STATE OF THE MARKET

EVERCORE | Private Funds Group

DESTITUTUS VENTIS, REMOS ADHIBE

STATE OF THE MARKET 2024

EVERCORE

Evercore

The contents of this document are not provided for any person other than those specified below including, without limitation, any retail persons.

This document must not be copied, reproduced, published, distributed, disclosed or passed to any other person, directly or indirectly, in whole or in part, by any person, through any medium or in any form, at any time without the formal written authorisation of Evercore Partners International LLP ("Evercore"). By accepting this document, the recipient agrees to be bound by the obligations and limitations in this disclaimer.

This document has been prepared using materials and information that were made available to Evercore and other organisations that have authored articles herein from publicly available sources. In writing the content of this document, Evercore and the other organisations that have authored articles herein may have assumed and relied upon the accuracy and completeness of any financial and other information and data they have used without independent verification of such information or data.

This document does not purport to be comprehensive or exhaustive or contain all the information that a recipient may need in order to evaluate or act on any of the matters disclosed within it. This document speaks as of the date hereof and has not been independently verified and no representation or warranty, express or implied, is made as to the accuracy or completeness or sufficiency of such information and nothing contained herein is, or may be relied upon as, a representation, whether as to the past, the present or the future. Each of Evercore, its affiliates and their respective directors, officers, employees, agents, representatives, affiliates and/or advisers expressly disclaims any obligations or undertaking to update or verify any such information.

This document is necessarily based upon economic, market and other conditions as Evercore believes to be in effect on, and the information made available to Evercore as of, the date hereof. There are a number of risks, uncertainties and factors that could cause actual results and developments to differ materially from those expressed or implied by these statements and forecasts. Past performance cannot and should not be relied on as a guide to future performance. To the maximum extent permitted by law, and except in the case of fraud, Evercore, its affiliates and their respective directors, officers, employees and agents expressly disclaim any liability which may arise from this document and any information contained within it, or any other written or oral information provided in connection therewith, and any errors, misrepresentation or misstatement contained therein and/or omissions there from.

This document has been prepared for information purposes only and is not to be construed as an offer or invitation or solicitation or recommendation or provision of advice to sell or purchase any securities or conduct any other investment activity or transaction and is not a commitment by Evercore (or any of its affiliates or their respective officers, employees, representatives or agents or advisers) to provide or arrange any financing or other service for any transaction or to purchase or sell any security or other investment in connection therewith.

This document may not reflect information known to other professionals in other business areas of Evercore and its affiliates.

By accepting this document, the recipient acknowledges and agrees that Evercore does not and will not act in a fiduciary capacity for the recipient. Evercore may only be regarded by any recipient as acting on its behalf as financial adviser or otherwise following the execution of an engagement letter between us on mutually satisfactory terms.

Evercore and its affiliates do not provide legal, accounting or tax advice. Accordingly, any statements contained herein as to tax, legal or accounting matters are neither written nor intended by Evercore or its affiliates to be used and cannot be used by any taxpayer for the purpose of avoiding tax that may be imposed on such taxpayer. Each person should seek legal, accounting and tax advice based on his, her or its particular circumstances from independent advisors regarding the impact of the information or matters described herein.

This document should not be viewed as advice or recommendations with respect to any particular investment or investment strategy. This document contains articles written by Evercore employees and by third parties. All third-party articles were written specifically for this issue, and any data or viewpoints contained in any third-party articles belong solely to their authors, may not reflect the viewpoints or authorship of Evercore or its affiliates, and in no way shall Evercore or its affiliates be held liable or responsible for them. Any views or opinions expressed herein reflect the judgment at this date of the respective authors and are subject to change without notice.

Where Evercore or an affiliate is licensed in a jurisdiction, the recipient of this document shall consider such distribution to have come from only from the relevant licensed Evercore entity (ies). Notwithstanding the foregoing, this document is not directed at, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any jurisdiction (including the United Kingdom) where such distribution, publication, availability or use would be contrary to applicable law or regulation or which would subject Evercore and/or its subsidiaries or affiliates to any registration or licensing requirements in such jurisdiction.

The distribution of this document and its contents in jurisdictions other than the United Kingdom may be restricted by law and, accordingly, recipients of this document represent to Evercore that they are able to receive this document without contravention of any legal, registration or regulatory requirements in the jurisdiction in which they reside or conduct business, or any requirement for Evercore and/or its affiliates to undergo any registration or licensing requirements in such jurisdiction. Recipients of this document outside of the United Kingdom should inform themselves about and observe any applicable legal restrictions in their jurisdiction which may be relevant to the distribution, possession or use of this document and recognise that Evercore does not accept any responsibility for contravention of any legal restrictions in such jurisdiction or which are otherwise applicable to such recipient.

To the extent this document or any statement contained within it constitutes a financial promotion which is not exempt for the purposes of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005 (the "Order"), this document is only being distributed and delivered to certain persons in the United Kingdom on the basis that such person falls within one of the exemptions contained in the Order. The contents of this document have accordingly not been approved by an authorised person for the purposes of Section 21 of the Financial Services and Markets Act 2000 ("FSMA"). Such approval of this document would be required by Section 21 FSMA if the exemptions referred to below, or some other exemption, did not apply. This document and its contents are being distributed and delivered on a confidential basis only to persons in the United Kingdom who are (or who are reasonably believed to be):

(i) a person having professional experience in matters relating to investments as defined in Article 19 of the Order; or
(ii) a high net worth company or trust or other person of the kind to which Article 49(2) of the Order applies; or
(iii) any other person to whom it may otherwise be law fully communicated in accordance with the Order.

Any investment or investment activity to which this document or information relates is available only to such persons as are referred to in the paragraph above and will be engaged in only with such persons. Persons not falling within these categories should not rely or act upon this document or any information contained within it. If you have received this document and you are not such a person you should immediately return it to Evercore. Otherwise you will be deemed to have warranted that you are such a person, or are otherwise a person to whom such information may be lawfully distributed and delivered by Evercore.

Evercore, its affiliates and their respective directors, officers, employees, agents, representatives and/or advisers shall not be responsible for any costs or expenses incurred by any recipient of this document in connection with the appraisal of it or its content and/or for any other costs and expenses incurred by such recipient.

Any matter, claim or dispute arising out of or in connection with this document or its contents, whether contractual or non-contractual, is to be governed by and determined in accordance with English law and the recipient, by accepting delivery of this document, agrees that the courts of England shall have exclusive jurisdiction to resolve any dispute, whether contractual or non-contractual, arising out of or in connection with it or its contents.

© Evercore. All rights reserved. This presentation is confidential and proprietary to Evercore. Evercore accepts no liability for the actions of third parties in relation to the redistribution of the material in this document.

Front cover photograph by Dmitrii Vaccininm

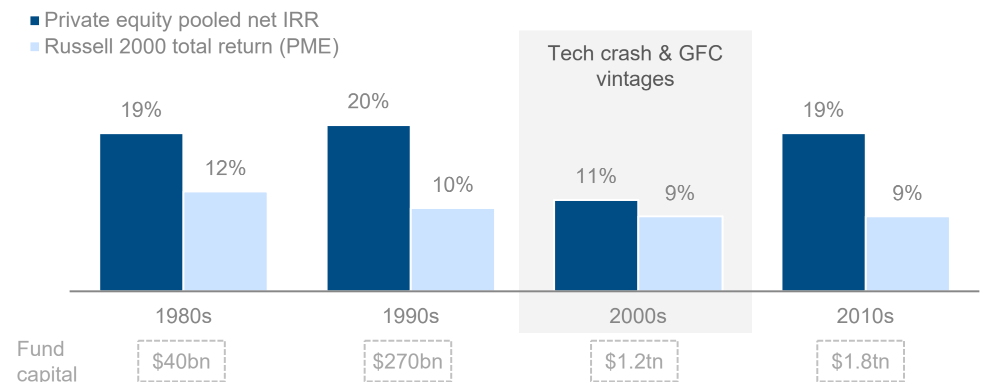
02

The next chapter for private markets

BY ZACH BARAN, DIRECTOR AT ARCTOS PARTNERS

The next chapter for private markets details our view of the history and future trajectory of our industry. Private equity ("PE") — now more capaciously termed "private markets" — is one of the most incredible growth stories of the last few decades in any industry, with assets under management ("AUM") growing more than 14x since 2001.[1] We have been careful students of this market for much of this journey, and many of us have invested through its major inflection points. This piece represents the synthesis of our learnings: why we have never been more excited to invest behind creative, alpha-oriented and growth-minded sponsors looking to build superior investing franchises, and yet never more convinced that sponsors will require new perspectives and capabilities in order to thrive.

Figure 1 – Private equity IRR vs. small cap public equity returns



Source: MSCI (Burgiss) (as of 30 June 2023). Columns refer to vintage year groupings, e.g., "1980s" refers to the pooled returns of vintage years 1980 to 1989. Defined as the implied return of the Russell 2000 gross total return index using the Direct Alpha method. Private equity includes venture capital, buyout and expansion capital

Introduction

Since its inception, the private equity industry[2] has accumulated AUM of $14 trillion.[3] Private equity — now "private markets" — firms have expanded their financial footprint dramatically in recent decades. Private markets funds own and operate lenders, while others such as "private credit" funds, are lenders. For years, private markets firms (via their funds) have owned and operated insurers and wealth managers. Now, a few of these firms are insurers and wealth managers. The fifteen largest publicly traded PE firms manage $4.5 trillion in private, liquid, co-investment and insurance capital (roughly one-third of the total) and have collectively created $425 billion of management company value.[4] Despite shouldering a growing capital deployment burden, and growing expectations of return erosion, the industry has maintained strong outperformance (Figure 1). **The private markets industry is now entering its middle age** and is changing materially. We expect this period to last for decades and disrupt much of the status quo, presenting what we believe to be a substantial opportunity for investors in the private markets ecosystem.

We believe that the industry is experiencing a unique set of challenges, which require a different approach from existing solutions. As such, we think there is a compelling market opening for an innovative, aligned and independent general partner ("GP") capital solutions provider of scale. This piece details why that is.

The corporate governance fix that became an asset class

At its core, private equity is a solution to principal-agent problems in corporate governance. The solution requires the manager to commit a meaningful amount of personal capital to the assets they manage in exchange for a levered, junior claim on the assets' performance. Investors receive the senior claim with a preferred return. This model has been in place for traditional private equity managers since its beginnings, tracing its roots to a negotiation between the founders of KKR and their original backer (First Chicago) in 1976; it has become the way that many companies, both private and public, compensate their key executives.

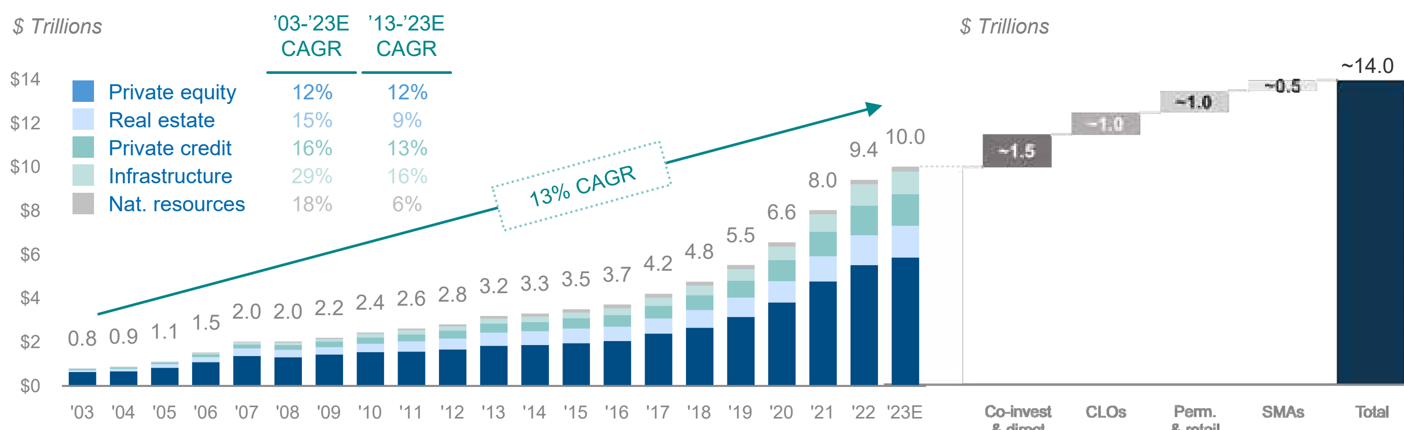
PE partnerships were originally formed in the 1940s to raise venture (or "development") capital and flourished again in the late 1970s after the first leveraged buyouts of founder-owned companies. Each new private markets strategy represented the opening of a novel financial market where none had existed previously, or which lacked liquidity. For example, before venture capital, R&D costs were borne solely by the internal cash flow of large corporations; venture capital became, in effect, the financial market for R&D. Before leveraged buyouts, small-to-medium-sized private businesses did not enjoy a robust market for corporate control and could only exit by selling to their larger competitors.

Each private markets strategy has been developed in this way, by combining innovation and "financialisation of the frontier" with strong alignment. We believe the mix of entrepreneurship, intelligent risk-taking and highly-aligned compensation has been a major factor in the industry's success. The formula has been: (a) find a nascent, illiquid or non-existent financial market; (b) form capital in order to act as a dedicated financial buyer in that market; (c) a compensation and incentive structure that aligns the manager (the GP) with their investors (limited partners, or LPs). This same framework guided our own firm's launch in 2019, as the first mover in the newly-opened institutional market for interests in major professional sports franchises.[5]

The original ventures in the private equity business — the American Research and Development Corporation ("ARDC"),

Figure 2 – Private markets AUM growth

Est. shadow capital



Source: Preqin, Debtwire, public company financials, Arctos estimates (as of October 2023). Permanent & retail includes all REITs, BDCs and insurance affiliates. AUM includes North America, Nordic and Western Europe managers and excludes funds of funds and secondary funds. 2023 AUM estimate based on anticipated 2023 cash flows, NAV growth and fundraising activity, based on annualised H1 2023 data

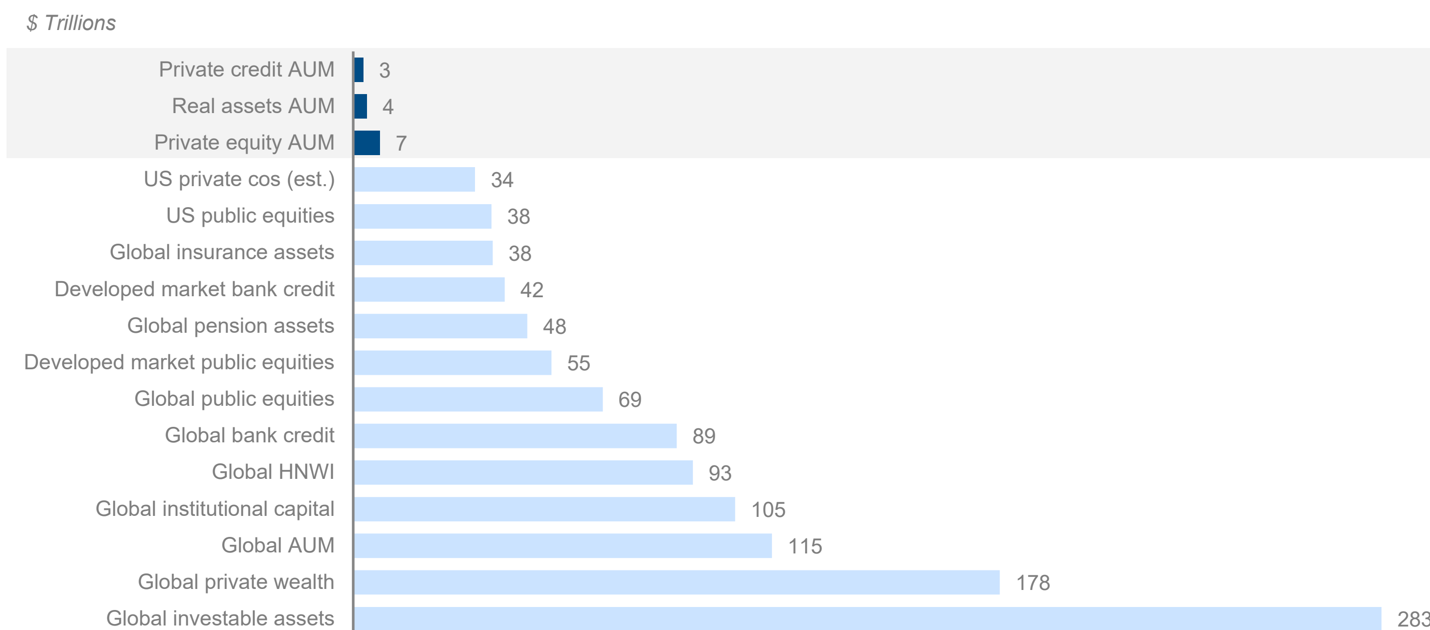
Small Business Investment Companies ("SBICs") in the late 1950s, Venrock, Warburg Pincus, Sequoia, KKR, etc. — were directed at equity in private, small- and micro-cap firms whose shares enjoyed little-to-no price discovery. Nowadays, the aperture has widened to include all forms of equity and debt across issuers of nearly every scale or situation. There is, in principle, no limit to how pervasive the industry can be; "private" capital covers everything but the largest, most liquid companies, though even there, a robust take-private market exists.

From its inception to 2001, traditional private markets fund AUM grew to $690 billion,[6] and since then, despite the tech wreck, the financial crisis, the European debt crisis, a pandemic and now a rate-driven slowdown, **it has grown by 14x to $10 trillion** (Figure 2). In addition to traditional funds, there has been a surge in capital raised via co-investors and non-traditional vehicles, which we estimate totals **~$4 trillion**, captured mainly by the largest GPs (Figure 2).

Despite this growth, **the growing influence of private markets belies its actual footprint**. Total assets managed by private markets sponsors ($14 trillion) represents only 5% of global investable assets ($283 trillion).[7] While innovation, entrepreneurship and alignment are parts of the equation, under-penetration is the main reason we believe PE has resisted return erosion (Figure 1). And, there are many other examples to illustrate this (Figure 3):

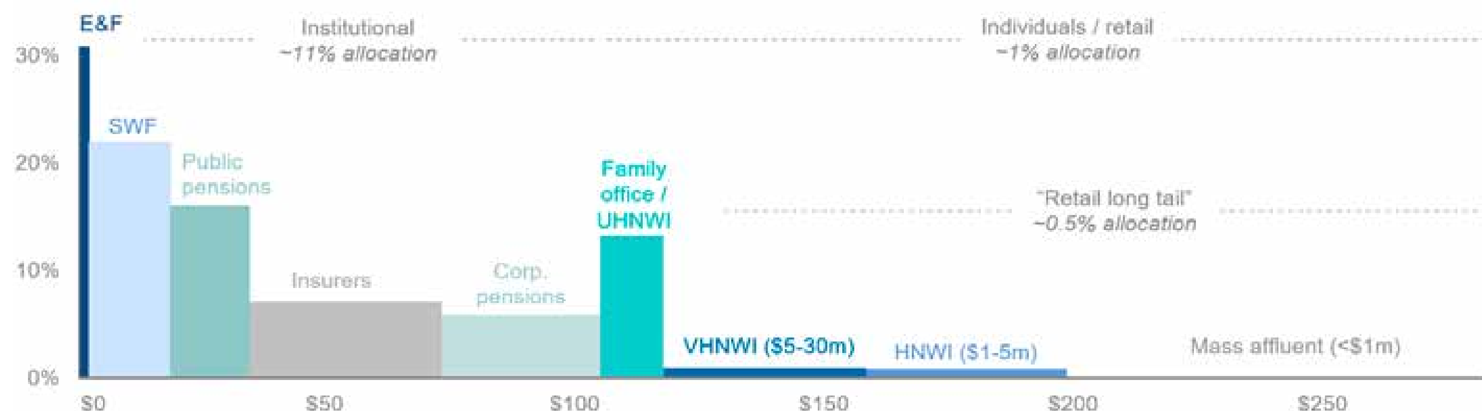
- There are ~$2.8 trillion of private credit assets vs. $38 trillion of insurance assets, $42 trillion of aggregate bank lending in the developed world, and $89 trillion in global bank lending;
- Global public equity markets are worth $69 trillion vs. $7 trillion in global private equity AUM;
- Total private markets AUM of $14 trillion is one-eighth of the size of all professionally-managed AUM globally across all asset classes ($115 trillion);

Figure 3 – Private markets AUM vs. other capital pools



Source: PricewaterhouseCoopers, Asset & Wealth Management Revolution: Embracing Exponential Change (2020); Willis Global Pension Study (2023); Preqin; Bank of International Settlements; UBS; MSCI; US Bureau of Economic Analysis; and Arctos estimates (data as of October 2023, unless otherwise noted)

Figure 4 – Private markets allocations across global capital pools



Source: Bain estimates (as of September 2022); PricewaterhouseCoopers, Asset & Wealth Management Revolution: Embracing Exponential Change (2020); Preqin; Willis Global Pension Study (2023); Statista; Bank of International Settlements; Credit Suisse; MSCI; and Arctos estimates (data as of October 2023 unless otherwise noted)

- And, most interestingly, even in the US we estimate that US PE AUM (about $4.5 trillion) only covers about 13% of total US private company net worth ($34 trillion).[8]

While it remains relatively small overall, private markets exposure differs greatly across major investor types (Figure 4). We estimate that, of the approximately $118 trillion in global institutional and family office (UHNWI) wealth, about $13.3 trillion is allocated to private markets — ~11% allocation. The remaining $0.8 trillion of private markets AUM — about 5% of the total — comes from the "retail long tail", primarily managed today via retail products like non-traded and traded Real Estate Investment Trusts (REITs), Business Development Companies (BDCs) and '40 Act closed-end funds. We estimate that about 80% of that amount is controlled by the largest public GPs, with just two firms (Blackstone and Brookfield) controlling one-third of it.

Beyond retail, there are institutional investors who were historically underpenetrated due to poor product-market fit: insurers and corporate pensions. Insurers are risk-conscious spread investors who have historically limited private equity allocations to 1-5%; the average corporate pension is 93% funded and 49% of corporate pensions have a fixed income allocation above 50%.[9] However, private markets now generate product across the entire risk and liquidity curve — from senior secured loans to asset-backed finance and opportunistic private credit — and are sourcing private credit directly for wholly- or partially-owned insurance affiliates.

In summary, we believe there is significant white space in the industry up for grabs. But, as is already apparent in the above, there are new challenges for ambitious GPs who sit outside of the upper tier trying to capture this next leg of growth. We would summarise these challenges as follows:

1. The end of fragmentation: Since 2021, there has been a major shift towards large, multi-product GPs, and market share trends favour these firms. Consequently, new firm formation is getting harder;

2. The end of easy money: The multi-decade "beta" tailwind that lifted all boats appears to be over. Determining and marketing alpha will be critical — both for GPs managing internal resources and for LPs selecting managers; and

3. The erosion of "20 over 8": The next leg of growth for the industry will likely involve more balance sheet-heavy business models. The industry is beginning to shift from renting capital to owning it, and this process will require significant capital and new forms of expertise.

Challenge #1: The end of fragmentation

In the history of private markets, revenue has usually stuck to people and not to brands. We like to say that private markets have been more like jazz than rock and roll: people follow musicians, not bands. (In jazz, as in early private equity, the bands tended to be named after the lead musician!)

In most professional services industries — say, accounting — provision of services requires little, long-term capital investments or working capital, and customers attribute service quality directly to the principals of the firm, so "hanging out a shingle" is not capital intensive and entry/exit from the industry is relatively easy. Now, that is not entirely translatable to private markets due to GP commitments, but it is still straightforward for most credible new GPs with some personal capital to start up. In addition, many LPs contributed to persistent fragmentation, by preferring highly-aligned, independent sector-specialist firms over large multi-product firms. The industry remains young, entrepreneurial and risk-seeking: of the top 100 non-public GPs, 60 remain founder-led.

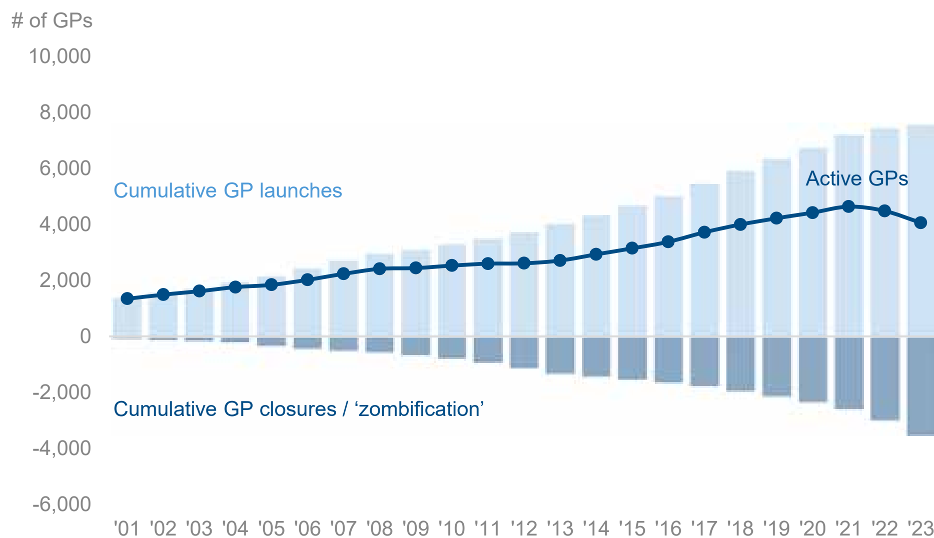
Most professional services industries — e.g., investment banks, consulting firms, accounting firms — have reached maturity and passed this "fragmentation" phrase; nowadays, the breadth and quality of E&Y's or Goldman Sachs' corporate relationships makes leaving to start a competitor prohibitively risky. Their scale raises barriers to entry.

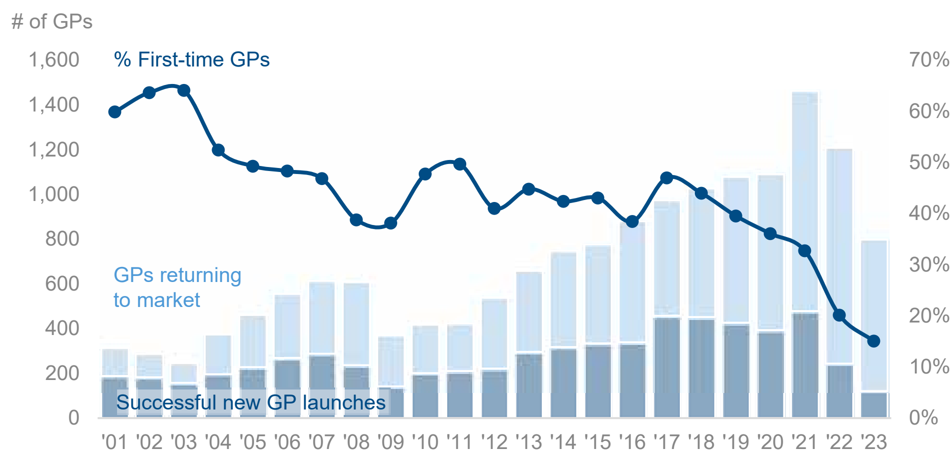
We believe private markets are only just now entering this "middle" phase, where fragmentation is becoming harder to maintain (Figure 5). The number of active GPs[1] in North America and Western Europe was over 4,600 at the end of 2021. This is up from roughly 1,300 two decades ago, or 3.5x, driven by 5,800 cumulative new firm launches and 2,500 cumulative GP closures over two decades.[2] But since 2022, **for the first time ever in our sample, the number of active GPs declined** to roughly 4,500 in 2022 and 4,050 so far in 2023, driven by unprecedented slowdown in new GP formation and fundraising struggles for returning GPs. **Not even during the GFC did the number of active GPs decline.**

Prior to 2022, start-up GP formation remained healthy, with the number of successful[3] freshman GPs growing from 188 in 2001 to 478 in 2021. **In 2022, new GPs that successfully raised capital dropped by**

Figure 5 – Two decades of manager formation dynamics

Year	Active GPs	GPs in-market	First-time GPs: # In-market	% Total	Fail to raise Fund II	Failure rate*
'01	1,344	314	188	60%	57	30%
'02	1,491	286	182	64%	45	25%
'03	1,615	245	157	64%	32	20%
'04	1,758	374	196	52%	66	34%
'05	1,844	461	227	49%	61	27%
'06	2,021	555	268	48%	75	28%
'07	2,233	613	287	47%	123	43%
'08	2,414	609	236	39%	85	36%
'09	2,443	370	141	38%	44	31%
'10	2,529	419	200	48%	60	30%
'11	2,596	423	210	50%	58	28%
'12	2,611	539	221	41%	54	24%
'13	2,709	659	295	45%	88	30%
'14	2,930	748	317	42%	96	30%
'15	3,147	776	334	43%	105	31%
'16	3,377	879	338	38%	117	35%
'17	3,719	973	457	47%	180	39%
'18	3,996	1,026	451	44%	240	53%
'19	4,221	1,078	426	40%	N/A	N/A
'20	4,418	1,090	393	36%	N/A	N/A
'21	4,637	1,462	478	33%	N/A	N/A
'22	4,481	1,208	243	20%	N/A	N/A
'23	4,058	798	120	15%	N/A	N/A





*Source: Preqin (as of 19 December 2023). *Failure Rate defined as # of first-time GPs which fail to raise a Fund II divided by # of first-time GPs in-market in each launch year*

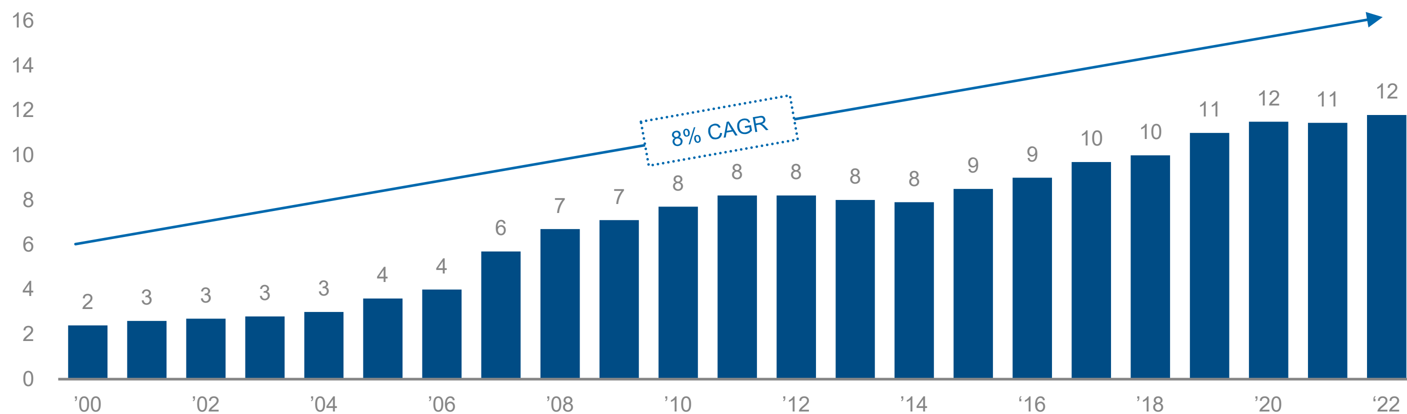
half, to 243, and **as of December 2023**, **new GPs number a record low 120**. Failure rates for start-up GPs have always been high, at around 30%; however, failures rates are ticking up further, to 53% so far in 2023.

Clearly, fragmentation is getting harder to support. In our sports investing practice, we often talk about the "Great Rebundling"[13] that we believe will happen in media over the next decade. We believe there is a similar dynamic emerging in private markets, as "unbundled" small sector-specialists are likely rebundled over the coming decades. Why?

First, there has been a strong and growing countervailing force to unbundling since the GFC: LP-manager relationship consolidation. To capture demand for both fewer manager touchpoints and sector-specificity, the top GPs now support over 10 different product lines (Figure 6). Second, as already mentioned, the largest firms have the easiest access to the retail long tail and the captive insurance opportunity. Third, the largest LPs have managed to negotiate dedicated, no- or low-fee separately managed accounts and co-investment vehicles with GPs of sufficient scale to profitably service them — a form of implicit price competition that benefits the larger players on both sides of the table. Fourth, other than price competition, there are growing fixed costs for running a mid-to-large-sized sponsor that supports the push for increased scale to better rationalise the business. This includes LP demands for larger GP commitments; increasing reporting, compliance and ESG requirements; increasing fundraising velocity and competition; and increasing competition for talent. Fifth, most GPs have at least one mega-cap GP entering their sector and capitalising on their themes at scale — and sometimes winning deals based on brand or capital formation ability alone. While not impossible to manage, the best GPs have always found protected niches where they can reliably deploy capital — it does, however, raise the cost of staying small. The net result is higher capital intensity, higher barriers to entry and increased differentiation based on brands as opposed to individual dealmakers — more rock and roll, less jazz — and more incentive to get bigger and ensure survival. Finally, all of this is exacerbated by the toughest fundraising market in over a decade.

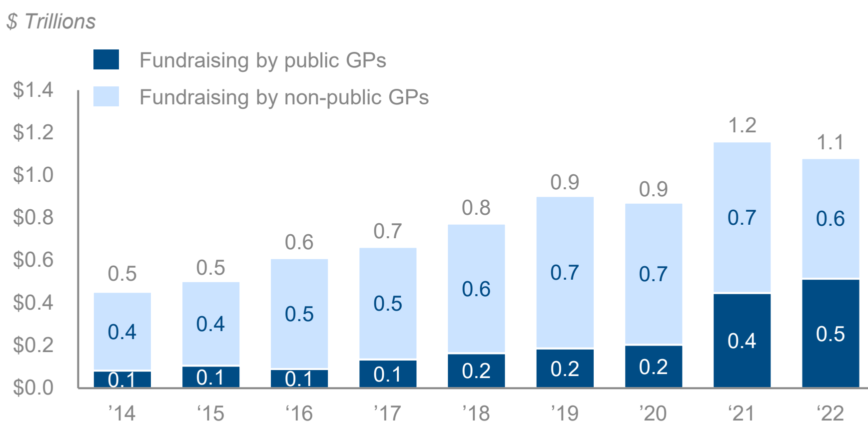
The data suggests that, at least post-pandemic, larger firms appear to be winning disproportionately. In 2021 and 2022, public GPs captured a whopping 42% and 51%, respectively, of traditional funds raised (Figure 7) and likely captured substantially more of the shadow capital marketplace. If this trend persists, even partially, we estimate that the current suite of public GPs will see

Figure 6 – Average number of active products offered by top 20 sponsors

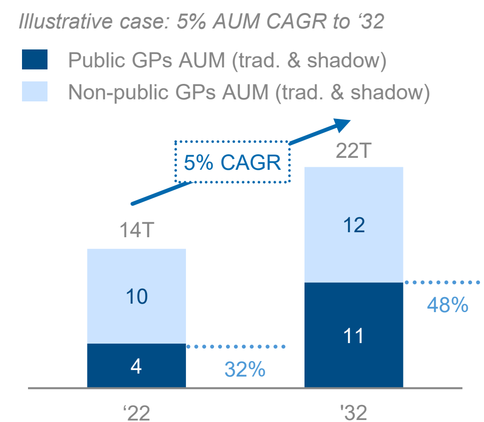


Source: Bain (as of December 2022). "Active product" is defined as a unique fund offering or series of funds with >$250 million of capital where a new fund has been raised in the past five years

Figure 7 – Fundraising captured by public GPs



*AUM market share trend**



*Source: Preqin; Goldman Sachs; Barclays; and Burgiss. *Forecast assumptions: (i) 3% traditional fundraising CAGR starting from $1.1 trillion in 2022; (ii) 8% shadow capital fundraising CAGR starting from $500 billion (est.) in 2022; (iii) 20% average distribution rate and 12% average NAV growth rate starting in 2025; (iv) public GPs capture 40% of traditional fundraising and 80% of shadow capital (permanent capital, retail, co-invest, etc.) fundraising each year*

their AUM market share grow to nearly 50% by 2032. In addition, we are likely seeing the beginnings of a major slowdown in new successful GP formation (down nearly 80% vs. 2021) and a spike in GP failures or new "zombie" GPs (Figure 5) — essentially GPs continuing to manage assets but unable to return to market.

Why does fragmentation matter? Loss of fragmentation means the industry can no longer sustainably support a lot of small, independent merchants where everyone can win. Instead, the market is transforming into a game of winning and defending market share. That brings us to our next challenge.

Challenge #2: The end of easy money

The prototypical new dollar entering the private markets ecosystem over the last thirty years has come from institutions, especially public pensions, facing the challenge of secularly declining long-term interest rates amid fixed future liabilities. Economists debate the reasons for so-called "secular stagnation", but the fundamental cause was an increasing propensity to save and a decreasing propensity to invest.[14] Possible causes include changes in tax and monetary policy; increasing globalisation and capital mobility; global savings imbalances; and declining capital intensity of industry. In a secularly stagnating world, interest rates eventually reach the zero lower bound and growth stagnates.

Traditional portfolio theory assumes investors select the mix of cash and the market portfolio that provides the best return possible for the risk that they are willing to tolerate. Investors are not leveraged. In the real world, many investors — like pension funds[15] — are, in effect, highly leveraged. They have fixed liabilities, which means that declining rates (common in disinflationary periods) makes exact liability matching with low-risk fixed income assets more expensive over time, while increasing rates (common in inflationary periods) makes exact liability matching easier. This phenomenon, exacerbated further by pension underfundedness in the US, has generated strong secular demand for equity risk broadly and private equity in particular, due to its strong track record of outperformance, or alpha, as well as its lower mark-to-market volatility.

This migration out on the risk curve (the "search for yield") has been a major source of autopilot growth for private markets. Declining rates have generated both new sources of capital for the industry to manage and boosted GPs' "beta" performance. Reported allocations to private markets have been behind the curve as the liquid, rate-sensitive portion of the portfolio has risen — a secular, accommodating denominator effect.[16]

But we believe this positive impulse from declining rates and secular stagnation is

over. Capital mobility is declining, tariffs or threats thereof are rising, and supply chains are being reshored or rebuilt for resilience and redundancy. In addition, developed market governments are growing defence spending and domestic technology investment, while activating more robust trade and industrial policies in response to China's rise. At the same time, they face increasing populism and demands from the public for domestic social and infrastructure spending at home. In total, domestic and international instability and likely increases in public indebtedness should mean higher and more volatile inflation, and likely higher (or at least, no longer falling) long-term nominal rates.

At the same time, the industry is facing a major cyclical headwind caused by a sharp decline in risk asset prices — and, just as important this time, a sharp, write-up in NAV starting 2021 — resulting in a punitive denominator effect. (We describe this phenomenon in greater detail in our recent piece, Navigating the Fundraising Cycle, July 2023.)[17] **Declines in private markets fundraising can be reliably tracked and forecasted using drawdowns in a simple, inflation-adjusted 60/40 total return index[18] (Figure 8). This index declined about 25% in 2022 — as much as it did during the last two recessions!** If macro headwinds do not lessen for risk assets, historical trends would suggest that the next few years will be challenging for fundraising, especially 2024. In Navigating the Fundraising Cycle, we estimated that the NAV overhang is likely to take three years or more to "clear" in an optimistic case, assuming LPs do not capitulate and accept higher long-term illiquid allocation.

Finally, as alluded to above, beta tailwinds uniformly benefited levered strategies like buyouts, and two separate tech manias (1995-2000, 2017-2021) benefited venture capital (which is, in effect, an implicitly levered strategy of buying out-of-the-money calls). In our experience in backing managers and advising LPs, we believe this backdrop has made disentangling manager luck from manager skill a difficult task for LPs. As a result, the strongest and most obviously alpha-generating GPs enjoyed incredible negotiating power and scarcity value for LPs over the last decade. But with declining performance momentum from "beta", we believe it will become more challenging to differentiate from competitors or build a platform as a GP, and more difficult to assess managers as an LP, without sophisticated analytical tools and performance optimisation playbooks focused on alpha — tools that we have actively helped build, pioneered and utilised throughout our careers advising GPs.

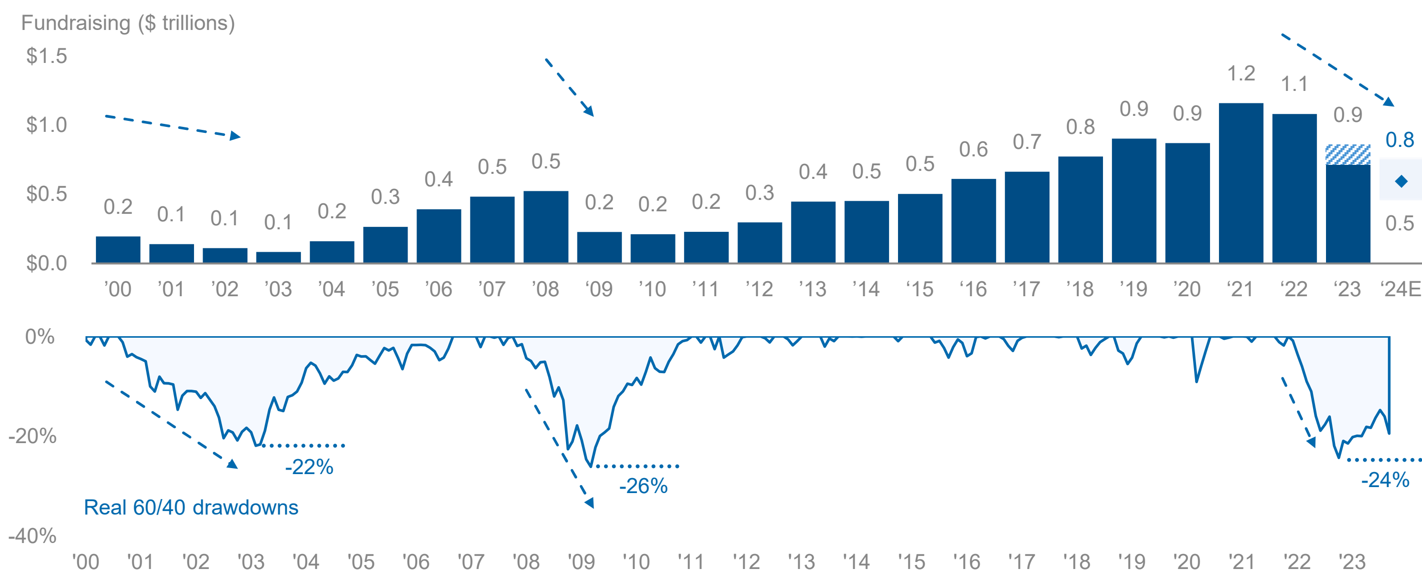
Challenge #3: The erosion of "20 over 8" and the birth of "100 over 3"

The largest GPs are slowly moving from renting capital at an 8% lease rate (the typical "preferred return") to owning permanent capital directly. It requires a lot of money — Apollo needed ~$20 billion of equity capital to form its insurance affiliate, Athene — but adding permanent capital dramatically changes the reach and capabilities of the business.

While insurance affiliation has been the first leg of the stool, we believe business diversification beyond traditional fee-for-service asset management and towards multiline financial services is most likely inevitable. Similarly, traditional multiline financial services firms are investing more in alternatives capabilities. For example, investment banks want to look more like wealth managers or alternative asset managers and insurers are developing alternative asset management capabilities or partnering with alternatives managers, especially those with direct origination and private credit capabilities, to service legacy liabilities and capture additional spread.

Including Athene, we estimate that the industry (across both GPs and LP co-investors) has spent approximately $80 billion in equity building insurance vehicles and sidecars that support ~$1.4 trillion in total insurance assets and ~$500 billion in commitments to private credit and private equity products. In most cases (e.g., Centerbridge/Martello Re, Blackstone/Resolution Life), these are strategic partnerships between the GP, several other origination partners and the selling insurer, but both Apollo/Athene ($20 billion) and KKR/Global Atlantic ($5 billion) were majority transactions. In fact, to pick the most obvious example, Apollo's business model today is as close to Prudential's as it is to the average private markets sponsor (Figure 9a). Apollo owns a $260 billion captive insurer, 60% of whose general account is managed by Apollo Asset Management (a $617 billion asset manager) via both asset management products (commingled with outside LPs) and alternative credit and asset-based finance originated directly for Athene's balance sheet. Prudential owns a $700 billion captive insurer, 60% of whose general account is managed by PGIM (a $1.4 trillion asset manager) in commingled asset management

Figure 8 – Fundraising does not recover until asset prices re-expand and 2022 was a GFC-scale event



Source: Preqin; Robert Shiller; S&P; and Arctos analysis (data as of October 2023). Uses inflation-adjusted (real) 60/40 portfolio monthly returns

products and direct origination. Prudential's business is identical to Apollo's with three key differences: (i) Prudential is more than twice the size of Apollo; (ii) Apollo is 100% focused on alternatives; and (iii) Prudential's capital is substantially more retail-based (Figure 9b).

While we have focused on insurance so far, the race to capture the retail long tail is more substantial and will also require both capital and new sorts of expertise. These include developing (i) retail-appropriate products and (ii) new relationships, whether hired or through acquisitions. The team breadth required to support these relationships is large and costly: specific distribution teams covering wirehouses, registered investment advisers (RIAs) and independent brokers; product and content specialists; and investment strategy and advisory services specialists. Note that owning insurance businesses often gives you retail access, given the synergies in terms of sales channel: many insurers have in-house retail distribution capabilities for their insurance products — so the race for the retail long tail and the expansion into insurance are critically related.

We believe this marrying of traditional financial services liabilities with alternative assets will continue to permeate financial services generally and represents the critical shared theme impacting both GPs and traditional asset managers, banks and insurers. The private markets business is now too large to be ignored by traditional multiline institutions; even if rates remain higher for longer, and perhaps especially if they do (given the growth of private credit), there will be strong demand for alternatives capabilities across financial services. To compete, we believe expanding into multiline financial services is a natural evolution that provides meaningful opportunity for those GPs with the right solution and business model. GPs need to do so carefully – with complex balance sheets come new risks, especially systemic risk, which can be managed but rarely ruled out ex ante. **But, absent that shift in mindset and openness to new organisation and capital structures, many mid- and even large-sized GPs could be left behind.**

What solution addresses the three challenges?

GPs do have a private capital market they can turn to, in order to try and address the three big challenges. The GP capital solutions market encompasses ~$400 billion in TAM between GP stakes, or management company solutions, and GP-centric secondaries, or fund- and asset-level liquidity solutions, which can tackle what we view to be five common execution themes for GPs (Figure 10):

1. Growing the core: Developing a more compelling go-to-market for the flagship product, that may include enhanced GP commit, new hires and fund rebrand or repositioning;

2. Platform growth: In effect, horizontal expansion. Developing new funds, products or solutions, productising sub-strategies of existing products as standalone funds or lift-out of existing assets, developing de novo retail distribution and product capabilities, and launching or expanding a GP balance sheet for an M&A, insurance, or retail strategy — provided the firm has the brand, intellectual property and resources to generate alpha and has a right-to-win;

3. Ownership transition: GP balance sheet-intensive solutions for partner or leadership retirement and realignment of the economic pie. A lot of GP stakes activity has historically focused on this theme;

4. Fund management: Encompasses a suite of GP-centric secondary solutions: single- and multi-asset continuation vehicles, fund restructurings, strip sales and stapled secondaries; and

5. GP seeding: Put simply, venture capital for new sponsors.

In other mature markets for growth capital that cover a particular vertical (e.g., software), there is a robust ecosystem of independent private investors with dedicated functional capabilities and holistic strategies for adding value, such as through improved sales efficiency, customer success, hiring and retention, etc. These firms compete for investment opportunities on both price and brand, relationships and resources. The ecosystem is value creation-driven, not transactions-driven; while there are shops that just do secondary solutions for early founders of VC-backed start-ups, most sophisticated software GPs can and do execute secondaries as well and will do so as part of a holistic value creation strategy for the business.

However, this is not how the GP growth capital market works. The GP capital market is split into heavily siloed and intermediated transaction universes where price and speed of execution are the main differentiators. As a result, we believe that GPs are "on their own" in these markets, there is little incentive for innovation, and the potential for generating misalignment is high — both between solutions providers and their investee GPs and between GPs and their LPs. As such, we believe the GP capital market can produce outcomes for managers that are antithetical to the innovation and alignment that has made private markets so resilient over the long-term.

To review the main transaction types:

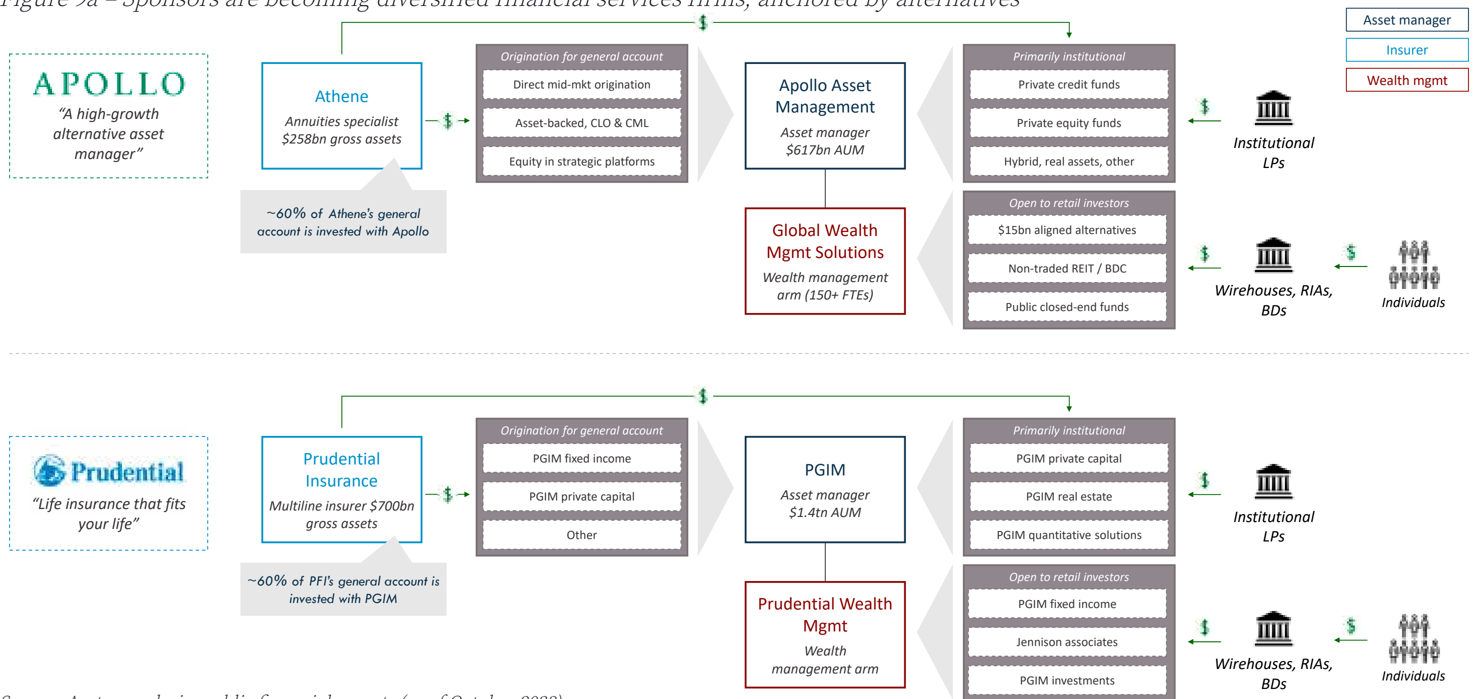
- There is an efficient **continuation vehicle ("CV") market** — where upwards of 80% of deal flow by dollar is intermediated by the major secondary advisers[19] — and where any GP a year ago could get a reasonably competitive bid on any asset or sub-portfolio in their book.[20] Most of the major secondary and GP-led specialist funds source a meaningful percentage of their deal flow through these syndicated, private exchange-like markets.
- The **GP stakes market** is a mature, highly intermediated market constituting of a handful of well-understood and copiable transaction archetypes, commonly (though not always) used to provide liquidity to managing partners.
- There is a burgeoning **NAV loan and fund finance market**, which provides debt and debt-like financing to GPs, funds and LPs, most commonly in the form of NAV-backed loans to funds, in order to fund a distribution to LPs or, increasingly, to provide the GP with new, "non-dilutive" dry powder for further investments after LP capital has been exhausted.
- There is the **LP secondary market writ large**, which can be tapped for LP liquidity at every imaginable scale and can be used by GPs to source commitments to upcoming funds or products (called stapled secondaries) — also efficient, well-intermediated and defined by a handful of known, repeatable transaction archetypes.
- Finally, there is the **preferred equity market**, whose solutions are often "in the mix" in regular-way GP and LP secondary processes. These are alternatives to standard LP trades or GP-led CVs that allow the seller to keep more upside from the assets in question.

Over the course of our careers, we have helped to start or have innovated in many of these markets.

Now, there is nothing inherently wrong with this setup. It has one big advantage, which is maximal price efficiency and speed of execution. Its existence is an asset to the ecosystem, just as public stock market exchanges or over-the-counter market makers are beneficial tools for public investors.

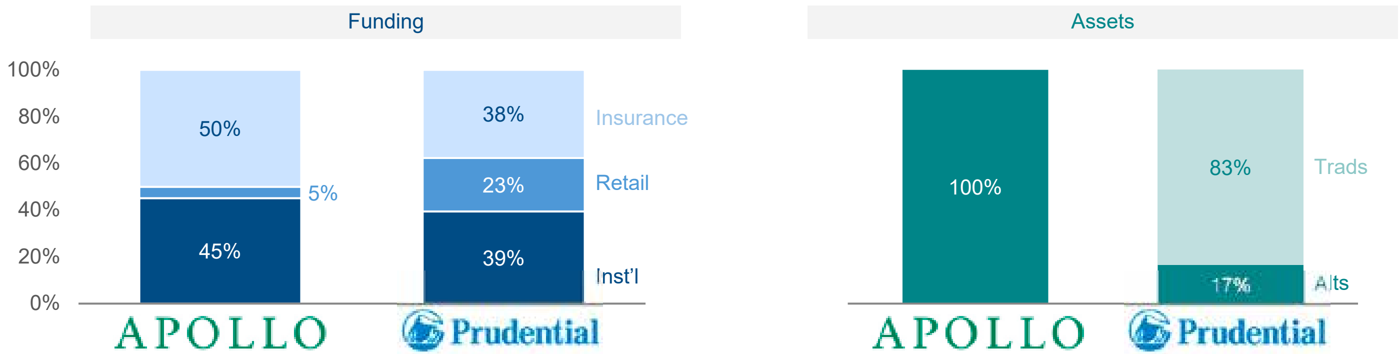
However, as for public market investors, **we believe market infrastructure that facilitates pricing and efficiency alone is incentivised to generate more transactions,**

Figure 9a – Sponsors are becoming diversified financial services firms, anchored by alternatives



Source: Arctos analysis, public financial reports (as of October 2023)

Figure 9b – Apollo vs. Prudential: Funding & asset mix



Source: Arctos analysis, public financial reports (as of October 2023)

Figure 10 – Significant $400bn+ opportunity to better serve the private markets ecosystem

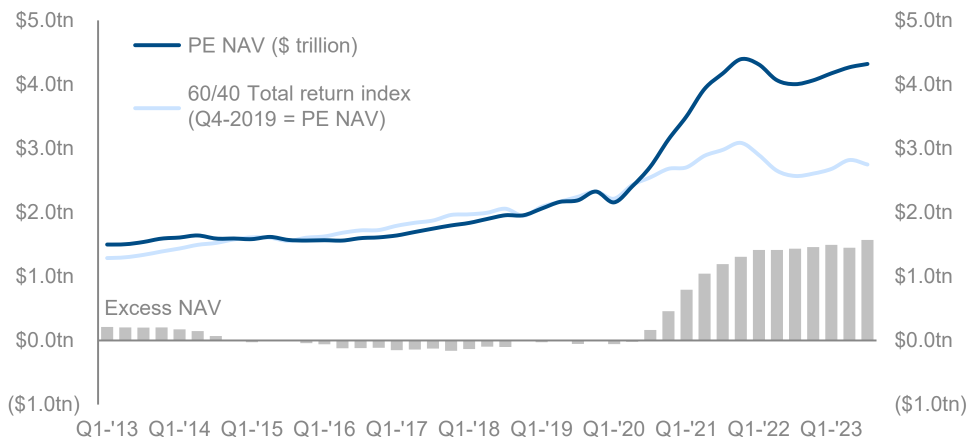
Theme	Pain point(s)	Use of funds	Target	TAM estimate ($bn)
Growing the core	▪ Growing flagship to match opportunity set & compete effectively	▪ GP commitment ▪ Working capital	▪ GP / mgmt. co (primary)	**~$10bn**
Platform growth	▪ Right to win or retain LPs ▪ Right to win the retail dollar ▪ Access to permanent capital	▪ Balance sheet creation ▪ Product seeding or lift-out ▪ Team build-out or acquisition ▪ M&A, incl. insurance affiliates	▪ GP / mgmt. co (primary)	**~$150bn**
Ownership transition	▪ Talent retention ▪ Leadership succession	▪ Stake repurchase ▪ Equity recapture ▪ Equity transfer	▪ GP / mgmt. co (primary / secondary)	**~$150bn**
Fund management	▪ Liquidity & performance mgmt. ▪ Late-in-life fund mgmt. ▪ Successor fund re-ups	▪ Value-added, aligned continuation funds & strip sales ▪ Direct secondaries ▪ LP tender / fund restructuring	▪ Fund(s) ▪ Asset(s)	**~$100bn**
GP seeding / spin-out	▪ Economic split between all-star talent and founding partners	▪ New GP spin, in partnership with existing founders, with GP seed capital and stapled primary	▪ GP / mgmt. co (primary) ▪ Fund / assets	**~$10bn**

Source: Arctos

not to maximise long-term value for those who participate in it. Highly efficient markets incentivise the ecosystem to produce repeatably transactable contracts that scale. In public markets, there are forwards and futures on every imaginable instrument, swaps on every currency pair or pair of rate-bearing instruments, etc. When it does happen, innovation is quickly copied and commoditised. **Once repeatable transaction paradigms are established, dedicated providers of scale enter them and are incentivised to defend their new franchises** and, relatedly, support trades that can be broadly syndicated. This can naturally hamper innovation and biases the ecosystem towards transactions-at-all-costs: few intermediaries or dedicated secondary buyers are incentivised to advise a GP not to pursue a standard, easily syndicated GP-centric transaction, even if an alternative is in that GP's best interest.

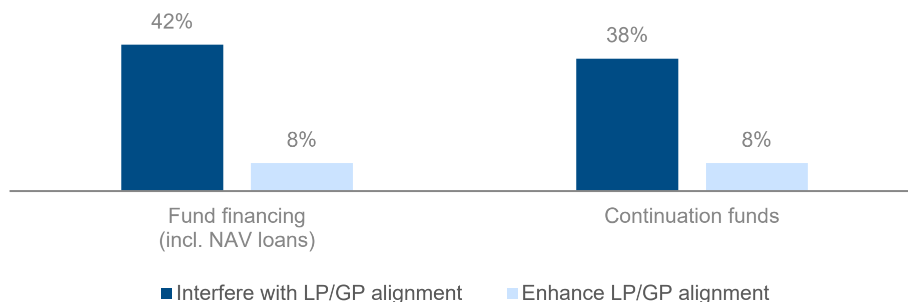
This lack of innovation is now **compounded by a lack of independence among buyers in the ecosystem**. Over the last three years, several dedicated, independent secondary buyers have been acquired by larger asset managers, many of which are public and have ambitious retail AUM targets for their new secondaries product. To be clear, we are in favour of firms thinking carefully about how to generate interesting retail product, which can include traditional secondaries, and responsibly growing AUM is more critical than ever for those GPs with a right-to-win and a clear mandate from LPs. That said, the result is that, more than ever, most secondaries firms are focused on originating as much deal flow as possible, and the easiest way to do so is through the "exchange"-like marketplaces. Secondary deals of scale are now, more likely than not, highly syndicated, meaning dedicated buyers are effectively stock-picking amongst the same set of on-the-run opportunities. **As a result, we believe differentiation amongst secondary funds will continue to decline and price competition will accelerate.**

Figure 11 – "Excess NAV" represents a $1.5tn+ problem



Source: MSCI (Burgiss), S&P, Robert Shiller, Arctos Insights, Navigating the Fundraising Cycle (July 2023). Excess NAV calculated as the difference between actual private equity NAV and hypothetical NAV that tracks the return on the 60/40 equity/bond portfolio, which has been the post-GFC trend. Private equity defined as North America and Western Europe equity strategies in MSCI (Burgiss)

Figure 12 – LP views on continuation vehicles and NAV loans (GSAM)



Source: Goldman Sachs, Private Markets Survey (June-July 2023)

Finally, many of the transaction archetypes we have discussed tend to create more problems than they solve; in particular, by generating misalignment, both between the GP and their existing investors and within the GP between retiring and rising partners. Please find some examples:

- **CV structures that allow GPs to hold their performing assets from recent vintages for longer tend to create GP/LP misalignment**. As capital has flooded into the GP-led market since 2021, the need to source transaction flow and compete with regular-way exit markets has grown. To do so, these funds began offering GPs new, stepped-up fee streams and the opportunity to crystalise their carry from the original fund just to execute a standard exit. This is counter to the original purpose of CVs, which were meant to extend new dry powder to high-quality but late-in-life assets. Regardless of the use, the problem of generating liquidity for LPs in today's exit market is far larger than CV-focused (or "GP-led") funds are set up to address. Existing GP-led fund dry powder is $57 billion, and annualised CV transaction volume in H1 2023 was $32 billion (annualised), vs. our estimate of nearly $1 trillion of "excess" NAV generated during the 2021 Private Markets Boom (Figure 11).[21] At a $50 billion run-rate deployment pace (closer to the last three-year average), it would take the GP-led market roughly 20 years to recapitalise and "clear" all excess NAV — and besides, so long as GP-led capital is sourced from the same LP base holding the excess NAV, it will end up being a wash in terms of LP allocation pressure. In other words, GP-led funds will not solve this issue.

- **Permanent GP stakes or control sales that create permanent fee-related earnings streams for outside investors take economics "out of system" at the expense of rising talent**. As a talent-focused business, we believe these types of deals are unlikely to be value enhancing in the long-term for most GPs.

- **NAV loans introduce clear misalignment with LPs**, especially if the proceeds are used to extend a GP's additional deployment runway outside of normal fundraising channels or allows a GP to distribute capital early but at a future cost to LPs of 12% or more. A recent survey conducted by Goldman Sachs Asset Management showed that about 40% of LPs believe that CVs and NAV loans "interfere with alignment", with only 8% in each case believing that they "enhance alignment" (Figure 12).

We believe a GP capital solutions strategy can address these issues, but only as a fully aligned and independent growth investor

focused on holistic solutions, like in other growth capital markets. Generating LP liquidity via CVs can be highly aligned and platform-enhancing by, for example, providing new roll-up or platform capital for an existing portfolio company that is having temporary balance sheet issues or recapitalising tail-end funds where liquidity for remaining investments is otherwise thin. Alongside other franchise-promoting strategies (e.g., higher GP commit, product revamp or expansion, new partner hires), fund management liquidity solutions can be a valuable tool. Flexible GP capital that brings the firm together around a shared solution for both retiring and rising partners is critical. Most importantly, capturing the next leg of growth and dealing with the three big challenges in an increasingly complex and maturing ecosystem will require innovation, fresh thinking and fully aligned long-term partners.

Introducing: Arctos Keystone

We are Arctos Partners. Our passion is catalysing innovation and transformation in the markets we serve. This was front-and-centre when we launched our Sports practice as the first dedicated institutional investor in that market. **Now, we are excited to launch our second strategy, which we call Keystone**. A "Keystone species" is not necessarily the most dominant in an ecosystem. Instead, the Keystone species is one without which an ecosystem would be drastically worse off, or a species on which others largely depend. As a fully aligned and holistic growth and liquidity partner of scale, **Arctos Keystone aims to fill what we see as a critical vacancy in the private markets ecosystem**, focused on deploying both the capital and capabilities needed to win in a rapidly changing industry. **Keystone will seek to bring both capital and innovation to strategic partnerships backing the most creative private investing franchises in the world**, and we have built a unique set of capabilities that we believe make us the partner of choice for ambitious GPs.

1. Preqin. Uses Arctos 2023 AUM estimate, see Figure 2
2. We will use "private equity" and "private markets" interchangeably
3. We are focused on the industry as it exists in developed markets (North America & Europe). We also exclude commitments to Funds of Funds and secondaries funds, which would double count AUM, but include our estimate of "shadow capital": co-investments, directs, perpetual capital (retail, insurance, etc.), CLOs, and separately managed accounts. See Figure 2
4. S&P (as of October 2023). Includes fee-paying and non-fee-paying AUM, liquid strategies, hedge funds, and separately managed accounts as reported. Management company value is total enterprise value. Includes: BX, BAM, APO, KKR, CG, ARES, TPG, OWL, EQT, PAT, BRDG, BPT, TKO, PX, and ANTIN
5. Arctos was the first institutional investor approved to make multiple investments in a single North American league (MLB, April 2020)
6. Preqin
7. See Figure 3
8. Estimated as 25x P/E multiple on annualised US corporate profits (current S&P 500 multiple) less total US public company market capitalisation (via MSCI). US BEA, MSCI, Arctos analysis (as of October 2023)
9. Vanguard Pension Advisory Solutions: Corporate Pension Trends 2022
10. "Active" is defined as an GP whose latest fund is at most five years old
11. Firms that failed to raise a follow-on fund but may still be managing residual capital
12. That is, GPs who successfully closed a first-time fund in that year
13. Arctos Insights, 2023 Media Update (October 2023)
14. Lawrence H. Summers, "US Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound.", Business Economics 49, pp.65-73 (5 June 2014)
15. This also applies to insurers, but capital ratio regulations, among other reasons, have kept private equity allocations to modest levels historically — though this is changing
16. There were a few temporary exceptions to this rule — e.g., 2002-2004, 2009-2012
17. Arctos Insights, "Navigating the PE Fundraising Cycle: Are We Out of the Woods?" (July 2023)
18. The index corresponds to the 60/40 bond portfolio and serves as a good proxy for overall investor wealth
19. Elevate 2022 Secondaries Summit — Survey (April 6-7, 2022), Question 48
20. In mid-2022, 47% of GP-led transactions were priced at or above NAV. Lazard Private Capital Advisory, Sponsor-Led Market Report, H1 2022
21. Evercore Private Capital Advisory, H1 2023 Secondary Market Survey Results (July 2023); Arctos Insights, "Navigating the Fundraising Cycle" (July 2023)

***Zach Baran is a Director at Arctos Partners**. He is responsible for all aspects of transaction evaluation and execution, as well as leading thematic and data-driven research initiatives across the Firm (Arctos Insights).*

Prior to the formation of Arctos Partners, Zach was an Associate at Warburg Pincus in New York, where he worked on firm strategy, economic research, and business development initiatives and was a direct report to the firm's Head of Research and the firm's President, a former US Treasury Secretary. Prior to working at Warburg Pincus, Zach was an Associate at Goldman Sachs in New York, within the Alternative Investments & Manager Selection (AIMS) Group and worked for Landmark Partners, where he was an early member of their Quantitative Research Group.

Zach graduated with distinction from the University of Pennsylvania, where he received a B.A. in Mathematics and Philosophy.