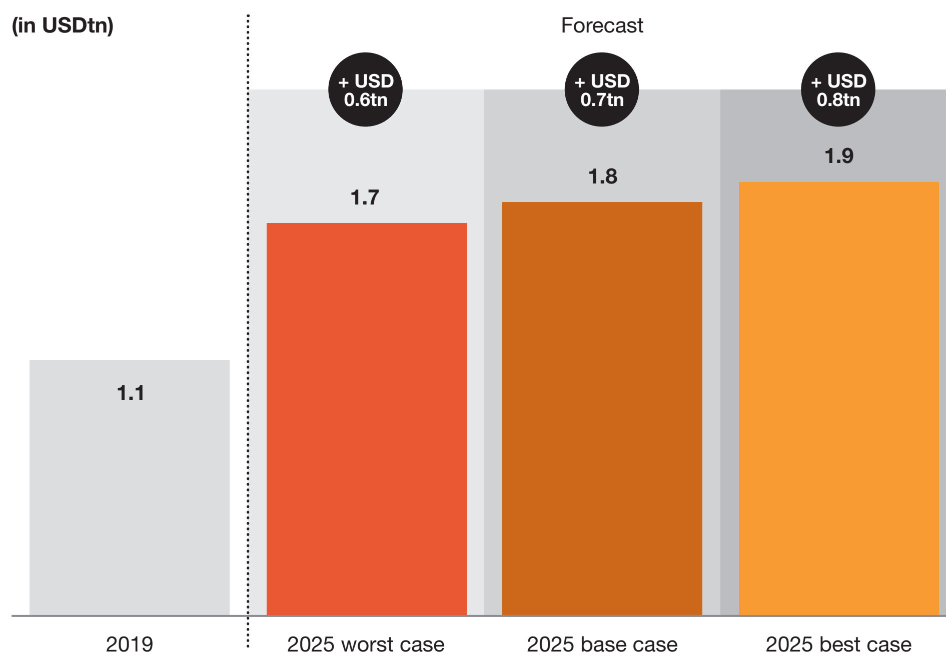
With economies fragile, the largest capital deployment opportunities are likely to be in rescue financing, real estate, infrastructure and direct lending.

Any rise in business failures as economies continue to struggle would put increased pressure on banks' balance sheets and ability to lend. Small- and medium-sized enterprises could be especially vulnerable to any dip in the availability of bank credit. This could create an opportunity for private credit funds to fill the breach by helping to finance businesses that have strong growth potential but little access to mainstream funding. However, few credit funds are focused on small- and medium-sized lending.

Further growth opportunities include acquisition of distressed debt and debt for equity deals, especially in Europe and the US. Secondary debt markets have rallied substantially since lockdown. Distressed businesses are picked over, in general. But there's potential both because of the large amounts of dry powder in the market and the search for yield in an ultra-low-interest-rate environment.

We believe that by 2025, private credit in Europe, which is already largely fund-driven, not bank-driven, will certainly be fund-driven. Direct lending will expand and will compete with syndicated bank facilities. Regulation of the sector is likely to increase. We also expect to see consolidation in direct lending, as small direct lenders fold into larger platforms.

Exhibit 6: Private credit AuM growth projection



Sources: PwC Global Market Research Centre, Preqin, PwC analysis

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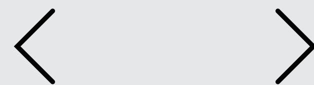

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Private markets have reached a turning point—new rules for a new game. Financial returns are harder won. And even if you can outperform, a growing focus on ESG and resilience means that your business can no longer rely on financial performance alone to sustain and create value.

Success demands that you have a clear business and investment strategy. It also requires that you have a value playbook that's geared to identifying and realising opportunities that might usually be overlooked, and that you develop the talent, operational agility and dynamic decision-making to seize those opportunities.

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We used econometric modelling to obtain our estimates. AuM was used as the target variable, generally based on data from 2004–19, and various macroeconomic indicators from the International Monetary Fund and IHS Markit were used as explanatory variables.

We have mainly used data from Preqin and from national sources whenever Preqin coverage seemed insufficient. The models were based on several economic factors. The most prevalent economic indicator across our models was the GDP in purchasing power parity and interest rates.

We used statistical software to search among hundreds of different possible (linear) models. We tested the models in levels, in differences, in logs, and with and without lags, and have shortlisted those statistically significant models. Our senior economists finally chose among the plausible models selected by the algorithm.

Our forecasts are based on the April 2020 International Monetary Fund World Economic Outlook, *The Great Lockdown,* which included substantial uncertainty across financial and real economy markets. We have subsequently used the scenarios provided by IHS Markit, the Organisation for Economic Co-operation and Development and the World Bank throughout 2020, until September. The most optimistic scenario was used to build our best-case scenario, and the most pessimistic was used to build our worst-case scenario. The base-case scenario is the one that seems to be the most plausible scenario.

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