McKinsey Global Private Markets Review: Private markets turn down the volume

March 21, 2023 Report

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According to our latest Global Private Markets Review, private markets faced a year of two halves in 2022, with buoyancy in the first half and plummeting deal volumes, declining performance, and falling valuations in the second.

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The music didn't stop, but someone turned it way down

Private markets have enjoyed strong tailwinds since the depths of the Global Financial Crisis (GFC). Interest rates stayed low, credit availability was high, and valuations rose consistently. Each year since its inception, this annual publication has discussed new records in fundraising and deal flow while celebrating strong performance across asset classes. Even in 2020, when activity stalled briefly during the early months of the COVID-19 pandemic, private markets hummed again in the second half. In almost every regard, 2021 was an exceptional year (as we highlighted in last year's report) but it was not a trend breaker. Markets climbed higher still, awash with central-bank-induced liquidity. In the first half of 2022, central banks fought roaring inflation by sharply raising interest rates, and public market valuations cratered. In the private markets, first-half deal activity softened but subtly so, nearly matching the record-setting pace set in 2021.

About the authors

The mood changed in early summer. Banks began to pull back, unwilling or unable to lend. Private markets deal volume plummeted, performance declined, and valuations fell—dramatically in certain sectors. Still, private markets outperformed public markets on the way down, whether due to truly more resilient portfolios, a lag in timing, or manager discretion over their marks (private markets tend to mark up less quickly during ascending markets and mark down less quickly in falling markets). The discrepancy this year drove private market allocations higher on a percentage basis across institutional portfolios—closer to preexisting targets for most, and above targets for many limited partners (LPs)—triggering the so-called denominator effect. Though few LPs thus far have abandoned commitment plans entirely or sold portfolios as they did 15 years ago, many have pulled back, particularly from smaller and newer funds, causing fundraising to decline.

Deal making slowed in the second half

After a frenzied 2021, private equity (PE) deal volume decreased 26 percent to $2.4 trillion, while deal count fell 15 percent to just under 60,000. The deal-making momentum of 2021 continued through the first half of 2022, and despite the striking slowdown in second-half deal activity, 2022 remained the second most active year on record. The number of buyout and growth deals greater than $500 million decreased by 33 percent. Add-on deals, which tend to be smaller, continued to gain share as a percentage of total deals. New platforms comprised 28 percent of total transactions in 2022, 14 percentage points lower than five years ago.

Real estate deal volume declined 20 percent to $1.1 trillion, also the second-highest year on record. Like PE deal making, first-half real estate deal making continued close to the record-setting pace of the second half of 2021, but second-half volumes declined precipitously. After more than doubling year over year in 2021, multifamily deal volume fell 29 percent in 2022, accounting for nearly half of the asset class's overall decline in deal activity.

The denominator effect took hold

Global private markets fundraising declined by 11 percent to $1.2 trillion. Real estate (−23 percent) and private equity (−15 percent) declined most precipitously from 2021's record highs, while private credit (+2 percent) proved more resilient. Macroeconomic headwinds, including rising inflation and interest rates, coupled with negative public market performance (−17.7 percent) triggered the aforementioned denominator effect, and LPs scaled down new commitments. Despite these challenges, 2022 is likely to be the second-best fundraising year on record (after all data is reported), demonstrating—thus far—discipline and longer-term thinking by LPs.

North American fundraising was resilient; Europe and Asia faced challenges

Fundraising results differed notably across geographies, more so than in previous years. Private markets fundraising in North America increased by a modest 2 percent year over year but declined in Asia and Europe by 39 percent and 28 percent, respectively. Since 2017, fundraising in Asia has declined 16 percent per year, driven primarily by reduced investment in China. In 2017, for example, China represented 83 percent of fundraising in Asia, a share that dropped to 34 percent in 2022. In Europe, an 11-year run of fundraising growth ended, largely due to geopolitical instability and broader macroeconomic challenges, including volatility in foreign currency exchange rates. A strengthening dollar accounted for a material portion of the dollar-based decline in fundraising in non-US markets.

Investors fled to known names and larger funds

Amid a pullback in commitments, an outsized share of capital flowed to the largest funds, as investors re-upped with their existing managers but reduced backing smaller and new funds. Funds over $5 billion collected a record $445 billion in aggregate, a 51 percent increase over funds of a similar size in 2021. Conversely, dollars raised by sub–$5 billion funds decreased by 28 percent. Just 2,141 funds were closed during the year, 1,600 fewer than in 2021 and the fewest of any year since 2013. First-time fund launches also decreased by 40 percent.

Dry powder inventory spiked

Total private markets assets under management (AUM) reached $11.7 trillion as of June 30, 2022. AUM has now grown at an annual rate of nearly 20 percent since 2017. As of the second quarter of 2022, dry powder exceeded $3 trillion, reflecting an 8.4 percent year-over-year increase and marking the eighth consecutive year of growth. Dry powder inventory—the amount of capital available to GPs expressed as a multiple of annual deployment—spiked. In PE, inventory jumped from a historically low 0.9 times at the end of 2021, following a year of record deal flow that outpaced fundraising, to 1.4 times, the highest ratio since 2013. That number is likely to have grown even higher in the second half of 2022, as deal flow dried up more abruptly than fundraising slowed.

PE multiples contracted

PE buyout entry multiples declined slightly in 2022, falling to 12.9 times EBITDA from a record 13.2 times a year ago, while public market multiples compressed dramatically, declining to 12.0 from 14.6 times EBITDA. Financial services (−2.5 times) and information technology (−2.2 times) recorded the largest multiple declines among PE subsectors, while rising commodity prices drove multiple expansion in raw materials and resources (+2.6 times).

PE posted negative performance for the first time since 2008

Global PE performance turned negative for the first time since 2008, posting a −9 percent return through September[1] and ending a five-year run as the highest-performing private asset class. Tech-focused buyout funds performed worse than other buyout funds for the second consecutive year, and venture capital (VC) underperformed buyout strategies for the first time since 2017. Counterintuitively, manager selection mattered less in 2022 than in years past: the interquartile spread of returns of PE funds narrowed in 2022 to 21.6 percent from the prior ten-year average of 33.8 percent. As the industry narrative turned from beta to alpha, there was less alpha to be had in 2022.

Real estate served as an inflation hedge

One of real estate’s biggest draws for institutional investors is the long-held belief in the asset class’s ability to protect real value during periods of higher inflation. Indeed, real estate performance has exceeded inflation in six of the last seven inflationary periods, in part due to cap rate compression even during a rising interest rate environment. The pattern in 2021 and 2022 was no different: despite rising US Treasury (UST) rates, cap rates decreased and values rose. However, cap rates started expanding toward the end of 2022, signaling heightened uncertainty across real estate markets.

Private debt had its moment (again)

Private debt fundraising continued to grow last year (+2 percent), once again bucking the trend of other private asset classes. Institutional investors sought out the asset class for various features that are attractive in times of market volatility: current yield, floating rates, and relative insulation (via its senior position in the capital stack) from declining valuations. The prevailing market uncertainty also served as a shot in the arm for private credit deployment opportunities. As bank financing dried up in the second half of the year, private lenders stepped into the void, providing financing for more than 80 percent of PE transactions in the middle market.

More mega-funds and a broader mandate for infrastructure

Infrastructure and natural resources fundraising rose to an all-time high of $158 billion, benefiting from the closing of a record five funds of more than $10 billion. The definition of infrastructure and natural resources continues to expand, with today's funds now taking more equity risk than yesteryear's did. Macroeconomic events had mixed impact across sectors: rising oil and gas prices drove a resurgence in demand for traditional energy investments, while growth in renewables fundraising continued amid the multiyear push toward decarbonization.

Sustainable investing gained scale

2022 will prove to be the best year yet for ESG-focused fundraising, with $24 billion raised through the first half of the year. Sustainability-related deals (the "E") increased by 7 percent to nearly $200 billion, proving resistant to the deal-making headwinds that affected other asset classes. Venture capital accounted for 40 percent of this total, while on a sectoral basis, power and transportation targets led the pack for the third year running. But ESG's growing impact on private markets goes beyond just dedicated funds and deals: most funds (of any strategy) now consider ESG risk factors in due diligence, and some explicitly include ESG concepts in their value creation plans.

Private markets firms still have work to do on diversity

Considerations for diversity, equity, and inclusion (DEI) have become an important part of the fundraising, hiring, and investing landscape in private markets. LP willingness to allocate more capital to diverse deal teams is prompting more GPs (52 percent in 2021–22) to share DEI data during fundraising. On some diversity metrics, private markets firms compare favorably with corporate America, although ethnic diversity is not yet broad based. Ethnic, racial, and gender representation also remains imbalanced in senior positions and investing roles, suggesting that firms broadly continue to miss talent opportunities. Increasing representation across all levels will require managers to take fresh approaches to hiring, retention, and promotion.

Compared with a heady prior decade of robust growth, 2022 was a subdued year in the private markets. Following the record highs achieved in 2021, which were buoyed by pent-up demand from the earlier stages of the pandemic, several exogenous macroeconomic events stymied growth. High inflation persisted throughout most of 2022, prompting central banks around the world to increase interest rates at a historic pace. Quantitative tightening and dislocation in asset prices raised fears of an economic slowdown. And the ongoing war and humanitarian crisis in Ukraine further exacerbated risks to the global economy, including higher commodity prices and disrupted supply chains. Amid the challenges, public markets sold off substantially, and though private markets remained relatively buoyant in the first half of 2022, they followed in the latter half.

These disruptions had substantial and varied impacts on private markets fundraising, performance, and AUM growth, with steep declines in certain regions and strategies, and pockets of resilience in others.

Private markets fundraising fell 11 percent to $1.2 trillion, as the denominator effect affected some LPs' ability to allocate capital. The decline was most evident in Europe and Asia, while fundraising in North America increased slightly (Exhibit 1). Capital deployments into larger vehicles increased as investors re-upped with existing managers while forgoing commitments to smaller and newer managers.

Exhibit 1

Performance of every private markets asset class declined relative to 2021 but continued to outperform public market equivalents at current marks, though private market valuation changes often lag those in public markets. In a break from years past, PE performed worse than other private asset classes, producing negative returns (through September 30, 2022) for the first time since 2008. Natural resources strategies, meanwhile, generated relatively strong performance for a second consecutive year, buoyed by elevated commodity prices.

While fundraising and investment performance declined, the industry's growth held reasonably steady, with assets under management increasing to $11.7 trillion as of June 30, 2022 (Exhibit 2).

Exhibit 2

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On the heels of a banner 2021, which set records for fundraising and deal making and produced exceptionally strong returns, PE fell back to earth in 2022. Aforementioned challenges—the higher cost and lower availability of debt, rapidly declining public market valuations, and macroeconomic uncertainty—stifled growth, activity, and performance in what had been the best-performing private markets asset class for many years running.

Globally, fundraising fell 15 percent from the all-time high achieved in 2021 (Exhibit 3). LPs concentrated commitments among large funds as many investors chose to re-up with known, tested names while forgoing commitments to smaller, newer managers. In particular, megafunds gained prominence: 11 funds of more than $10 billion each were raised, totaling $170 billion collectively (Exhibit 4). VC and growth equity both had their second-largest fundraising year on record, cumulatively accounting for more than 50 percent of PE fundraising for the first time.

Exhibit 3

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Exhibit 4

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AUM ascended higher, as it has in every year since the global financial crisis, to $7.6 trillion. Additionally, the deal-making momentum of 2021 continued through the first half of the year before falling dramatically in the second, weighed down by reduced credit availability and valuation uncertainty. Exit volume fell sharply, as sponsors chose to hold assets rather than sell into a declining-valuation environment.

PE returns disappointed, recording the worst year (through September 30) since 2008, and PE ended a five-year run as the top-performing asset class. Because of the deterioration in technology valuations, VC and growth equity returns led the fall, in stark contrast to the last several years. The median VC and growth funds lost 6.3 and 7.3 percent, respectively, through the first three quarters of 2022, while the median buyout fund earned 0.9 percent.

For real estate, 2022 was a year of relative highlights and challenges, with previously-struggling sectors finding stability, and top-performing sectors slowed by tailwinds.

In closed-end funds, AUM reached a new peak, as it has every year since 2016, and managers raised the second-highest total on record, led by commitments to opportunistic vehicles. Open-end funds in the US grew NAV by 24 percent, with contributions exceeding distributions for the first time in two years. Office, retail, and hospitality—the sectors most affected by pandemic-driven changes in working, shopping, and traveling—showed signs of emerging stability. In office, for example, net absorption turned positive as attendance rates seemingly reached a new equilibrium.

Yet, like most private market segments, real estate experienced a downturn in 2022 compared with the record year it followed. Closed-end fundraising declined 23 percent year over year. Deal volume fell 20 percent, declining in each consecutive quarter throughout the year (Exhibit 5). Expanding capitalization (cap) rates across sectors, which represent the multiple investors are willing to pay for net operating income (NOI), drove performance lower. And multifamily and industrial—sectors benefiting from changes in living and shopping behavior—softened after rapidly rising rents and occupancy of the past two years boosted performance (Exhibit 6).

Exhibit 5

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Exhibit 6

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Signs of a flight to quality, or at least to better-known managers, emerged. The largest five managers accounted for 29 percent of all fundraising, the highest share of the last decade, and tenants favored class A real estate as they fought to attract and retain employees.

Finally, amid the broader slowdown in technology-oriented PE deal making, investments in property technology companies fell to the lowest total in five years. While the industry continues to digitize rapidly, companies leading that effort found fundraising more difficult than in years past.

After more than a decade of rapid fundraising growth, strong macroeconomic headwinds slowed—but did not stop—private debt's growth. In a year when other private classes fell back to earth somewhat, private debt set a new fundraising record, led by several megafund closes.

The continued momentum in 2022 was understandable, as debt's current yield and senior position in the capital stack have long made it a haven in volatile periods. The diversity of strategies within private debt also helps explain its consistent growth. As in 2020, when private debt was the only private asset class that recorded fundraising growth, investors' ability to allocate to one or another strategy based on the prevailing market environment has contributed to consistent top-line growth through business cycles (Exhibit 7). In 2022, mezzanine strategies were most in favor, posting record fundraising totals and more than tripling 2021's haul. Direct lending fundraising declined from 2021, but only marginally, raising over $100 billion for the second consecutive year.

Exhibit 7

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Private debt was not immune to the macroeconomic conditions last year, however. There was a notable drop in private debt deal volumes, driven by the slowdown in PE and only partially offset by market share gains taken from bank and syndicated financing channels (Exhibit 8). Performance also declined from 2021's high as lower marks offset current yield gains.

Exhibit 8

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Infrastructure and natural resources (NR) overcame broader market headwinds in 2022 to set a new fundraising record of $158 billion (Exhibit 9). Investors flocked to the asset class because of its ability to provide stable cashflows, less correlated returns, and a hedge against inflation. On the supply side, the closing of a record number of global megafunds boosted fundraising. AUM grew as well, reaching a new high of $1.3 trillion, 14.2 percent higher than in 2021.

Exhibit 9

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Like the strategies for other asset classes, infrastructure and NR strategies were affected by macroeconomic challenges. Deal volumes declined 27 percent as financing became more expensive and harder to access. And while infrastructure and NR fund performance declined somewhat from 2021, these funds were the top-performing private markets asset classes in 2022. NR outperformed all others, returning 15.6 percent in a second consecutive year of strong performance driven by rising commodity prices.

Beneath these headline statistics, revolutions in energy, mobility, and digitization are changing the face of infrastructure investing. The flow of capital into the asset class has pushed investors to look beyond traditional core infrastructure assets (Exhibit 10). Core-plus and value-add strategies are now investing in new asset categories and infrastructure service providers as GPs seek to accommodate the return expectations of a new class of infrastructure investor. While the long-term demand for capital is tremendous, with a projected global infrastructure spending gap of $15 trillion through 2030,[2] current macroeconomic and geopolitical events are creating short-term pressure on high-growth sectors such as telecommunications and renewables.

Exhibit 10

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More private markets managers are incorporating considerations for ESG factors into their corporate policies, operating procedures, and investment decisions. In 2022, 1,069 more investors committed to the United Nations Principles for Responsible Investment (PRI)[3], and a further 88 asset owners became PRI signatories, bringing the total to 681.[4] The proportion of total private capital fundraising that came from managers with an investment policy that includes ESG issues rose to 66 percent in 2022,[5] a new high.

This progress is a result of many factors. First and foremost, the evidence supporting a positive correlation between ESG and financial performance continues to mount, as long as the underlying company is healthy. For example, recent McKinsey research found that publicly traded ESG outperformers that also outperformed peers on margin and growth delivered 200 basis points in excess return to their shareholders over companies that only outperformed financially.[6] New government policies that provide incentives for certain ESG investments—most notably the US Inflation Reduction Act of 2022—are likely to strengthen this correlation further. Second, LPs are increasingly incorporating ESG metrics into their capital allocation processes. One recent survey indicates that nearly three-quarters of LPs would consider eliminating a manager from consideration if it was unable to provide acceptable standards of ESG-related disclosures.[7] Finally, macroeconomic forces, including higher energy prices and geopolitical conflict, have strengthened long-term investor interest in alternative energy sources and overall energy independence.

Consideration of ESG is not limited to fundraising and deal activity. Across the entire investment life cycle, from fundraising and asset selection to value creation and exit planning, ESG is on the minds of investors (Exhibit 11). Across our clients, we see ESG becoming a competitive differentiator and driver of returns. A pre-investment ESG diligence includes a materiality scan, ESG performance and benchmark, value-at-stake analytics, and an ESG maturity assessment.

Exhibit 11

After making an investment, GPs have five value creation levers they can pull to improve their portfolio:

1. *Top-line growth.* Attract B2B and B2C customers with more sustainable products and achieve better access to resources through stronger community and government relations.
2. *Cost reduction.* Lower energy consumption and reduce water intake.
3. *Regulatory and legal interventions.* Achieve greater strategic freedom through deregulation, and earn subsidies and government support.
4. *Productivity uplift.* Boost employee motivation, and attract talent through greater social credibility.
5. *Investment and asset optimization.* Enhance investment returns by better allocating capital for the long term, and avoid investments that may not pay off because of longer-term environmental issues.

ABOUT THE AUTHOR(S)

Pontus Averstad is a senior partner in McKinsey's Stockholm office; Alejandro Beltrán is a senior partner in the Madrid office; Marcel Brinkman is a partner in the London office; Paul Maia is a partner in the New Jersey office; Gary Pinshaw is a senior partner in the Sydney office; David Quigley is a senior partner in the New York office, where Aditya Sanghvi is a senior partner; and John Spivey is an associate partner in the Boston office, where Brian Vickery is a partner.

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