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Private Capital Fundraising: Outlook Constructive Despite Uncertainties

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Global private capital fundraising reached an all-time record $888.0 billion in 2019, according to PitchBook data summarized in its *2019 Annual Private Fund Strategies Report* published last week. Record flows into private investment vehicles came in the context of high public equity valuations, a growing supply of negative-yielding debt around the world and signs of coordinated global deceleration in economic growth.

The Outlook: Constructive

On the whole, market conditions in 2020 look set to support sustained momentum in fundraising. Public equity valuations are even loftier now than a year ago, U.S. interest rate benchmarks are testing all-time lows, the global stock of negative-yielding debt is on the rise and potential sources of volatility have become more prominent. We see each of these factors as favoring ongoing asset allocation into private vehicles as investors solve for investment return and mark-to-market volatility challenges.

At the same time, issues that have been simmering on the back burner may command more attention this year. High asset prices that are driving capital flows into the private market pose a challenge within the market as sponsors are forced to choose between idling capital or making potential performance tradeoffs by investing. In a historic first, private equity returned less than the S&P 500 over the 10-year period to June 2019, according to recent **research** by Bain & Co. As public and private market performance converge, sponsors will likely face intensifying pressure to adjust the traditional economic model. The trend toward consolidation among sponsors may, in part, reflect a growing understanding that platform scale may be part of the answer to achieving cost efficiencies and economic flexibility in the long run.

Rising market volatility can become counterproductive at a point. According to Bain & Co. data, roughly a quarter of buyout firms stopped raising capital after the last recession, with the impact disproportionally felt by smaller firms. Potential sources of disruptive volatility abound in 2020, not the least of which is the potential for a private market-unfriendly election outcome.

Without assigning a probability weighting to each of the risks in the outlook, we believe clearly distinguishing between long-term and short-term variables is essential to a complete fundraising outlook. Looking beyond the immediate concerns, we see expanding individual participation in the private markets potentially providing meaningful lift to fundraising for years to come. Earlier this month, Vanguard announced a strategic partnership with HarbourVest, through which the partnership expects to deliver private equity access to individual investors in the future.

The reality is that more investment activity, especially growth investment, is taking place in the private market. Illustrating this point, in 1996 there were more than 8,000 publicly listed companies in the United States. Today that number sits around 4,400, based on data from the World Bank. We expect asset managers to increasingly develop products to offer individual investors more representative market access by adding private market offerings. Regulators have signaled a willingness to support the shift. In December, the SEC **proposed amendments** to the Accredited Investor definition, which, if implemented, would expand the classifications of individuals that qualify to participate in private markets.

2019 Fundraising in Review

As noted earlier, global private capital fundraising reached an all-time record $888.0 billion in 2019 as institutional investors upped private capital allocations, in part by rotating out of hedge funds and public equity, according to Pitchbook data. While dollars raised increased, fund count extended a multi-year decline to 1,064, reflecting the trend toward greater fund sizes. Total private capital AUM increased by 7% to reach $6.53 trillion.

Private equity powered much of the overall gain in fundraising. Dollars raised for the strategy totaled $474.1 billion, up 6.3% over the prior year, while the number of funds closed increased by 1%. Average fund size increased, and the top-10 funds raised posted significant step-ups in fund size versus the prior vintage. The decline in sub-$1 billion funds that has been evident in recent years paused. Funds sized below $1 billion made up 16% of private equity fund raising, in line with the 2018 share, and down from a 32% yearly average over the preceding decade. By count, 256 sub-$1 billion funds closed in 2019, roughly in line with 2018, and down about 21% from the trailing 10-year average. Fundraising by first-time funds declined significantly from the past three years to total $9.0 billion across 30 funds, down 46% and 29%, respectively.

Private debt fundraising accelerated during the year to $131.1 billion, up 21% over 2018. Here again, the trend was toward larger funds. Sub-$1 billion funds accounted for 15% of 2019 private debt fundraising, down from 35% yearly over the preceding decade. By strategy, infrastructure, general debt, special situations, and direct lending funds posted significant gains in fundraising, while real estate debt raised declined 56% from the prior year.

In other strategies, venture capital fundraising declined 15% year-over-year to total $75.5 billion, real asset dollars raised declined 9% to total $170.2 billion, fund of funds activity was also lower by 18% at $15.6 billion and secondaries moderated by 23.3% to total $21.6 billion.

Capital deployment continues to challenge both investors and sponsors. CalPERS highlighted this trend when it reported total distributions of $7.4 billion and contributions of $4.6 billion for its fiscal year ending June 30, 2019. The notional value of dry powder continues to press higher, reaching $2.41 trillion for private capital overall and $1.25 trillion for private equity specifically, according to mid-year 2019 PitchBook data.

What’s often lost in the discussion on dry powder, however, is the context of total AUM. Dry powder made up 37% of total private capital AUM in the recent PitchBook estimate, exactly in line with the market average dating back to 2006. As the private capital market grows, it’s natural that the notional amount of dry powder grows with it.

Conclusion

If anything, drivers for private market fundraising have been amplified in 2020. Liability-matched investors that were yield-deprived in 2019 are now contending with a fixed income matrix wherein the long end of the Treasury curve is testing never-before-seen lows. At the same time, accommodative central bank policies have supported financial asset values and investors have meaningful gains to re-allocate. With this backdrop, we expect institutional investors to continue to rotate into private funds to solve for investment return challenges and thereby support 2020 fundraising momentum.

We expect to see further consolidation among asset managers. The Brookfield-Oaktree tie-up in 2019 pointed to a trend among managers to combine multiple strategies on a single platform that benefits from scale. Last week, Franklin Resources Inc. announced an agreement to acquire Legg Mason Inc. Investors are increasingly opting for passive investment vehicles when investing in public markets, and when paying for active management, increasingly prefer to do so in the private market – both trends that are likely to continue to re-shape the asset management landscape.

Finally, we expect to see private fund sponsors contending with intensifying investor pressure to adjust the economic model. The existing paradigm for management fee and performance economics looks increasingly anachronistic as private and public fund performance converge and may drive investors to demand more economic concessions in exchange for the give-up in liquidity to make private fund commitments.