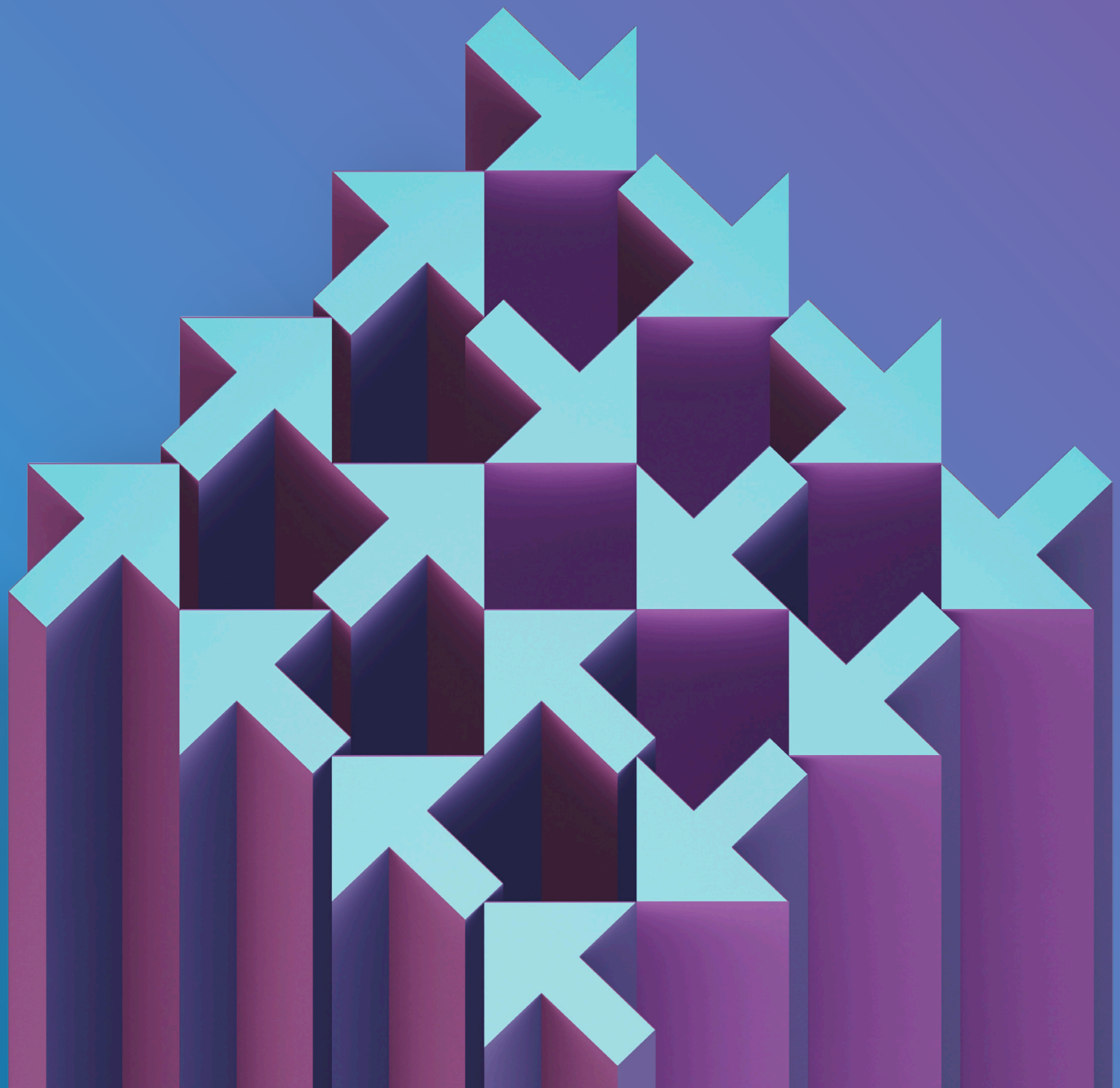
MERCER

welcome to brighter

Dry powder meets low interest rates – Time for a private market boom or bust?



High valuations, crowded markets and uncertainty around COVID-19 have converged to push the level of uncalled capital commitments in private markets to a new absolute record in 2021.

Interestingly, there is evidence that the current record level of dry powder may not be as problematic as it first seems.

Other factors, such as low interest rates, are at play which have encouraged general partners (GPs) to use more leverage to finance deals and increase their use of loans. Both these practices can potentially improve the internal rates of return (IRRs) on funds while also contributing to higher levels of un-deployed capital.

Adding these elements to the mix immediately raises the question of whether the increased capital flow into private markets will lead to a decrease in the returns that private markets fund managers have produced in recent years.

This paper examines some of the issues associated with this question and finds:

- Capital commitments in private markets have reached new levels, but on a relative basis, the dry powder level may not be as high as it appears.
- Although valuations are also high, GPs have invested more selectively and deal flow was substantially reduced in 2020.
- GPs are employing processes to manage the potential drag on their returns by using subscription lines and credit facilities.
- Private market fund managers may be well positioned to help their portfolio companies adapt to the fundamental industrial transformations resulting from the pandemic, potentially leading to attractive investment opportunities.

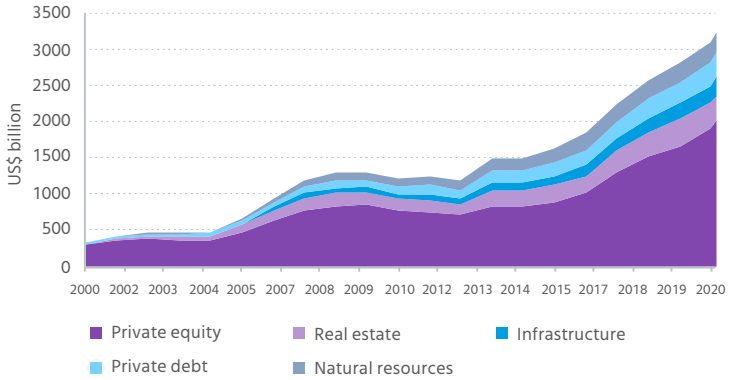
Dry powder refers to capital committed by investors that has not been invested or allocated.

Exploring the record levels of dry powder

Globally, the uncalled capital commitments of private market funds have been increasing consistently for several decades and reached a record level of US $3.1 trillion in February 2021 (see Figure 1). This represents a nine-fold increase over the past 20 years. Interestingly, during this same period, assets under management by private market fund managers have grown even faster, reaching US $7.5 trillion and marking a more than 11-fold increase (see Figure 2).

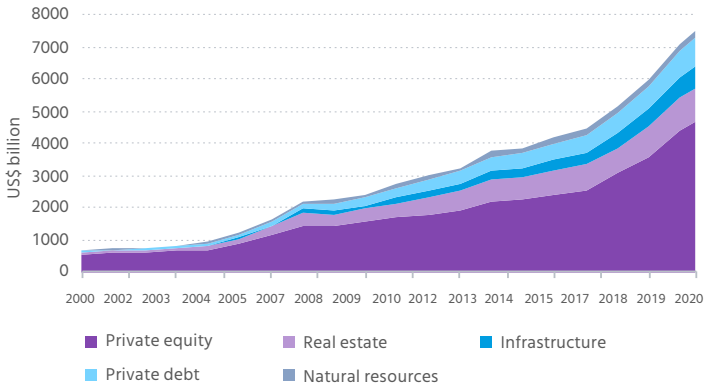
However, it is worth noting that both statistics have potential measurement issues. The measurement of capital commitments excludes separate accounts and co-investments, so the true uncalled capital figures and effective assets under management may both be understated. Additionally, assets under management may be further underestimated as it is common for private markets fund managers to carry their investments below their true market value.

Figure 1. Unallocated capital has been rising in absolute terms



Source: Preqin as of end of 2020

Figure 2. Private market assets under management



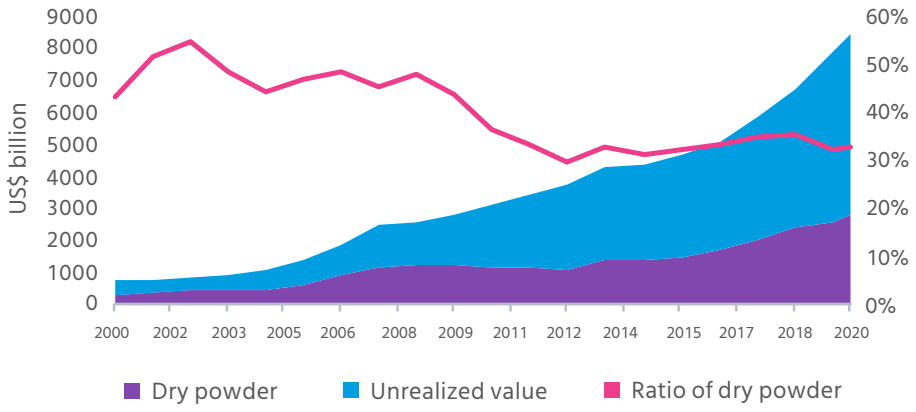
Source: Preqin as of end of 2020

Although the absolute level of dry powder is certainly high, it may be more useful to view it from another perspective. This ratio (see Figure 3) shows that the level of dry powder relative to unrealized assets ranged between 40% and 50% in the early 2000s. It leveled off at just above 30% around 2012 and has remained reasonably constant ever since.

This phenomenon is likely due to several causes. After the Global Financial Crisis (GFC) many limited partners (LPs) paused their private market investment programs and fewer funds were raised. As a result, many funds extended their investment periods and drew down their existing commitments. They also delayed raising new capital, which lowered the available dry powder.

As it became clear that private market fund managers could generate strong returns even during difficult market conditions, investors increased their allocations. This led to many private market managers raising new funds while also shortening their investment periods. This often resulted in many deploying capital more quickly and kept the level of dry powder relatively low.

Figure 3. Dry powder ratio



Source: Preqin; Potential asset allocation is defined as unrealized value plus dry powder

Higher market valuations coupled with increasing deal flows have contributed to the decrease in the dry powder ratio shown above over recent years. For example, US private equity EBITDA multiples increased from 5.6x at the end of 2018 to 7.0x through Q3 2020,[1] which is also consistent with the upward trend in public equity markets.

Moving forward, capital may be deployed more quickly given that attractive investment opportunities may develop post-COVID-19.

Additionally, Mercer's paper on lessons from the GFC illustrates how the vintage years that followed the crisis allowed funds to invest capital at attractive multiples and take advantage of the subsequent appreciation of valuation multiples. This generated attractive returns, as measured by both IRR and multiples relative to more "normal" market conditions.[2]

[1] Private equites – see Mercer's quarterly alternatives

[2] Lessons from the Global Financial Crisis – Mercer 2020

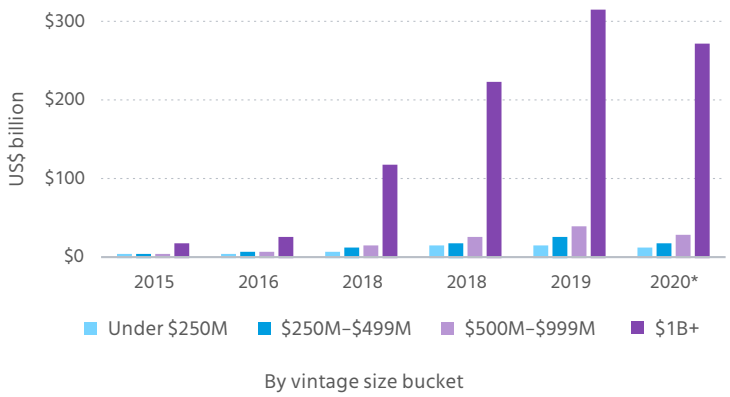
Dry powder concentration

As could be expected, the level of dry powder is highest for mega funds and for funds of more recent vintages. Figures 4 and 5 present dry powder concentration by fund size and vintage year. Dry powder for mega funds[3] has increased over the last few years. This is likely a consequence of the significant increase in the number of mega funds that had been raised post-GFC. According to Pitchbook, at the peak of 2019, there were 35 funds that had raised more than $5 billion — totaling $386 billion — compared to nine funds that did so in 2012 — totaling $73 billion.

As mega funds constitute the largest pool of capital, GPs are challenged to strike the balance between carefully evaluating investment opportunities and pressure from LPs to put the money to work. Investors might be concerned that due diligence processes could be compromised. Additionally, a severe recession could leave GPs with many years of uncalled capital.

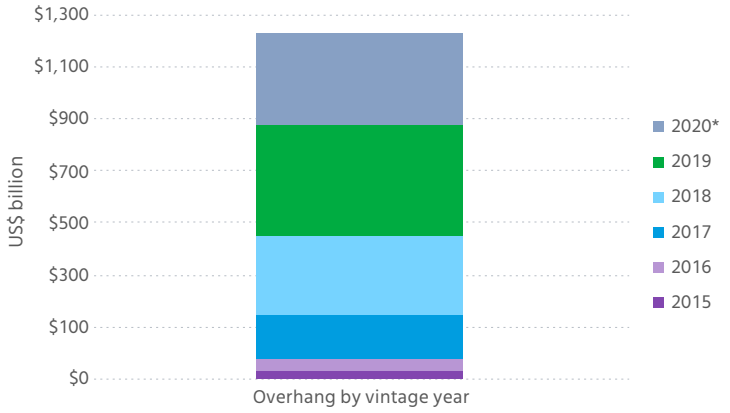
To their advantage, larger funds can engage in public to private investment transactions, may have less deal competition and may be more experienced. They may also have access to more favorable financing and leverage terms. Mercer's experience has shown that mega funds have tighter return spreads and more consistent return patterns than smaller funds. Typically, these mega funds have extensive track records, which allows them to continue raising larger funds. Additional benefits may include better downside risk management and opportunities in other private market segments.

Figure 4. Dry powder concentrated in largest funds



Source: Pitchbook *through June 2020

Figure 5. Total dry powder by vintage year



Source: Pitchbook *through June 2020

[3] Funds with assets under management plus $5 billion

Impact of low interest rates

Increasing private market allocations

One of the key drivers of the underlying growth of investor interest in private markets is the extended economic regime of ultra-low interest rates coupled with quantitative easing.

Cyclical and structural factors driven by low or negative yielding bonds, along with alternative financing options, help stimulate the shift in capital allocation to private markets. Additionally, private markets can benefit from low interest rates in multiple ways:

- Businesses are able to raise more money than ever before and have access to deep capital markets and sophisticated partners.
- The yields in public fixed income are at historic lows and investors have turned to private debt in search of higher yield.
- The abundance of financing models, including leverage and restructuring options across equity and debt, allows private companies to fund their expansion outside of public markets for longer periods.
- The lower cost of debt puts less stress on portfolio companies and can amplify private market returns.
- Refinancing or restructuring deals are more readily accomplished.

As an example, a number of pension funds and insurance companies have rotated out of government and corporate bonds and developed dedicated asset allocation targets for private debt investments. Private markets are also being supported by a significant increase in supply, with a growing number of larger private market funds.

With central banks committed to keeping rates low for longer and return assumptions for public bonds and equity returns assumptions muted, investors will likely continue to look to alternatives for income, diversification and growth.

Low rates, lower capital costs

Another factor that comes into play is the ease with which capital can be accessed — and at a low cost. Funds typically employ leverage to enhance their rate of return, meaning low interest rates and credit accessibility are key factors to potentially achieving higher returns.

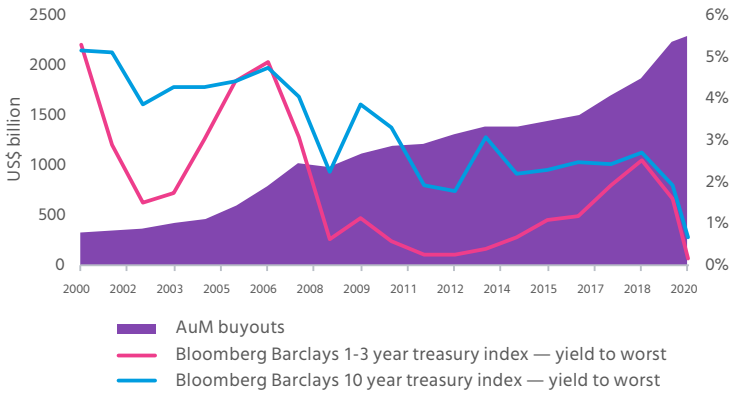
In recent years, the relationship between private equity fund managers and private debt providers has strengthened. Private debt providers are offering direct financing to privately owned companies in place of traditional bank financing with increasing frequency. Fueling this trend is LPs providing capital to private debt funds as a way to improve the returns in fixed income portfolios.

Low interest rates could help drive increasing allocations to private markets and favor deal sourcing, encourage leverage and use of credit lines, which can all increase IRRs.

Leveraged buyout private equity strategies are especially sensitive to interest rates since these funds can employ significant leverage. Low rates create attractive investment opportunities for GPs to finance transactions cheaply, with the added effect of increasing the IRR. Figures 6 and 7 illustrate how favorable market conditions affected asset growth and leverage in the US buyout market over time.

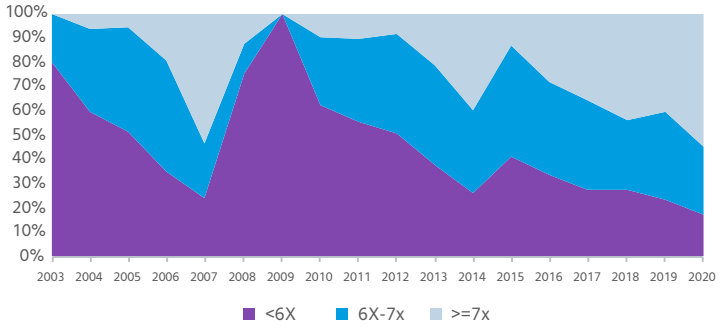
As of the end of 2020, approximately one-third of private market assets were committed to buyout fund strategies. With yields moving lower, the financing of buyout deals used increasing amounts of leverage, reaching new highs. Following figure 7, in 2020, approximately 55% of the buyout funds deployed capital at a leverage rate of 7x or higher.

Figure 6. Leveraged buyouts surged while rates declined



Source: Preqin, Bloomberg Barclays as of end of 2020

Figure 7. US share of US leveraged buyout market by leverage level



Source: Refinitiv as of end of 2020

Subscription lines are short-term loans taken out by private markets funds to bridge temporary financing needs between when a fund makes an investment and when a PE fund calls capital from its investors. These lines are backed by limited partners' committed capital to the fund.

Using subscription lines to good effect

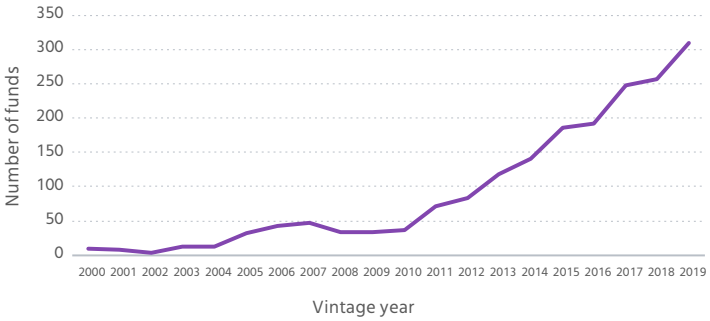
Low interest rates and easy access to credit also encouraged the use of subscription or credit lines. Their size and duration, as well as the percentage of LPs' commitment have been increasing rapidly. By 2018, more than 90% of funds used these credit facilities, as highlighted in Figure 8.

The use of credit lines is not new. They allow GPs and LPs to simplify liquidity management and bridge the financing gaps from the time when a PE fund makes an investment to when it calls capital from investors. This results in less frequent, more predictable cash flows and the ability for managers to act quickly on opportunities. They also provide some J-curve mitigation. Today, there are GPs that raise credit funds specifically to provide financing solutions to other private market funds.

The utilization of credit lines delays capital calls and shortens the investment period for LPs, which can increase net IRRs over the lifespan of a fund. A higher reported IRR may also improve a manager's quartile universe ranking, when in fact, the actual levels of cash calls and distributions to investors have not changed, merely the timing of them.

GPs may also achieve an IRR-based hurdle rate faster, which in turn may accelerate the accrual and pay-out of carry. It could also increase the risk of a claw back if the fund underperforms in later years. Additionally, the use of credit lines can lead to higher levels of reported dry powder when, in fact, some of that dry powder has actually been invested but not yet called.

Figure 8. Private funds using subscription credit facilities



Source: Preqin as of end of 2019

The impact of COVID-19

The pandemic has disrupted both private and public markets. Investment activities have stagnated, deal flow has declined and distributions to LPs have been limited. On the other hand, fundraising showed resilience, increasing dry powder to new absolute highs while private equity valuations remain elevated. Moreover, high uncalled capital levels provided some downside protection for portfolios. GPs with dry powder coming into the COVID-19, combined with private credit markets offering sophisticated sources of financing, are well positioned to take advantage of future market dislocations.

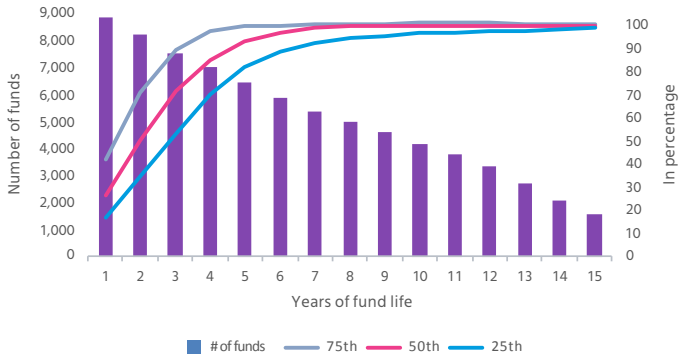
Renewed economic growth will likely focus on innovation and new technologies. If new ways of working and consuming are here to stay, at least to some degree, after the pandemic recedes, this will likely spur M&A across multiple sectors.

From an LP demand perspective, the ongoing low interest-rate environment has resulted in alternative sources of income becoming an ever-greater necessity. Furthermore, private vintages raised in the aftermath of shock events have historically tended to perform well. We expect forthcoming private debt fund vintages to benefit similarly.

One of the main challenges investors face today is selecting strategies that best suit their individual risk and return requirements. The landscape of private strategies is more diverse than ever. Additionally, we observe a large dispersion of returns with some managers performing poorly even in strong vintage years. Therefore, proper advice and manager selection is key. A key evaluation point is if the GPs have taken a portfolio through a crisis before. Additionally, complexity has increased with LPs able to select investments by stage, sector, security type, etc.

During long lasting economic downturns, GPs may face challenges to find attractive opportunities. However, this concern has not been substantiated to date. The capital call analysis in Figure 9 illustrates that managers typically have called 100% of the capital commitments after eight years.

Figure 9. Capital call curve — Paid in capital as of end of 2020



Source: Burgiss

Conclusion

Given high valuations and an uncertain economic environment, GPs have begun to take a cautious approach to deploying capital into new investments with the number of deals down for 2020. Meanwhile, fundraising has been solid as investors are positioning themselves to benefit from the global economic recovery post-COVID-19. With the combination of low interest rates and the available dry powder, the stage is set for GPs to invest into private markets.

The pandemic presents several potential investment opportunities to improve existing portfolios such as investing in transforming industries (e.g., supply chain management, health care technology, and transforming working place), offering bridge financing (e.g., PIPE transactions[4]) or acquiring distressed assets (e.g., real retail revitalization programs).

Mercer believes investors can participate more directly in growth opportunities and dislocations in private markets than in public ones. While the depth and length of the economic impact is still uncertain, many private market fund managers are well positioned to help their portfolio companies adapt to the fundamental industrial transformations arising from the pandemic.

This means investors have the power and potential to transform industries and create even more investment opportunities.

Mercer's Strategic Research Community

Access our investment research on a single digital platform, as well as content and third-party analysis from the broader investment community.

Join free today

[4] Private investment in public equities

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

This does not constitute an offer to purchase or sell any securities.

Funds of private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequentially, higher risk. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action. An investor could lose all or a substantial amount of his or her investment. There are restrictions on transferring interests in private capital funds. Funds of private capital funds' fees and expenses may offset private capital funds' profits. Funds of private capital funds are not required to provide periodic pricing or valuation information to investors. Funds of private capital funds may involve complex tax structures and delays in distributing important tax information. Funds of private capital funds are not subject to the same regulatory requirements as mutual funds. Fund offering may only be made through a Private Placement Memorandum (PPM).

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see http://www.mercer.com/conflictsofinterest.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary and actual results may differ materially.

Information contained herein may have been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential, or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

Please see the following link for more information on indices: https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2020-investment-management-index-definitions-mercer.pdf.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited, Mercer (Ireland) Limited and Mercer Limited.

Mercer Global Investments Europe Limited and Mercer (Ireland) Limited are regulated by the Central Bank of Ireland under the European Union (Markets in Financial Instruments) Regulation 2017, as an investment firm. Registered officer: Charlotte House, Charlemont Street, Dublin 2, Ireland. Registered in Ireland No. 416688. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.

Investment management services for Canadian investors are provided by Mercer Global Investments Canada Limited. Investment consulting services for Canadian investors are provided by Mercer (Canada) Limited.

Investment management and advisory services for U.S. clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, New Jersey, North Carolina, Oklahoma, Pennsylvania, Texas, and West Virginia; as "Mercer Investments LLC (Delaware)" in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Mercer Investments LLC is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Mercer Investments' Form ADV Part 2A & 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.

March 2021

6011460-WE