MEGATRENDS

EXECUTIVE SUMMARY

NEW DYNAMICS OF PRIVATE MARKETS

Investment Risks and Opportunities

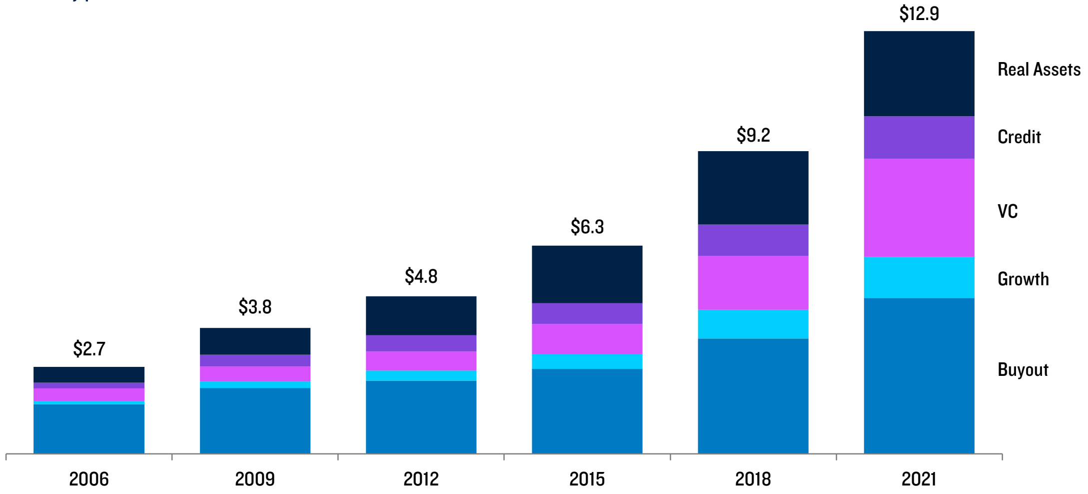
Global pools of private capital – including private equity, private credit and real assets – stand at over $12 trillion, double the size from just six years ago. What's more, the complexity, breadth and influence of private capital on markets and the global economy is greater than ever.

Why should investors care about these shifting dynamics? Quite simply, traditional models of companies raising capital through bank loan officers and stock exchanges have been disrupted. The resulting growth and transformation in private capital markets is opening new investment opportunities – as well as new sources of risk – for institutional investors.

To fully understand these new dynamics of private markets and the resulting investment implications, we have drawn on the insights of more than 40 investment professionals across PGIM's private alternatives, real estate, fixed income and equity managers – as well as over a dozen leading academics, investors and sell-side researchers.

Private market funds have doubled in the last six years

Total net asset value and dry powder, US$ Trillion



Source: Pitchbook

Note: Real Assets include both real estate and infrastructure.

WE IDENTIFY FOUR KEY FACTORS DRIVING THE TRANSFORMATION OF PRIVATE CAPITAL MARKETS TODAY:

01 Banks and finance companies receding from riskier segments of lending

Over the last 20 years, regulatory changes and business model shifts have led banks – and several scaled specialty finance companies – to withdraw from riskier segments of corporate and real estate lending.

02 Investors seeking income and yield increase allocations to privates

The median share of private market assets for the world's 10 largest institutional investors is now 23%.

03 A growing number of business models are better suited for private markets

Some businesses can be better appreciated and funded via private markets. One example is weightless firms – companies centered on intangible assets like proprietary software or other intellectual property. Another example is conventional fossil fuel companies, which are increasingly relying on private capital markets as some ESG-minded investors exclude the sector from their investment portfolios.

04 Companies are staying private longer

The median age of companies at IPO has more than doubled over the past two decades to 11 years. This is driven by the growing availability of private capital at different funding stages (e.g., not just venture but well into growth investment), but also the onerous disclosures and costs of going public, especially in developed markets.

PRIVATE CREDIT EXPANDS ITS REACH

1. **Private credit is gaining share and moving to larger deals in corporate lending**
   Over the last 20 years, banks' share of business loans has been cut in half to about 30% in 2021. In addition, as private equity firms go upmarket and buy out larger companies, both purchase multiples and the size of debt facilities to support these deals have grown. Increasingly, private credit players are displacing the broadly syndicated loan market.
2. **Real asset debt is growing as an asset class**
   The amount of private capital deployed by private real estate and infrastructure debt funds has almost doubled over the last eight years to $2.6 trillion.
3. **Specialized lending is maturing into an institutional asset class**
   Deals that used to be structured by commercial banks and distributed via public markets are finding their way to non-bank structurers and private distribution channels. Furthermore, issuers themselves are bypassing banks and public markets altogether to directly tap into select investors through private bespoke deals.

"

Cyclical and structural transformations have led to a significant deepening and broadening of private credit in the post-GFC era."

Investment Risks and Opportunities

1. **Investors should evaluate their credit exposure holistically**
   A credit risk approach that looks at private credit separately from public is no longer suitable due to the growing overlap and interplay between the two segments.
2. **Look beyond sponsored lending**
   Attractive investment opportunities in private credit lie beyond the crowded sponsor-driven segment where capital is less ample.
3. **Energy infrastructure offers unique opportunities**
   For direct lenders, the middle-market segment of conventional energy in North America offers intriguing opportunities as capital can be scarce.
4. **Newest segments of specialized lending have yet to be tested**
   The AI-informed models underpinning new fintech lenders have yet to be stressed through a complete default cycle, which raises concerns about the performance of ABS backed by them.
5. **Housing is an enduring global trend for real estate**
   With the price of individual homes surging in major urban areas globally, more households are turning to multifamily rental housing.

PRIVATE EQUITY ENTERS A NEW PHASE

We define equity opportunities in private markets to include venture, private equity, real estate and infrastructure and see several forces at work re-shaping private capital:

1. **PE leaders are separating from the pack as dry powder and deal size approach new highs**
   The median size of LBOs has doubled since 2011 from $48 million to $101 million today. In 2021, new VC unicorns outnumbered IPOs in the US for the first time.
2. **Private equity secondary markets are deepening**
   For LPs, the secondary market has proven to be an effective tool for managing their growing private portfolios – whether it's a simple rebalancing of target allocations or a major change in investment strategy. The share of GP-led transactions – such as continuation funds – has more than doubled over the past five years and makes up almost 50% of all secondary volume.
3. **The largest institutional investors are transitioning from LPs to GPs**
   A handful of the largest investors, including CalPERS in the US and Singapore's Temasek, either have co-invested with PE and VC firms or manage direct investments themselves, providing higher net returns through lower fees.
4. **Private equity firms are seeking more permanent sources of capital**
   Permanent sources of capital reduce PE's reliance on perpetual fundraising. Several ways of accessing this are emerging, including acquisitions of insurance firms and structures tailored towards individual investors.

"Some PE fund practices and structures have the potential to misalign GPs and LPs."

Investment Risks and Opportunities

1. **Secondary markets increase flexibility and create new opportunities**
   As private markets grow, so does the need for portfolio rebalancing, fund restructuring and liquidity options. For secondary funds, secondary transactions can provide low entry points for investment as well as transparency into the identity of portfolio companies and their track record.
2. **Closely monitor fund practices and structures**
   Transfer of assets to continuation funds can be done responsibly, but do have the potential to misalign interests of GP and LP investors. Also, if misused or undisclosed, subscription lines can be a source of hidden leverage and distort performance metrics.
3. **Reconsider the role of venture capital in a portfolio given performance challenges**
   Among alternative investments, VC fund performance has lagged in risk-adjusted returns net of fees since 2000. Nevertheless, perhaps VC fund allocations can provide institutional investors access and insight into the frontiers of technology and future disruption.
4. **Renewable and digital infrastructure provide global opportunities**
   As renewable-power generation ramps up, there will be long-term opportunities in adjacent areas such as floating platform offshore wind, low carbon hydrogen, and modular nuclear. Within digital infrastructure, data centers to support cloud computing are an example of a sector seeing growing global demand. Within the sector, demand for hyperscale data centers – large-scale facilities that cater to the global cloud providers and tech companies – has been especially strong.

PORTFOLIO IMPLICATIONS

01 Consider more flexible investment approaches given blurring lines across publics and privates

The distinctions between public and private markets have grown hazier (e.g., the once bright line that separated broadly syndicated loans and direct lending has become obscure). Correspondingly, the once-clear boundaries between the public and private market investment teams at institutional investors are getting increasingly blurred. This phenomenon increases the need for cross-team analysis and evaluation of opportunities as well as potentially broader investment mandates for managers that span both public and private realms.

02 A more sophisticated understanding of portfolio liquidity risk from private assets is essential

A comprehensive portfolio framework that includes multiple time periods as well as more granular models of the cash flows and contribution timing of private market assets can be used to stress test and model different market scenarios. These results can be compared with public market assets as well. This can enable CIOs to establish a deeper understanding of the liquidity characteristics of their private alternative portfolio.

03 ESG is only beginning to shape private markets

It is conventional wisdom that private markets lag their public counterparts in ESG considerations. However, private market investors have an increasingly important role to play in stressing the need for more detailed reporting of risk, impact, sustainability and equity. Since private equity (and, in some cases, private debt) investors have broad influence over portfolio firms' practices and operations, they can potentially achieve greater and more direct impact.

04 Explore integrating privates into defined contribution plans over the long term

There is an increased focus on creating a responsible path for retail investors to participate in private alternatives, especially in DC plans that have a long-term investment horizon that potentially mirrors the longer lock-ups of private assets. However, significant challenges to widespread implementation in DC plans remain.

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