The Rise in Private Equity allocations: Crowded Fundraising market forecasted in 2022

By Shanu SHERWANI, Private Equity Analyst

Currently, every investor class desires to increase their allocation to private equity to pursue yield. However, a crowded fundraising market in 2022 gives the advantage to the fastest returning managers, while others doubt how long the celebration can endure.

Private equity has benefited from the pandemic. With returns nearing record highs and far outstripping those from fixed income, institutional investors seeking yield have recognised the relative stability on offer compared to more volatile public markets. According to data provider Preqin, investors put over USD 810 billion into private equity funds in 2021, the most ever.

According to Cambridge Associates' research published last year, increasing allocations makes financial sense: institutions with more significant funding to private markets typically experience higher returns. It discovered that those with a private investment allocation of at least 30% outperformed those with a private investment allocation of 10% or less by 200 basis points over the last decade.

Private asset holdings are expected to increase by 60% between 2020 and 2025. According to Preqin, private equity is growing the fastest and will account for nearly 70% of alternative AUM by 2025. In a survey of LPs conducted by Intralinks at the end of last year, a vast majority (roughly three quarters) planned to increase their overall allocation to alternatives (including private equity) over the next 12 months.

However, as interest in private equity grows, one might wonder how long this growth in fundraising from institutional investors will continue. Hence, private equity firms are looking for new sources of capital.

Institutional Investors

Pension funds and insurance companies, typically have lower exposure to alternative investments in private markets because they are more tightly regulated, giving them less capital deployment flexibility. These institutions also typically have longer-term obligations that have historically been met with large fixed-income investments. Three things have changed in the last two years: more online pitching during successive lockdowns has accelerated fundraising cycles; pension funds have set more aggressive private equity allocations, and GPs have created more liquid fund structures to unlock new sources of capital.

For the past three years, the proportion of US pension funds invested in real estate and hedge funds has decreased, while private equity has increased.

According to Preqin, their private-equity investments increased to 8.9 percent of holdings in 2021, following three years of uninterrupted growth. The California Public Employees' Retirement System (CalPERS), one of the world's most significant pension funds, increased its allocation to private equity from 8% to 13% over the next four years, equating to approximately USD 25 billion in additional investment based on current AUM.

Despite fierce competition, private equity funds' efforts to access such large institutions will continue. According to recent data published, the most significant pension funds (with more than USD 134 billion in AUM) currently allocate the least amount of their total asset mix to private equity. However, I believe that some of the more mature pensions could achieve a 25 per cent allocation through a combination of fund and direct investment by 2025.

Many GPs in Europe and the United States are turning to alternative sources of capital, where the hunt for capital is heating up: retail investment and private wealth.

Family Offices

There are approximately 7,300 single-family offices globally, with a combined value of approximately USD 5.9 trillion. According to UBS data from 2020, about eight out of ten have some form of private equity investment, allocating approximately 16 per cent of their portfolios (split between 9 per cent direct investment and 7 per cent funds).

According to placement agents and fund managers worldwide, the risk appetite for private equity among family offices is the greatest among all investor types and is still growing. While more money is being allocated to private equity globally by almost all investor types, it is not being distributed evenly among fund managers, and 2022 is expected to be the most competitive fundraising market yet.

Mega Funds

While the amount of capital flowing into private equity funds is increasing, the number of funds receiving these allocations is mainly limited to mega-funds. It may take some LPs several years for their programmes to move beyond well-known brand names and invest more broadly into the market. According to Pitchbook data, such mega-funds raised roughly half of all private capital raised in the first nine months of 2021. Hellman & Friedman's 10th flagship buyout fund (USD 24.4 billion), Silver Lake (USD 20 billion), and EQT, with two funds totalling USD 18 billion, are among these mega-funds.

The Carlyle Group's latest flagship fund, targeting USD 27 billion, will be the largest private equity fund in history, followed by KKR's USD 17 billion North America Fund XIII and Partners Group's fourth buyout vehicle, targeting USD 15 billion.

According to Hamilton Lane, a private market consultant, 15 managers intend to raise at least USD 15 billion in private equity funds in 2022. Fifteen of the sixteen most significant European funds (over EUR 5 billion) will be fundraising in 2022. The fundraising market in 2022 is expected to be so crowded as more significant funds return to the market more quickly, according to placement agents, that some smaller GPs would be better off simply concentrating their efforts on premarketing funds for 2023.

Private equity funds waited an average of 4.8 years before returning to the market in 2017. They now have to wait only 2.9 years. With the growth of fund platform extensions, it has become a never-ending cycle for many of the largest GPs to exit the market.

In 2022, the critical question for GPs will be, «What percentage of allocation do LPs have for new relationships?»

Private individual investors and feeder platforms

Individuals with high net worth and retail represent a new growth stage in private equity allocations. As regulators keep a close eye on the situation, the largest fund managers lead the charge. Ten years ago, Blackstone, the private equity goliath, relied solely on large institutional investors for capital. Individual investors contributed roughly 20% of its USD684 billion AUM last year. According to the firm, it could reach half in the next decade. Retail is a USD 80 trillion addressable market, and other large private equity firms such as KKR and Apollo are taking notice.

When we look at where the significant funds are putting a lot of their focus and where they're building new teams, private investors stand out. It's an untapped market, and for the most part, those markets have been frozen out of institutional commingled funds for a long time.

Banks, particularly in Europe and Asia, have been developing or outsourcing alternative investment platforms to capitalise on the increase in the appetite of private clients for this asset class. Fintech feeder vehicles such as Moonfare (founded by an ex-KKR executive), iCapital Network (part-owned by Blackrock), Luxembourg-based Antwort Capital and French-based Private Corner are channelling vast sums of private capital into the most well-known private equity funds, with the latter two focusing on the mid-cap PE segment, which in my view is one of the most appealing in terms of returns.

Regulators may have been paying attention. Last September, a US Securities and Exchange Commission (SEC) advisory group recommended making it easier for the less wealthy to invest in private equity. Changes to the European Long-Term Investment Fund (ELTIF) have also been proposed by European authorities, eliminating minimum investment and wealth requirements for individuals while also expanding the types of assets that fund managers can hold.

The appetite for alternative assets among private investors has been steadily growing for some time, echoing what has happened among institutional investors. Now is a good time for private investors to broaden their exposure to alternatives. Market conditions are creating some very appealing opportunities, and post-downturn vintages are known to outperform.

Do the investment vehicles adapt to clients needs and behaviour?

By Ivaylo MARKOV, Managing Partner of Thales Solutions

AIFMD II, DAC 6, Solvency II, ESG, SFDR, CBDF, etc… seem to the investors like inexplicable acronyms which can impact their investments. But is that true and what do the investors really need from funds? Three topics can give us some elements of response, ESG investment, fund distribution and relevant data management.

What we observe is that the fund industry is generally moving in the same direction globally, all regions confounded, there are some interesting regional differences when it comes to the rate of adoption of new technology and establish the relevant strategic priorities and targets. Some of these are due to the legacy infrastructure and different demographics of jurisdictions, as well as the relative maturity or immaturity of the relevant investment markets and the high speed adoption of new technology.

One of the least surprising findings from a recent survey published by Funds Europe and Calastone for the future landscape of investment funds, is the universal appeal of ESG funds. Not always for the right reason, but it is a fact and we cannot ignore it. The future of the funds industry entered into a new era, the one of sustainability and data management.

The famous British designer Vivienne Westwood was militating against the climate change already 50 years ago, but the financial world was too blind to see it and deaf enough pretending not to hear it. We, at Thales Solutions Luxembourg, are trying not only to provide a quality service

to our clients by structuring their investment funds, but educate them simultaneously of how and when their projects will impact the economy and the planet. This is how the totality of 315 ManCo and 57 Depositary banks in Luxembourg shall act when fund promoters push their doors and present their projects. 21 century's investment vehicle has to go even further and include into its TER, at GP, SPV or fund level a percentage which is granted for social or environmental improvements, independently of its investment policy and strategy.

The average TER for UCITS in EU is at 1,68% and with the 2% of management fees for the AIF, the margin for action is important. A simple extra basis point per fund out of the EUR 5,545 billion of AuM in Luxembourg funds, could split an annual amount of roughly EUR 550 million for social and environmental projects. Which is the value of dividends distributed by companies in Luxembourg in 2019. It is a pure common sense. We, at Thales Solutions, have determined the bracket to be 5%-10% of our annual income, donated to such initiatives. There is no other possible exit than sharing of competences, time, experience, wealth. And the fund industry has a tremendously important role to play in that process. Let's more focus on achieving long term sustainable returns, to create a positive footprint in people's futures. This is what will save us. As the deputy PM of Luxembourg François Bausch said "There is no vaccine against the climate crisis", we have to create it by acting in the right way at more less the right time, as we are quite late even, some say.

When asked for the factors driving firms' distribution strategy, ESG was one of the most frequently retrieved one by all regions, Calastone survey says. As ESG standards develop, such as the brand new Europe's Sustainable Finance Disclosure Regime (SFDR), there will be a greater focus on data for fund managers, service providers such as depositaries, and investors.

Partly designed to eliminate greenwashing, SFDR disclosures aim to make it easier for investors to compare ESG funds and select the one corresponding to their target, plan, wealth and ambition. But how to properly select it? I have always said that a person's life is determined by 5 main components: innate intelligence, family environment, education level, personal ambition and people met all the way long. This postulate can be used for funds selection too, adapting the terms and actors. That's why it is extremely important to have your own idea of what type of vehicle you want to create or invest in, correctly surround yourself with the right providers and give yourself the means of your ambition.

Another obvious constatation is that we do not invest enough in the land, properly speaking. Not to build up a huge residential real estate project on it, but develop the land. Like vineyards, agriculture. Climate change and the reduction of CO2 emissions are a major challenge for the world, way bigger than the disastrous Covid pandemic we are currently living. In wine-producing countries, vineyards cover on average less than 10% of the agricultural area, but in some cases represent 25% of pesticide use.

The viticulture of the future is one with a vision in which organic farming would only be too simple a summary of the problem. It also makes little sense to measure yourself a clear conscious by planting a hectare of forest for every new hectare of vineyard you create. This is often just window dressing, and most of the time only a plaster for a wooden leg, if we go further. Like we can imitate sugar for our own body and metabolism, we can also give signals to the land and nature so that it responds positively to our presence and the crops we plant.

Respecting the land through, among other things, regenerative and diversifying plantations helps our CO2 footprint further and faster than afforestation compensation or the sometimes-insufficient rules and commercial compromises of the organic standards we have all established and are currently still following.

Digitalisation's role in the funds industry is purely primordial. We are only at the beginning of a trend that will strongly accelerate as companies keep expanding the capability of their systems and front office weight. The initial idea behind is cost and risk reduction, but also to extract back-office data, adapt it and fully use it to enhance client applicationss and systems in the front office, where the game is played. Despite the global move in the same direction of the fund industry, some disparity occurs between regions and countries. For some of the markets, we clearly see a much greater move to direct-to-consumer policy. Consequently there is a higher demand for advisory services in those relevant markets. We, at Thales Solutions being in the advisory business, distinctly observe an increasing demand from clients to propose them such services.

The new technology has another positive impact on the investment fund markets which is the fresh horizon it opens to asset managers to go to unexplored places offering more data, opportunities, clients and a lower level of expenses.

How to attract and acquire clients continue to be a true challenge for the investment funds market. It is not just a cost point, but complexity as well, with AML/KYC obligations to be met. It starts to be clear that a simpler client onboarding could be one of the keys to a higher accessibility to the funds market for investors.

The tokenisation of the shares of investment funds is another milestone we shall take into consideration. Only few of them are tokenized today in Luxembourg, but the journey began. There are already some companies which are committed to tokenisation and developing products into that direction. Tokeny is definitely one of them and we are lucky to have it in Luxembourg. They have put tokenisation at the centre of their business and are looking to develop a personalised service, making it available on a much larger basis. Data management, connectivity, market access and time to market are all becoming more important for companies, with the cross-border market growing, establishing a higher connectivity between all stakeholders involved in the life cycle of an investment fund.