Elston

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Elston Insights

Private Market Managers: assets, fees and interest rates

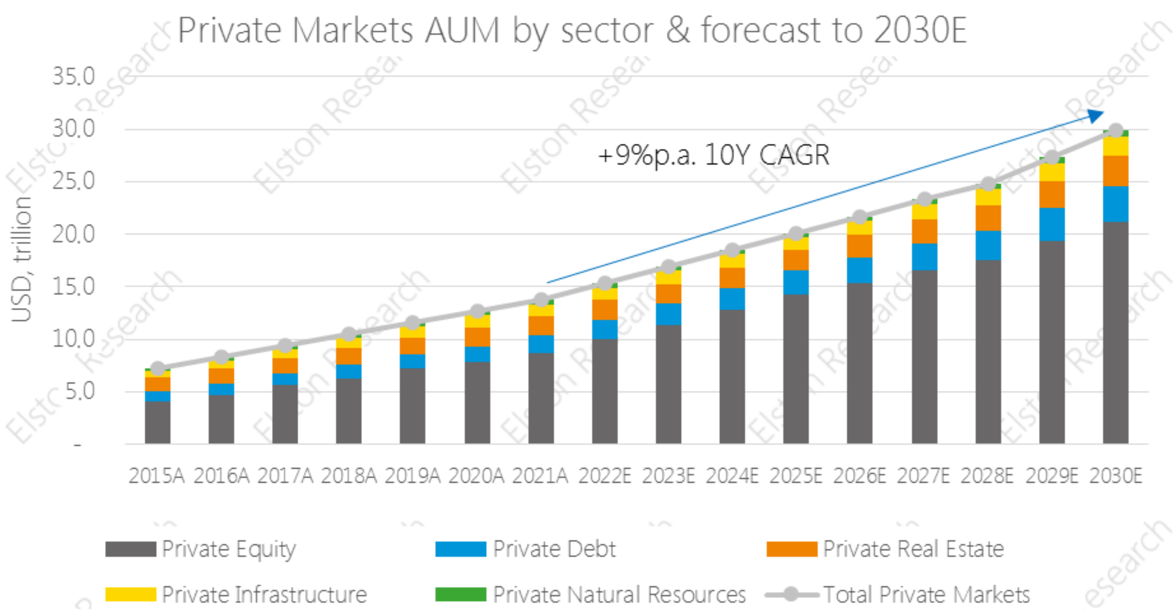
- Private Market Managers' valuations hit in 2022 on rising rates
- Sustained asset growth to 2030E supports positive outlook
- Highly sensitive to US interest rate expectations

Private Market Managers share prices have had a strong rebound in 2023 (+10.55% YTD, vs +4.79% for Global Equities), following a very weak 2022 with declines of some -20% in GBP terms with the shock of higher inflation and interest costs. We see three trends that could support sustained performance for private market managers: a growing level of assets, a high sensitivity to any easing of interest rate policy, and – potentially – a broadening base of investors.

Growing level of assets

Based on latest estimates from Preqin, a private markets specialist research firm, total assets under management by private market funds is expected to grow to $23.3trillion by 2027E, from $13.7trillion in 2021A. Looking forward, we expect private market AUM to reach $30.0trillion by 2030E, a 9%p.a. 10 year growth rate.

Fig.1. Private Markets AUM continue their secular growth



Data Source: Preqin historic data and forecasts to 2027E, Elston estimates to 2030E Chart: Elston research

Sharing in the management fees

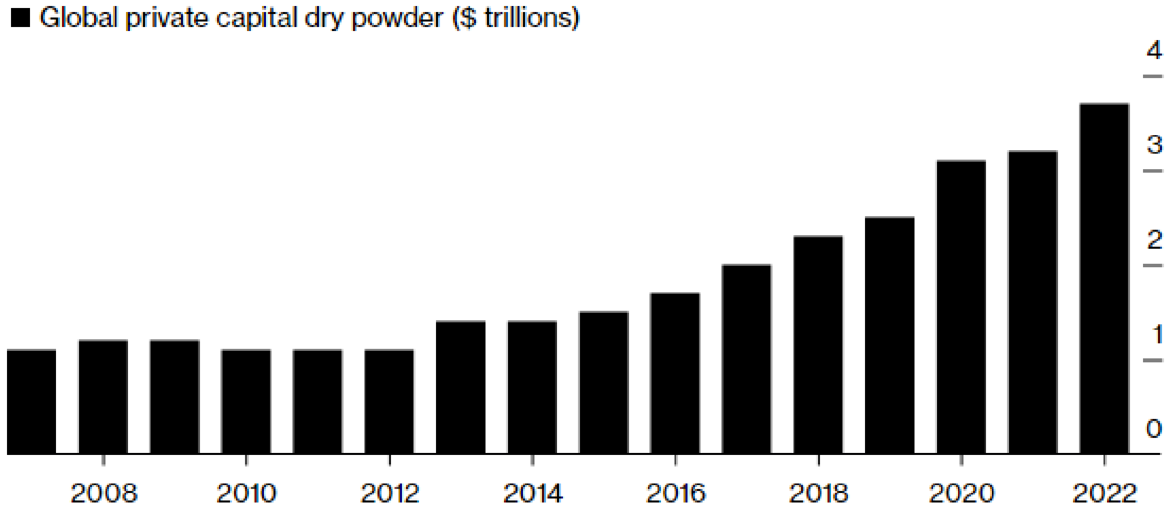
Whilst the return on private market funds is uncertain and will depend on its vintage, its opportunity set, its leverage and interest costs. Indeed, such is the complexity involved, that whilst the illiquidity premium should in theory enhance returns, we wonder whether institutional-level private market investment is actually worth the risks (we think not).

By contrast, a large part of the management fees earned by private market managers is far more certain than the returns on their underlying funds. By owning shares in the leading private market managers, investors can indirectly benefit from this secular trend.

Hunting for deals

The turmoil of 2022 put private market activity into slow motion. As a result, private market funds now hold a record of $3.7trillion in unspent cash ("dry powder") waiting to deploy, up from $3.2trillion in 2021[1].

Fig.2. Private market "dry powder" cash to deploy



Source: Bain & Co. Private Equity Report 2023

When financing those deals, private market fund managers are being more circumspect around leverage, and adopting a 70/30 equity/debt model, in stead of a traditional 50/50 approach to mitigate interest rate risk exposure.

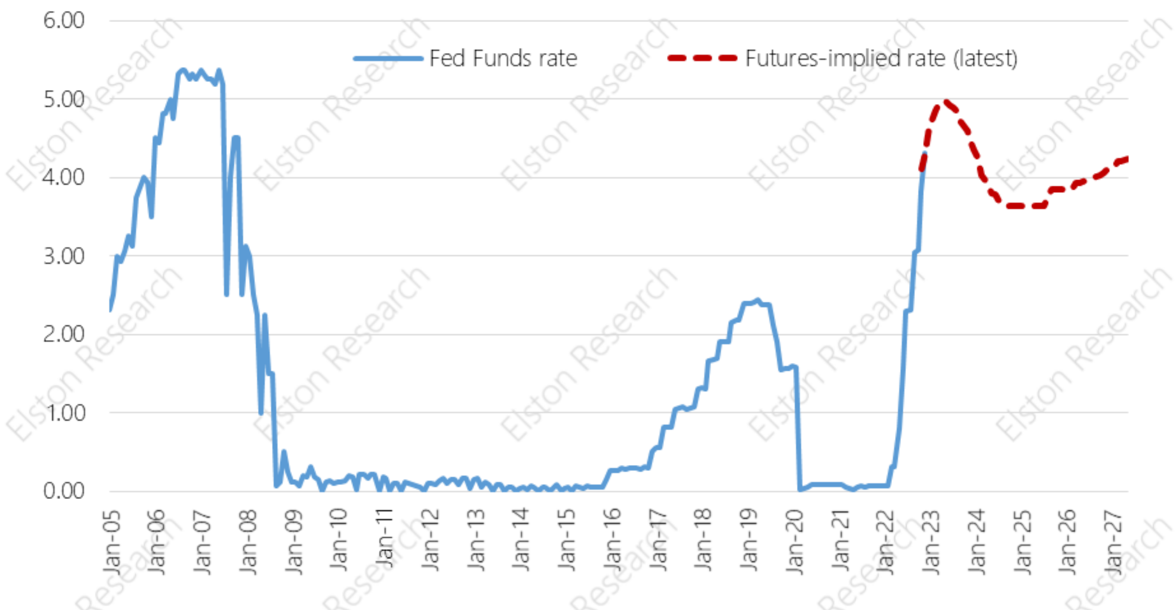
Sensitivity to easing policy

Whilst traditional equities are sensitive to interest rates, private market managers are highly sensitive to interest rates owing to the amount of borrowing (leverage) deployed in a fund. Thus has interest rates soared, private equity manager valuations plummeted. As markets began to anticipate a potential Fed "pivot" and a lowering of interest rates, that relationship reversed.

[1] See https://www.bloomberg.com/news/articles/2023-02-27/buyout-firms-looking-for-bargains-will-be-left-disappointed

Private Market Manager valuations are therefore highly sensitive to changes in interest rates both as "long duration equities" and owing to the high degree of leverage.

Fig.2. Outlook for US policy rates (as at Dec-22): expecting a "pivot"



Source: Elston research, Bloomberg data

A new holding vehicle enables a broader base

As outlined in our CPD webinar "Introduction to Private Markets", advisers have three ways of accessing Private Markets for their clients

1. **VCT/EIS schemes**: these are necessarily illiquid
2. **Private Market Investment Trusts:** which trade daily with a premium/discount to NAV and can hold underlying illiquid assets
3. **Private Market Managers:** the share price of the publicly listed private market investment management firms.

Now private market managers are looking for a way to give retail investors more direct access to the funds they manage. A new fund structure called the Long Term Asset Fund (LTAF) is under consideration by regulators[2]. It would be structured as a fund (and not be exchange-traded), but would not promise daily dealing, but instead would give retail investors 'liquidity windows' via direct investment and secondary market investment so that they can access their funds, if required. We agree that daily traded funds are not the right structure for illiquid assets, and LTAFs would make more sense. However, whether the returns on illiquid retail private market funds can outpace public markets or indeed the returns on private market managers remains to be seen.

[2] https://www.bloomberg.com/news/articles/2023-02-08/funds-eye-private-equity-push-for-1-2-trillion-uk-wealth-market

Summary & Outlook

In the meantime, within the asset class, we prefer the shares of private market managers over private market funds. We would become more positive on private market managers when we have higher confidence that the US Fed will start reducing interest rates. Given the current "higher for longer" outlook, we are not there yet.

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