STATE STREET

New Challenges

Impacts of the New Macro Economic Environment on Private Markets

May 2023

Introduction: An inflection point for private markets

In the last 15 years, private markets have benefited from the low interest rate environment in place since the 2008 Global Financial Crisis, which helped keep borrowing costs low and fostered greater risk appetite among investors for higher growth assets.

After the stellar returns seen in public markets started to run out of steam, investors began turning to private markets in search of the next generation of growth companies. Demand for better returns fueled boosted allocations to private equity, while appetite for higher yields steered some investors to private credit and infrastructure.

The double hit last year of the world's productive capacity opening up after the COVID-19 shutdowns (during which demand was maintained through economic stimulus) and the Russian invasion of Ukraine stifling the production and export of a number of agricultural and other commodities have had a significant inflationary effect.

Our 2023 Future of Private Markets Study has confirmed what many people believe, that markets have reached an inflection point, and the era of cheap borrowing and low rates is over. These changes to the investment environment have significantly impacted how investors view private markets.

However, the research also shows that institutions continue to see value in private market asset classes and are willing to continue growing allocations to them, despite the difficult environment in which they now have invest. Private markets as a means of raising capital for companies and projects remains essential to the global economy.

The recent Silicon Valley Bank (SVB) collapse and the tremors it created in the bank lending market are a reminder of 2008 crisis and demonstrate the need for a diversified fund raising ecosystem in which capital markets, private and public, play their role alongside the banking system. However, the SVB story also raises a broader question underlined in our survey responses, that investor demand for increased transparency and better availability of frequent, trustworthy data is growing. Even in public markets, which have a head start in these areas, the old private market reporting procedures will need to change soon, to meet the demands of investors, institutional or retail.

The research also shows that institutions continue to see value in private market asset classes and are willing to continue growing allocations to them, despite the difficult environment in which they now have invest.

26 percent of respondents believe the new higher inflation investment environment will be short-lived and the tailwinds of low interest rates and quantitative easing that drove asset prices for much of the past decade will return.

A higher rate and inflationary environment will bring challenges for private markets.

More than half of traditional asset managers (61 percent) and asset owners (63 percent) believe higher rates will increase the relative attraction of traditional fixed income assets as a source of yield compared to private markets. Over two-thirds of respondents (69 percent) believe increased cost of borrowing will negatively affect the attractiveness of highly leveraged private assets, with asset owners (81 percent) feeling strongly about the impact of higher rates.

Despite these concerns, only one-quarter of respondents say they will allocate less to private markets because they do not believe they will outperform public markets or because the cost has increased.

While the conditions are quite different, the appetite for private market assets remains strong. Greater familiarity with the asset class has allowed investors to change how they use private markets within a portfolio.

68%

of institutional investors, including asset owners and insurers, plan to continue investing in private markets.

61%

of all respondents believe that private markets remain a good long-term investment.

How have economic conditions changed perceptions of private assets?

Greater investor familiarity with the asset class has changed the way investors look at potential barriers to entry; what were once considered to be major hurdles are now less of an issue for asset owners. A minority of respondents believed high fees, a lack of transparency and long lock-up periods were challenges to investing. Investors broadly accept that high fee levels are justified by the expertise required to navigate these complex markets, with only 29 percent of asset owners and 19 percent of insurers, calling this a concern. Similarly, lock-up periods are not considered long, with 32 percent of asset owners and 31 percent of insurers flagging the issue.

However, with greater familiarity of private markets investors have a better understanding of how they function and how best to incorporate them within a diversified portfolio.

Changing macroeconomic conditions have seen investors use private assets in different ways. In the 2021 State Street Private Market Study, diversification, returns and better yields were among the chief reasons for allocating to private markets. By 2022, respondents had become more concerned about how private assets could help them in an inflationary environment. 44 percent of respondents argued that the asset class could act as an inflation hedge within portfolios. More than half of all respondents (58 percent) said that they will favor private assets that deliver returns above inflation or act as a useful hedge.

Despite their recognition of the challenges presented by the macroeconomic environment, 68 percent of institutional investors, including asset owners and insurers, plan to continue investing in private markets in line with their allocation targets. 61 percent of all respondents believe that private markets remain a good long-term investment.

What do you think will be the impact of higher inflation and interest rates on how investors view investing in private markets?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
The increased cost of borrowing will negatively affect the attractivenss of highly leveraged private market investments	69%	68%	54%	81%	72%
We will continue to allocate to private market assets consistent with our existing target allocation	68%	64%	65%	78%	64%
Higher inflation and interest rates will persist, but private markets are still a good long-term investment	61%	59%	69%	65%	49%
We are likely to favor private market assets that typically offer above inflationary returns (e.g., real estate) and are a useful hedge against inflation	58%	54%	68%	64%	48%
Higher interest rates will increase the relative attraction of traditional fixed income, compared to private market assets, as a source of yield	54%	61%	43%	63%	48%

Which private markets are garnering the most attention?

Although the wider investment backdrop has changed considerably over the past year, the most popular private market asset has remained unchanged. Private equity/venture capital remains the most popular type of private asset for all types of investors across regions. For some institutions, the challenging macroeconomic conditions of the past 12 months and volatility in public markets have provided an attractive entry point for private equity investors.

Overall, 62.5 percent of respondents say that they will invest the largest amount in private equity over the next two-to-three years. Support for private equity is strong in all regions, but strongest in APAC (69 percent) and North America (68 percent), regions with strong traditions in private equity.

The strongest advocates for private equity were private markets asset managers (70 percent) and asset owners (70.8 percent), support for private equity was particularly strong among family offices and endowments/charities/foundations.

While private equity will likely attract the greatest amount of allocations from European investors, there is also healthy demand for infrastructure assets, where investment has been growing in recent years.

Infrastructure will likely play an increasingly important role in investors' private market allocations. The study found almost four times the number of institutions planned on large increases compared to decreases over the next two-to-three years. Anticipated allocations to infrastructure are even larger than the net increase in allocations to private equity.

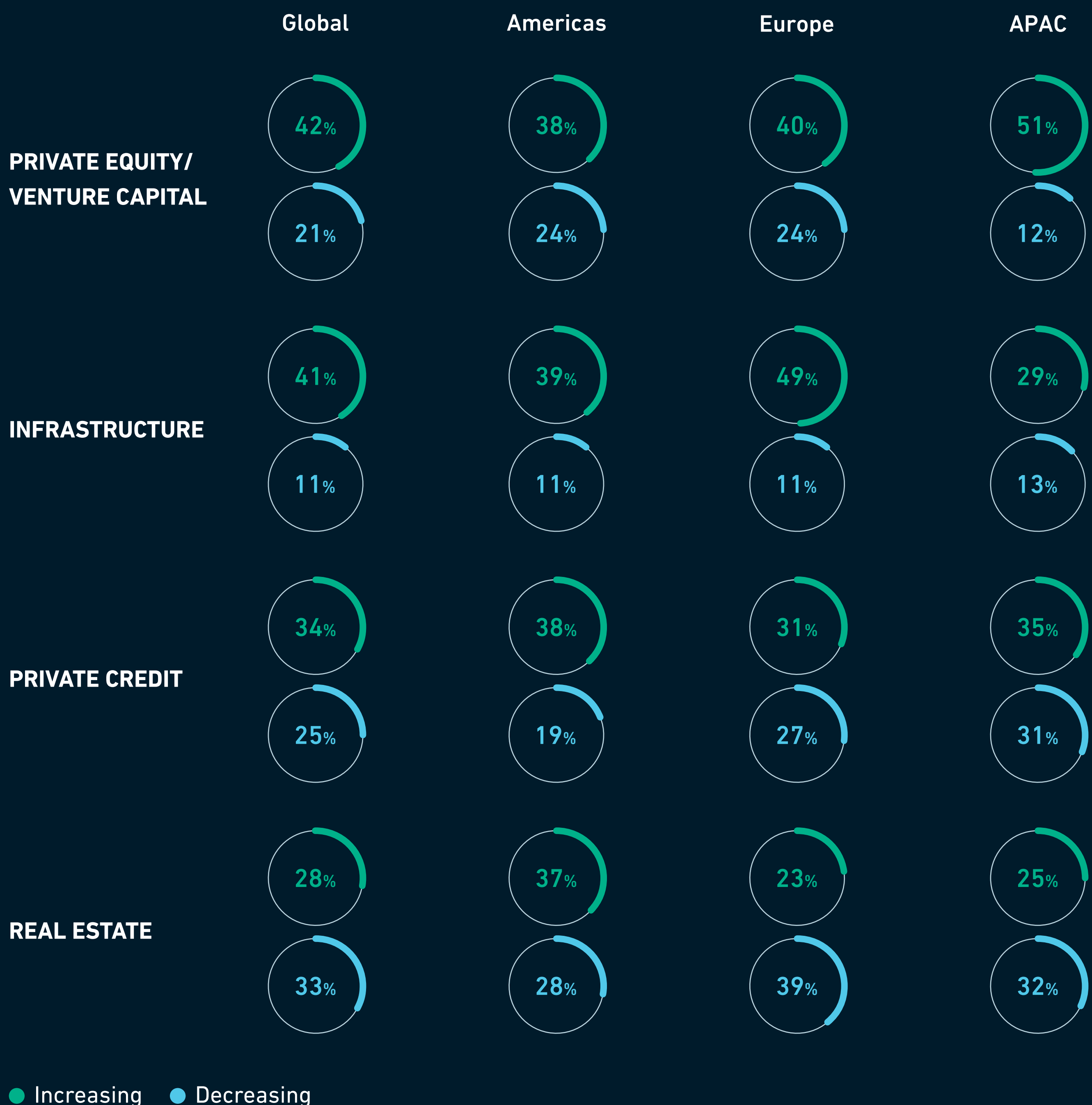
A net 39.2 percent of insurers plan on making the biggest allocations to infrastructure, followed by 35.9 percent of traditional asset managers. From an insurer's perspective, the asset class offers attractive long-term – and often inflation-linked – yields and exposure to more ESG-friendly assets.

On a regional basis, Europeans are most bullish on infrastructure, with 38 percent planning on a large increase to the sub-asset class. However, there is also strong appetite in North America – where private equity has traditionally held sway – where 35.8 percent of respondents anticipate making big allocations.

Strong appetite for infrastructure notwithstanding, there remains a considerable appetite for private equity, which will rise on a proportional basis globally by 21 percent, with very strong appetite in APAC (39 percent).

Which private markets asset classes do you anticipate increasing your allocations to by the largest amount, as a proportion of your current allocations? Select all that apply.

Which private markets asset classes do you anticipate decreasing your allocations to by the largest amount, as a proportion of your current allocations? Select all that apply.



Which private markets are out of favor?

While the changing macroeconomic conditions and market environment favor some private markets, not all have increased in popularity.

Private debt has been one of the beneficiaries of the low-rate environment in place largely in the last 15 years since the Global Financial Crisis, as institutional investors have sought higher yields. According to Prequin, since 2013, private debt assets under management have grown from US$439.3 billion to US$1.3 trillion as of 30 June 2022[1]. However, as interest rates have started to rise over the past 12 months, there are signs that appetite for private credit – one of the great growth areas in the low-rate environment – has waned. Heading into 2022, more than half of respondents (54 percent) to the 2021 State Street Private Market Study expected to increase allocations to private credit in the next three-to-five years.

Heading into 2023, only 43 percent of all respondents planned on making a higher allocation to the asset class in the next two-to-three years, the lowest of any private market asset. Appetite for private credit was lowest in Latin America, where only one-third (33 percent) planned to make a higher allocation. However, half (50 percent) of APAC respondents were keen on committing more money to the asset class.

Among asset owners, private debt remains popular with corporate defined benefit pension funds – with 69.2 percent planning on increasing allocations – and endowment, charities and foundations, half (50 percent) of which plan on adding more to the asset class.

For defined benefit pension funds with longer-dated liability payments to consider, some areas of private credit can offer stable and predictable income over the long term and an illiquidity premium, further enhancing yields.

Another private market that has witnessed significant decline is real estate. In recent years, the asset class has been one of the first to gate during times of greater uncertainty, such as the COVID-19 pandemic and Brexit, as investors have rushed to liquidate their holdings. With expectations of tougher economic conditions and a potential recession, some investors have argued the asset class looks overvalued with significant downside potential[2].

Our study highlighted real estate as an area from which asset managers and owners would be limiting their allocations in the coming years as a proportion of their total portfolio. One-third of respondents (33 percent) said they would decrease allocations, compared with 28 percent who would increase exposure to the asset class.

Investors in Europe were the most bearish on the asset class, with 39 percent planning on holding back their investments from the sector compared with 23 percent planning to add exposure. 32 percent of APAC respondents also planned on minimizing exposure to the sub-asset. Respondents in the Americas were most bullish about the asset class, with 37 percent planning on increasing allocations compared with 28 percent who planned to decrease their allocations.

Among asset owners, support for the asset class is weaker, with 31.7 percent planning to reduce exposure, compared with 27.5 percent planning an increase.

Michael Knowling

Head of Asset Owner
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Asset Owner Perspective

Allocation

We have seen a growing trend among asset allocators and owners – such as pension funds, endowments and foundations – making bigger allocations to alternative investments across the board. Some of this was prompted by changes in legislation. For example, in the US, public pensions are legally required to have private equity allocations at a certain level.

Asset owners are saying that they are interested in all private market assets. The only area where we have seen some pullback is real estate, which is more likely to be disproportionately hit by interest rate uncertainty.

There is also less appetite for leveraged strategies, as greater market volatility can significantly impact returns. Volatile markets have also highlighted the importance of manager selection, finding those with proven track records and understanding how they use leverage.

Fear of leverage generally has led to a slowdown in the secondary market, where asset owners have traditionally sought these strategies. There has been a greater willingness to make direct investments in private markets.

Operation

Some of the biggest challenges surrounding private market investing for asset owners are around data: managing it, ingesting it and analyzing it. Many asset owners rely on their service providers to help them augment data ingestion and management. For example, a lot of information and data comes in the form of physical documents, so a partner with machine learning capabilities that can validate data and make it usable is extremely important.

We have also seen a lot of talent mobility over the past 18 months. Indeed, industry turnover in 2022 was very aggressive, although it has slightly cooled down. There is a need for people with a background in private markets and operations because of the growing demand for data. ESG is another big data issue for the industry.

The available data is not easily comparable across the different areas of alternatives. If you want to understand the risk of an investment, you need to understand the characteristics of the underlying assets. Many providers are trying to figure out how to get ESG information from private investments, but it is extremely difficult to get valid data.

Democratization

There is growing interest in private markets, but the regulatory regime is not there right now. Regulators have not spent time analyzing how retail investors can invest in private markets because public markets have performed so well. But that could change.

There may be more activity in this space because public equity and fixed income markets have struggled. Last year was challenging for the average retiree; the traditional 60/40 asset allocation model simply did not perform. Therefore, regulators will have to speed up their work to figure out how they can open up private markets for retail investors, many of whom have invested in these assets through their pension plans.

Dry powder and new opportunities in private markets

The changing macroeconomic conditions and ongoing geopolitical uncertainty have pressured investors to liquidate investments in their portfolios, resulting in forced selling in private markets. Expectations of bargains to be had may explain why some asset managers have been hoarding dry powder.

Last year was one of the most active years of the previous decade for private equity transactions, according to EY[3], with transactions valued at under US$730 billion.

However, towards the end of 2022, private equity firms became increasingly cautious, with only 200 deals worth US$214 billion announced[4].

The value of dry powder estimated by private equity firms stood at approximately US$2 trillion towards the end of last year[5], a 21 percent year-on-year increase from the US$1.6 trillion reported in December 2021 by alternative assets data provider Preqin.

Opportunistic investors are beginning to sense there may be attractive returns. Three-quarters (75 percent) of respondents believe tougher conditions will lead to better opportunities.

Although forced selling could provide attractive investment opportunities, investors remain concerned about the dealmaking environment. Half of the respondents (51 percent) believe that private equity valuations have not yet adjusted to new market conditions, although private markets asset managers are less likely to think so.

What are your biggest investment concerns when investing in private markets today?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
Private equity valuations have not yet adjusted to new market conditions	51%	59%	39%	52%	55%
A lack of information and transparency on private marktets in general	32%	36%	31%	30%	32%
Capital is locked up for too long	31%	36%	26%	32%	31%
Erosion of convenants on private debt and loans (e.g., Cov-lite loan structures)	21%	19%	18%	20%	28%
Overcrowding and competition for deals in certain private markets	48%	39%	52%	54%	47%
A private equity bubble risk generated by the falling revenues and profits of companies going to IPO	32%	32%	32%	30%	33%
High fee levels are not justified	26%	33%	24%	29%	19%

% Multiple answers allowed

72%

of private equity firms always screen target companies for ESG risks and opportunities at the pre-acquisition stage.

46%

of private markets asset managers believe private markets are better for ESG than listed markets.

Another significant challenge for investors is overcrowding and competition for deals in private markets, which was flagged by 48 percent of respondents. It is something that more than half of private markets asset managers and asset owners are concerned about.

The case for private markets in an ESG portfolio

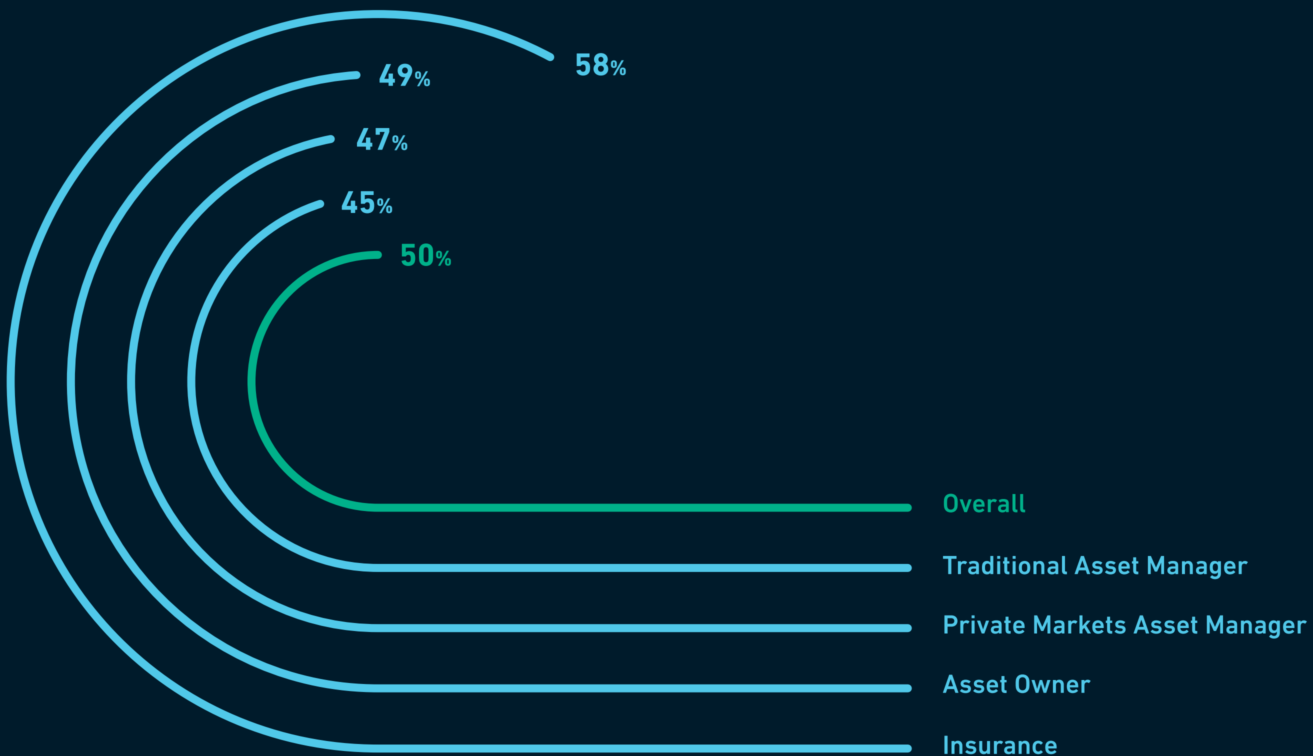
The growing popularity of ESG strategies in traditional asset management has been well-documented, but the trend is yet to become fully embedded in private markets. Nevertheless, private markets have made significant strides in the ESG stakes in recent years. And investors are starting to recognize how private markets can play an increasingly important role in their ESG strategies.

In private equity, ESG has become an increasingly important consideration when investing, according to consultancy PwC. Some 72 percent of private equity firms always screen target companies for ESG risks and opportunities at the pre-acquisition stage, and over half (56 percent) have refused to enter general partner agreements or turned down investments on ESG grounds[6].

Indeed, half of all respondents (50 percent) believe private markets provide better opportunities for ESG impact than public markets, including 58 percent of insurers and 49 percent of asset owners. 46 percent of private markets asset managers believe private markets are better for ESG than listed markets; this rises to 60 percent for private debt managers.

To what extent do you agree with the following statement on private markets at this time (percent agreeing)?

Private markets provide a better oppurtunity than publlic ones to make an ESG impact



Managers will likely face greater scrutiny as more investors turn to private markets to fulfill their ESG commitments. Around two-thirds of all respondents (63 percent) believe it will be one of the most scrutinized areas, with 68 percent of asset owners believing so.

While scrutiny will increase, it is likely to focus on specific areas. Environmental and/or social components will likely receive greater scrutiny (57 percent) than governance (41 percent). Furthermore, carbon emissions will also be important for respondents, particularly for insurers.

To what extent do you think this increased transparency will apply to ESG within private markets investments specifically?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
ESG in general will be one of the more scrutinized areas of private markets transparency	63%	63%	58%	68%	62%
The Environmental and/or Social elements of ESG will receive the most scrutiny, in a more retail oriented market of private assets	57%	52%	61%	53%	62%
The carbon emissions (and/or contributions to a Net Zero goal) will receive the most scrutiny in a more retail-oriented market of private assets	53%	52%	53%	48%	60%
ESG in general will be an area of data/ transparency scrutiny in private markets, but not an area of greatest scrutiny	51%	48%	42%	56%	57%
The governance aspect of ESG (especially around corporate ownership and decision making) will receive the most scrutiny, in a more retail oriented market for private assets	41%	44%	39%	40%	42%

On a regional basis, there is support for greater scrutiny from European investors from two-thirds (66 percent) of European respondents, having been early adopters of ESG investing, compared to over half (57 percent) of North American investors.

Nevertheless, it remains to be seen how the industry will overcome the challenges of data and transparency that will allow more ESG investors to participate in private markets.

The potential of secondary private markets

As investors seek opportunities and bargains in private markets, there is one obvious area where they could begin looking: secondary markets.

Around two-thirds (65 percent) of total respondents believe that current market conditions will force investors to sell private assets in secondary markets for liquidity purposes creating buying opportunities. Interestingly, three-quarters (76 percent) of asset owners agree, perhaps suggesting that some may have already had to raise liquidity this way.

64 percent of respondents believe that secondary market investments offer attractive features for investors (such as avoiding J-curve effect and offering an earlier return of capital), but 41 percent say they have yet to use secondary markets despite interest. Furthermore, half (51 percent) say they plan on taking advantage of buying opportunities in secondary markets over the next year.

Despite strong appetite for secondary markets, professional investors face several issues, with 91 percent of all respondents facing at least one challenge.

To what extent do you agree with the following statements (percent agreeing)?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
Current market conditions will lead to some investors having to sell private market assets in secondary market (e.g., for liquidity), creating buying opportunities	65%	66%	55%	76%	64%
Secondary markets are an important tool for better portfolio management in private market assets	65%	72%	55%	67%	67%
We plan to take advantage of buying opportunities in secondary markets for private assets over the next 12 months or so	51%	46%	57%	48%	52%
Secondary markets aid price discovery by combining market perception with an asset's supply/demand curves and transforming into a market clearing price	55%	58%	55%	59%	48%
Infrequent pricing is a positive characteristic of private markets in volatile market conditions, however this benefit is being eroded by the growth of secondary markets	33%	34%	30%	27%	40%
We are interested in using secondary markets for private assets but have not done so yet	41%	43%	45%	38%	39%
Secondary market investments have some attractive features for investors (e.g., avoiding the J-curve effect and an earlier return of capital)	64%	69%	68%	66%	54%

What are the biggest hurdles for your organization to using secondary markets for trading private market assets?

	Overall	Traditional Asset Manager	Private Markets Asset Manager	Asset Owner	Insurance
There are big gaps in the validations between would-be buyers and sellers	44%	47%	41%	43%	45%
Difficulties in doing due diligence on secondary market transitions	41%	43%	37%	43%	41%
Lack of well-developed secondaries outside private equity	38%	32%	48%	43%	30%
Inadequate supply of suitable or attractive private market assets via secondary markets	30%	39%	32%	23%	28%
Lack of familiarity with different options for secondary market transactions	28%	26%	28%	21%	36%
We lack the networks and contacts to find good secondary market transactions	25%	23%	23%	24%	30%
We are not facing any hurdles	6%	3%	5%	10%	7%
My organization does not use and does not intend to use secondary market for private assets	3%	3%	0%	7%	1%

% Multiple answers allowed

The biggest overall concern highlighted by 44 percent of respondents was huge gaps in valuations between would-be buyers and sellers, the major concern for traditional asset managers. Another significant issue raised by 41 percent of respondents was the difficulty in performing due diligence on secondary market transactions.

38 percent of respondents also stressed the lack of well-developed secondary markets outside of private equity, a challenge for 48 percent of private markets managers and 43 percent of asset owners.

Although the investment backdrop has changed substantially in recent years, appetite for private markets remains stable. As awareness and understanding of the asset class have grown, the use of private assets has become more sophisticated as investors use all the tools at their disposal to construct resilient portfolios.

Private equity remains one of the most sought-after assets within private markets, but investors are increasingly open to emerging areas, like infrastructure, that can offer different investment characteristics. However, the changing investment backdrop and increased market uncertainty have weakened the appeal of real estate and private credit. Nevertheless, there will be opportunities in both primary and secondary markets for investors with dry powder, as greater uncertainty and market volatility lead to forced selling.

Finally, having become well-established in traditional asset management, ESG investing could play a significant role in private markets in the years ahead and open up the asset class to a new cohort of investors.

Jesse Cole

Global Head of
Private Markets Product,
State Street

Private Markets Manager Perspective

Private markets have been core to the needs of institutional investor segments. In recent years, private market has witnessed several new product launches across client base and a growing demand for asset servicing across asset classes.

However, in uncertain times, growth might not follow as linear a path as it might have enjoyed in the past three years. As adoption increases, private market is expected to be reshaped as well.

Macro-economic scenario would shape how institutional clients allocate to specific asset classes and timing the market. For instance, private credit is a growing area as compared to private equity. Infrastructures continue to be an opportunity area.

Despite the macroeconomic headwinds, both investors and asset managers see merit in being invested in private capital. From an investor perspective it is an opportunity for risk diversification, access to private asset classes, and more holistically manage the portfolio risk. For asset manager, it is an opportunity to diversify how they raise capital.

Since institutional investors are experiencing this market dynamic for the first time after a long time, they need to think through having the capabilities and tools to choose the right manager, right investments without taking too much risk, and achieving the overall portfolio diversification.

The uncertain financial markets and pick-up in inflation are prompting even retail investors to look beyond the listed asset categories. This peaking interest is met with support and resistance in equal measure. The question is not about 'if' but 'how' to make private markets accessible to retail investors balancing the level of sophistication and liquidity of the product. It is important not to react to democratization pressure in a haste and work towards developing the right infrastructure, safeguards and regulations. Addressing liquidity and data transparency would be key to make private markets suitable for retail investors. Lack of data transparency remains as a key huddle to operate within private markets. Several factors contribute to this mounting challenge.

Historically, private market has been exclusive and largely been the preserve of institutional investors and high net worth individuals. Developing an operational infrastructure was not a focus area. However, now with increasing adoption, institutions are realizing the need to scale up their infrastructure.

Each asset class within private market is distinct and its structure is complicated. Most firms lack the resources and know-how to scale. Having the domain expertise is key to scaling up.

With respect to data management, data collection or normalization is not the hardest part. It is time to think about creating a universal data model for each asset class with a governance mechanism that would allow users to validate against use and harness the information across portfolio including public assets. Service providers have an opportunity to add value by bridging the data across credible sources to the needs of the users.

Today, institutions spend considerable amount of time and efforts around managing risk, investment analytics and forecasting, and layering in ESG. Investors and managers need private market data available through APIs or such mechanisms and retain the flexibility to run their own analysis within their functions such as risk management, compliance or investor relations. Data not only limited to investments but investors as well. To enable better data, investor reporting needs to modernize.

Each of the institutional segments are different. They have different infrastructure, business and regulatory requirements. Service providers are at unique vantage point to understand the challenges from diverse perspectives and take a leadership role in developing solutions holistically.

Endnotes

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