PitchBook

Capitalize on your private markets allocation with the right data

How data plays a critical role in helping asset allocators invest in the private markets

Contents

Introduction

Timelines are expanding, deal sizes are growing, funds are getting larger and high returns are being reaped in the private markets. Given the opaque nature of alternative asset classes, however, it can be daunting to approach this constantly growing and evolving portion of the market.

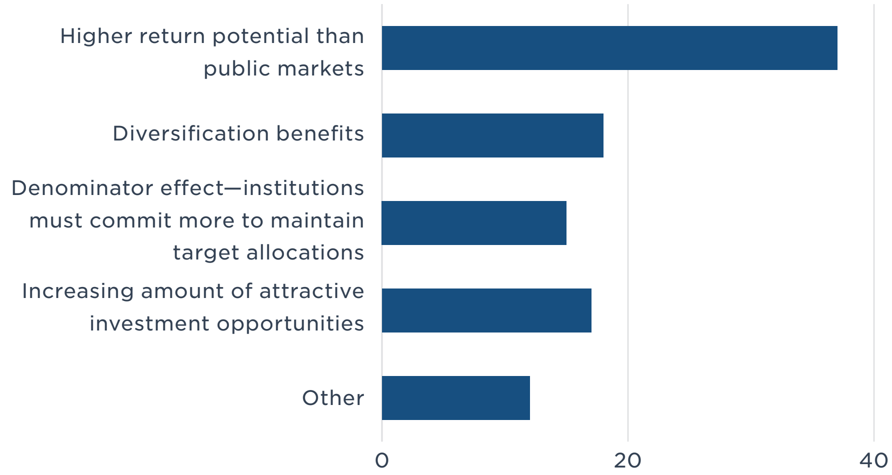
In recent years, institutional investors have been particularly drawn to the promise of higher returns and greater diversification that the private markets offer. While the obstacles posed by an ever-changing landscape can be challenging, asset allocators stand to benefit from a better understanding of how to gauge historical performance across strategies, compare track records of fund managers and use data to unearth promising opportunities.

01

What institutional investors need to know about the private markets

According to a **survey conducted** in Q2 2019, the top three reasons why institutional investors believe the private markets have continued to pull in record numbers of capital are: higher return potential than public markets, diversification benefits and an increasing amount of attractive investment opportunities.

Why are private markets continuing to attract record amounts of institutional capital?



Source: PitchBook

Investors can tailor their exposure to private markets based on their specific needs and risk tolerance. For example, secondaries investing can provide greater access to a wider range of geographies and strategies by design, offering somewhat mitigated risk compared to an area like traditional private equity.

Continue reading to learn how different investment strategies are performing in today's changing private market investment ecosystem and see what has encouraged record-breaking value and activity across alternative asset classes.

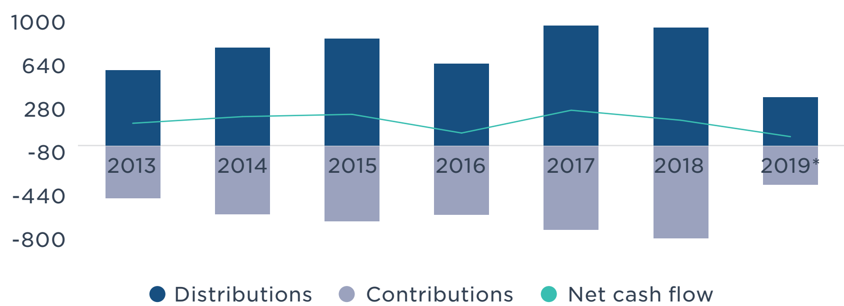
01

Private market performance and cash flows trending positively over recent years

From 2013 through 2019, private market net cash flows were positive, meaning that more distributions were sent to institutional investors than calls were required from them. The pace of these distributions continued to increase, reaching record numbers through the end of 2019, until falling when met by the significant impacts brought on by COVID-19 in 2020. Though cash flows have shifted more negatively for the time being as firms seek to hold onto their capital, the private markets have proven a diversified and valuable source of returns for allocators that are involved in this space.

*Assess private market performance on a broader timeline using **PitchBook Benchmarks***

Private capital cash flows ($B)



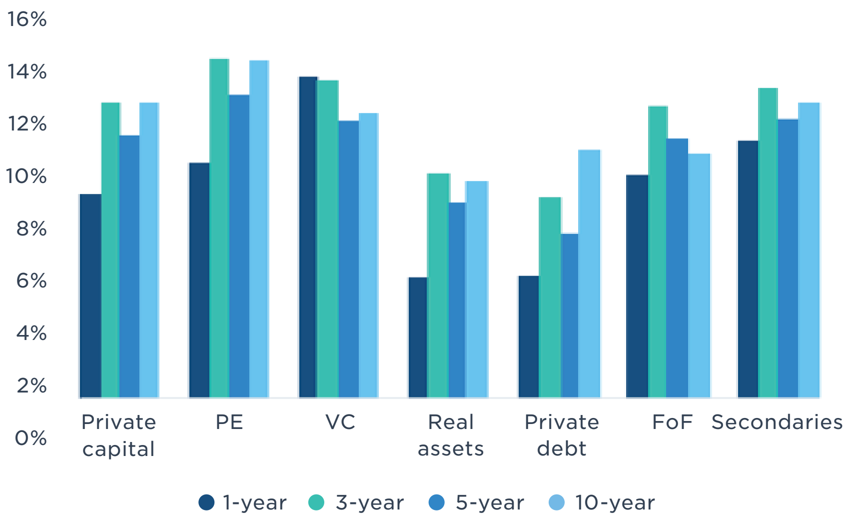
Source: PitchBook

Year	Contributions	Distributions	Net cash flow
2013	-$439.56	$624.52	$184.96
2014	-$572.40	$812.13	$239.73
2015	-$628.04	$887.03	$258.99
2016	-$575.87	$679.77	$103.91
2017	-$701.95	$994.71	$292.76
2018	-$771.40	$980.78	$209.38
2019*	-$327.46	$401.38	$73.91

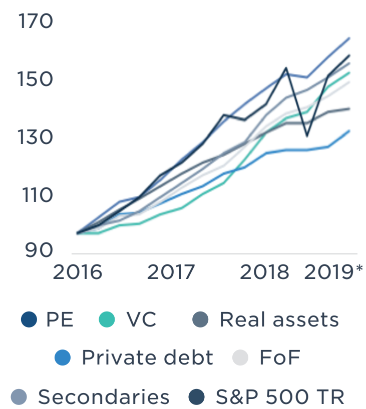
Source: PitchBook Geography: Global *As of June 30, 2019

Looking at private market performance through the lens of internal rate of return (IRR), you can get a clearer view of the strengths and weaknesses of differing strategies. From 2016 through Q2 2019, private equity was the overall top-performing strategy by IRR, even outpacing the strong returns in large cap companies in public equity markets. On the basis of one-year horizon IRR, the highest returns came from venture capital—though the strategy pulled back from its high point in the 20% range (as seen in 2018). Further, VC is the only strategy that has consistently performed stronger in recent years compared to its five- and ten-year horizon IRRs—though this could be challenged by a slowed exit environment compared to the exceptional showings in previous years.

Horizon IRRs by fund type



Source: PitchBook Geography: Global *As of June 30, 2019



***NAV growth rebased to 100 in January 2016:** Return on $100 across aggregated results for private market strategies*

*Source: PitchBook | Geography: Global | *As of June 30, 2019*

As fewer portfolio companies list on public markets and corporate development teams look to hold on to capital that can be used in case of emergency, it also becomes harder for allocators in PE and VC to exit and recover their capital. Further, holding times will continue to extend as GPs seek to avoid realizing relatively lower valuations, hampering IRRs. As the overall timeline is extended, "time value" will continue to go down, bringing performance metrics down with it to some extent*.

For a more detailed view of private market performance by strategy read our ***2019 Annual Private Fund Strategies report***

**As IRR accounts for the timing of cash flows, a longer hold time equates to less efficient use of capital from a mathematical perspective*

01

Spotlight: Private debt performance and future potential

Although contributions and distributions each topped an impressive $90 billion in 2017 and 2018, private debt trailed other strategies for overall performance in this timeframe. This makes sense, as the main upside available to debt investors comes from investing during periods of distress when managers can buy at a relative discount and effect a better result than originally expected. Additionally debt cash flows come primarily from interest payments, which helps explain the apparent disconnect between it and other private market strategies during this time period.

Still, coming into 2020, private debt fundraising had experienced its best three-year period in history, having raised $388.9 billion globally since 2017. Dry powder had ballooned too, reaching $276.5 billion as of Q2 2019—all signaling that private debt funds have plenty of capital to deploy in these trying times.

In addition to ample dry powder available for the strategy, recent volatility and an increasing need for liquidity mean that debt could be poised to offer greater potential for profit than in recent years. Though the risks remain legitimate, especially considering current challenges, many participants in the private markets will be looking to extend their runways. In venture debt as of Q2 2020, lenders were already seeing an increase in new borrowing requests, while their existing clients called down credit lines and extended debt facilities in greater numbers.

02

What public market volatility means for institutional investors' allocation strategies

At the highest level, institutional investors are held to seeing that their investment mandates are met. But sudden shifts in one asset class or another can pose a serious threat to allocators who are active in the private markets.

When public market values swiftly fall it could mean that allocations that had previously been balanced may no longer appropriately reflect an investor's target allocation framework. This is especially true for investors who operate in the private and public markets, as relatively slower-moving, illiquid private market funds will take longer to reflect changes in the broader environment.

Known as the ***"denominator effect,"*** this is an issue that has long been on the radar of institutional investors. In addition to not appropriately reflecting agreed-upon allocations, a key concern here is that such changes can leave an investor overexposed to a particular asset class. In the first half of 2020, public market volatility brought on by impacts related to COVID-19 yet again brought this concern to light as values in the public market rapidly and severely swung.

$$\textit{Denominator effect} = \frac{\textit{Private market asset class value}}{\textit{Overall portfolio}}$$

What does this look like in practice?

If a portfolio was initially worth $100 million and a previously 40% stake in public equity dropped by 35%, then the total portfolio would have dropped by $14 million to reach $86 million. Then, imagine that before the same drop, the private equity target was $20 million. Given the sudden change in public equity values, that allocation becomes 20% of $86 million, or $17.2 million. If the investor was at or above the original 20% allocation target before the stock market drop, then the allocator now finds itself overallocated.

Before stock market drop

$$\frac{\text{\$20M PE target allocation}}{\text{\$100M portfolio value (\$40M public)}} = \text{20\% PE allocation}$$

After 35% stock market drop

$$\frac{\text{\$20M PE target allocation}}{\text{\$86M portfolio value (\$26M public)}} = \text{23\% PE allocation}$$

How institutional investors can adjust to dramatic shifts in market values

One way that institutional investors have responded to this concern is through more flexible parameters in investment policy statements. While traditionally, allocators would have implemented a rigid target to cap investments at a specific percentage, more are building in widened ranges that give them room to maneuver if values in a given asset class were to change.

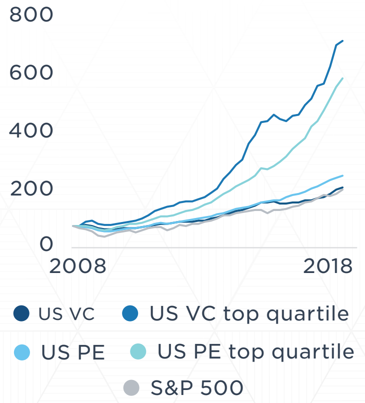
Further, institutional investors are giving themselves more leeway by setting additional parameters around time in the case of a crisis. For example, an allocator may include a provision that establishes a grace period if drastic changes to the broader market environment were to occur (e.g. allowing them two consecutive quarters to reach compliance again). This added time would enable a private market portfolio to adjust to a newly changed environment as things hopefully cool down and participants come to more of a consensus on valuations. An added benefit is that this grace period could free up more time for an investment team to assess the situation and adjust accordingly.

How else might shifting values challenge allocators?

As opposed to the more commonly known denominator effect discussed above, allocators could potentially have more to worry about with regards to a numerator effect (also known as the reverse denominator effect). It is possible that institutional investors could be faced with the same problem on the opposite side of the equation, where values in the private markets actually increase relative to holdings in other asset classes.

Take venture capital, for instance. For years, top-tier firms have wielded asymmetrical influence over the industry due in part *to their exceptional returns*, ample resources, strong networks and proven track records. As a result, these firms see consistently strong demand from institutional investors. This is particularly true when market conditions are challenging, as they represent a somewhat safer bet.

In a post-COVID-19 world, requirements to conduct in-person due diligence can hamper an allocator's ability to engage new managers or make new commitments. According to a PitchBook survey conducted in Q2 2020, 22% of LP respondents said that travel restrictions and in-person due diligence requirements could pose a "large" impediment to fundraising. Further, about 29% of LP respondents said they would suspend commitments through the rest of the year. When the market at large is faced with headwinds, allocators may be more likely to stick with proven methods and existing relationships, as opposed to seeking out new managers or strategies.



Pooled quarterly aggregated changes to NAV (rebased to 100 in January 2008), Source: PitchBook

03

Identify top-performing funds—first

It’s well accepted that top-performing funds generate outsized returns, but how do you find and access top-tier firms and funds?

The private markets are continuing to grow and see increased levels of participation, despite challenges in the economy. The number of US PE-backed companies has doubled between 2007 and 2020 (going from 4,381 to 8785). In that time, strategies across the asset class have also proliferated. Continuously evolving, the industry has found new ways to deploy capital and collect returns. Some firms have looked to broaden their offerings to cover every corner of the market, while others have employed specialized approaches such as buying minority stakes in GPs, pursuing secondary buyouts or completing platform acquisitions. The rise of secondaries investing has also helped allocators achieve greater diversification and exposure to different geographies. Further, investment timelines are continuing to expand—ballooning up from the traditional 10-12 years to as long as 15+ years in some cases.

See where other asset allocators are finding success

To be more thorough in your due diligence, you may want to see where your competitors are finding success. Data that offers insight into where competitors are committing capital can help you build or validate your investment strategy.

Plus, with visibility into investment activity, you can see where pensions, foundations, endowments and fund of funds are committing capital and see who’s most active in the asset classes you care about. Information on previous investors’ locations, commitments and recent deals can help you get the full picture. From there, you can check their return rates against other funds to test your hypotheses on allocation strategy. Comparing open funds to historical funds of the same strategy or even fund family can help you better understand how well they have performed over time. With access to underlying funds, their investments and historical data on metrics such as IRR or cash flow multiples, you can more clearly assess strengths and weaknesses of different approaches.

03

Tracking performance based on fund family can help investors see the value of a specific strategy with the same financial sponsor. Often, large firms will dedicate entire teams to a strategy that is focused on a specific geography or investment thesis. The prevailing perception is that a fund family is a continuation of a successful investment thesis that is still worth devoting resources to.

How data helps you find high-quality opportunities

With the right data, it's possible to get in front of high-quality managers—before your competitors do. A good place to start is to look at fund-level details for previous funds of managers who are currently fundraising. Consider focusing on historical performance, including investments, IRRs, deal multiples and liquidity events to see whether their next fund might give you the returns you're looking for.

One way to identify GPs primed to launch new vehicles is to track fund managers that have minimal capital remaining in a fund but have yet to announce an upcoming fund. If you can identify these sorts of opportunities, you can discern when your targets are looking for partnerships—before the next fund opens.

Beyond researching individual fund managers, it's important to get a higher-level view of the private markets. Identifying and monitoring which asset classes are generating outsized returns and which ones aren't can help you better manage your allocation strategy and stay ahead of the competition. In addition to standard private market benchmarks, creating custom benchmarks can further help you understand differences in performance across strategies and geographies. For instance, PitchBook offers clients the ability to create benchmarks with custom peer groups based on various criteria including target industry and underlying investments. Plus, PitchBook provides built-in pivot tables that allow users to easily identify hurdle rates for peer groups.

04

Mitigate risk through better fund manager evaluation

The number of private equity and venture capital fund managers has roughly doubled between 2006 and 2020—a clear sign that the private markets have grown tremendously in recent years. But with so many options, how do you find the right fund manager to partner with?

Fortunately, there is now more data than ever on the private markets, helping investment professionals mitigate risk. This abundance of data enables allocators to find the right firms to work with, invest smarter and ensure their capital is safe.

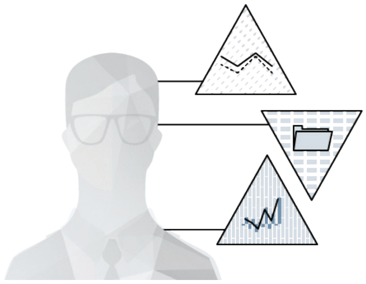
Risks and challenges of the private markets

An ***extended investment time horizon*** means that the LP/GP relationship is continuing to lengthen, increasing from the textbook 10–12 years to as long as 15–18 years in some cases. Given this added length, selecting the right fund manager is an even more important, long-lasting decision. Altogether, this highlights the need to find a highly compatible fund manager for your firm.

__Investment timelines are expanding:__ The private markets are seeing a notable increase in timelines, up from the traditional 10-12 years.

Despite the competition, an increase in the amount of data that is available on the private markets makes it easier to conduct due diligence and be confident in your investment strategy and fund manager selection. Access to such data means you can ensure a fund manager has really created value in the past—and is worth pursuing—before making a commitment.

When deciding on a fund manager, every detail matters. If you haven't seen all of a GP's past investments, you aren't getting the full story. ***Access to data like fund return profiles, investments, IRRs, cash flow multiples and liquidity events*** can illustrate a general partner's true value or shortcomings—and allow you to be more strategic in your manager selection process. Knowing if a manager drove growth across their entire portfolio or if they capitalized on the success of one unicorn might change your mind. Further, firms change over time as key figures come and go. Tracking activity down to the level of an individual and finding their involvement in past funds can help show drivers of success.



__The right fund manager.__ Access to data like fund return profiles, investments, IRRs, cash flow multiples and liquidity events can illustrate a general partner's true strengths and weaknesses.

05

Considerations for structuring your limited partnership agreement

Despite being a fundamental component in an LP/GP relationship, there aren't really hard and fast rules for structuring limited partnership agreements (outside of the ILPA's guidelines). There are, however, a lot of variables to consider—all of which could be assigned different levels of significance based on your goals. Obviously, the details matter, but more importantly, the LPA is a key component in what will be a 10+ year relationship. In this section, we discuss some ways to align incentives between your firm and a fund manager, as well as strengths and weaknesses of different fee types and carry structures.

Aligning incentives between parties

It's important to align incentives between your firm and a fund manager so that everyone is working towards a shared goal. One way to do this is to ensure that the GP's commitment is a sizeable portion of the overall fund (somewhere in the 5-10 percent range is pretty typical). A fund manager's own capital at risk will be a huge incentive for them to perform well. This is particularly important as fund lifecycles are growing longer.

Additionally, incentivizing not just the top investment professionals at a firm, but also the more junior individuals can be impactful. ***Ideally, everyone across the entire LP/GP relationship should have an interest in the carry at the end of the fund lifecycle.*** When possible, having a commitment in the form of a cash contribution is best. This is easier for more established GPs, but you could also use management fee waivers for more junior GPs who can't make cash contributions up front.

Ideally, everyone across the entire LP/GP relationship should have an interest in the carry at the end of the fund lifecycle

05

Determining an appropriate investment period

From the start, you should have the investment period clearly spelled out. Although this is becoming more difficult to predict given lengthening investment cycles, fund managers should nonetheless clearly outline their strategy, expectations and timelines. Fund extensions should be permitted in 1-year increments only and be approved by a majority of the LPAC or LPs.

Deciding on carry structure–whole fund carry, or deal-by-deal carry?

The first big choice to make regarding carry structure is between a whole fund carry or deal-by-deal carry. Depending on your strategy, one structure might not necessarily be better than the other, but the most important thing is to note how the different structures incentivize managers. Again, it helps to have not just top-level investment professionals, but also more junior figures involved as well.

	PRO	CON
Whole fund	Managers are incentivized to maximize value for every investment—as that will have an impact on the overall level of carry.	If early investments in the fund begin to underperform, the manager may feel compelled to take out additional risk—because those funds are weighing down the overall performance fee that the fund manager will expect.
Deal by deal	Performance is rewarded on an individual basis—rewards individuals who are most closely tied to successful deals.	This approach doesn't foster the same level of collaboration. For underperforming deals, the manager may dismiss them and only concentrate on the winning deals.

What fee structure matches your approach?

Naturally, there is a bit of a tradeoff between management fees and performance fees. The typical structure has been 2 and 20 (2 percent management fee, 20 percent performance fee), but more firms are offering other options. For instance, a firm might offer a choice between a 1.5 percent management fee with a 20 percent performance fee, or a 0.75 percent management fee with a 30 percent performance fee. It's also important to decide whether you want to base those fees on committed capital or contributed capital.

Committed capital

With committed capital, GPs are basically rewarded for having the assets—and this is still the most common fee structure we see in the private markets (particularly in the private equity space). ***One important aspect to consider for this strategy is negotiating step downs.*** A lot of the fund manager's efforts will take place during early phases of a fund (during the first 3–5 years). As a result, you want to see the management fee tier down over the life of a fund—this is especially true over the 10+ year period when maintenance exit route planning is taking place.

One important aspect to consider for this strategy is negotiating step downs.

Contributed capital

With contributed capital, the management fee doesn't kick in until the manager actually does a deal. This could potentially encourage a fund manager to quickly find and complete a deal they might not have otherwise taken to get the management fee to kick in. But in some cases, this may be a more beneficial way to go. For instance, one fund of Sequoia's is only charging on contributed capital instead of committed capital (that is specifically earmarked for follow on rounds for previous Sequoia investments), which helps them deploy contributed capital more quickly.

Regardless of all the potential provisions and inclusions, what matters most to you and your firm will ultimately guide your decisions when it comes to drafting an LPA. Beyond its important legal implications, the agreement also sets the tone for a 10+ year relationship—so it's worth exploring the many options available.

06

Getting visibility into your investments

The lack of a uniform methodology for gauging private market performance has led to inconsistent approaches across the industry and difficulties in really seeing how well individual funds and investment strategies have fared. Without a shared methodology, it can be challenging to make true apples-to-apples comparisons. Still, there are ways to present more appropriate comparisons when it comes to fund performance using custom benchmarks.

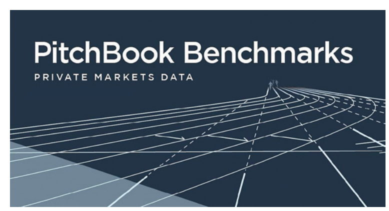
Why custom benchmarks matter

As private market funds are based on different strategies and structured for entirely different return profiles, they face a distinct set of challenges compared to public market funds. This means that it's especially important to consider alternative metrics when evaluating their performance. Featuring longer time horizons, extended lock-up periods and less liquid fund structures, private market funds require benchmarks that take these factors into account.

Standard, pre-made private market benchmarks are useful for getting a high-level view of asset class performance and typically show peer groups based on fund type (such as VC, PE, real assets, etc.), fund size, vintage and *geography.* But, these basic attributes can be expanded upon in order to create even more relevant comparisons. Important factors such as portfolio construction, underlying investments and more specific location data can help ensure that the comparisons being made are equitable.

Custom benchmarks can also help provide greater transparency. Investors need insight into the underlying data used to construct a benchmark to determine if it is suitable for their purposes or if a more tailored approach is needed to make a fitting comparison. A lack of transparency can leave important questions unanswered. For example, are the compared funds investing in the same industries or types of companies?

In the end, this means critical details that can be used to better evaluate performance are lost. All of these factors can be helpful for creating a more accurate understanding of fund performance—which ultimately leads to better investment decisions.



PitchBook clients get full transparency into the underlying funds that make up each benchmark, all of those individual funds' return histories and even the investments made by those funds.

*Take a look at **PitchBook Benchmarks** to see what these benchmarks look like in practice.*

07

How comprehensive data helps asset allocators

From tracking fund managers to making investments, you need a full view into the private markets to fulfill your fiduciary duty. PitchBook tracks the entire landscape of private capital—from institutional investors and commitments down to GPs, funds, investments, companies and individuals—all in one place. Our information can help you get ahead of top-performing funds before they come to market, select the best fund managers and better serve your stakeholders.

What makes PitchBook a better choice?

- A full view of the private capital markets—with access to all our data and connected datasets
- Individual investments and transaction details (like deal sizes, multiples, valuations) connected to their fund vehicles
- Accurate, relevant custom benchmarking based on actual investments complete with visualizations and pivot tables
- Track fund managers throughout their career with deal, fund and board seat attribution
- The world's largest source of fund returns and transparency into who is reporting returns
- Historical performance data on fund families to help you validate your investment thesis and select fund managers
- Allocation history and insight into current and past mandates, so you can gauge private market involvement and interest for similar LPs

"I use PitchBook for PE and VC analysis in a fund of funds environment and I'm a big fan. Since the beginning, I've found it to be an excellent product in terms of information quality and user interface. The customer service is also top notch and highly responsive."

GREG LITTLE
Vice President, Pantheon Ventures

Learn more