An Alternative View

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Q1 2024 Outlook

Introduction

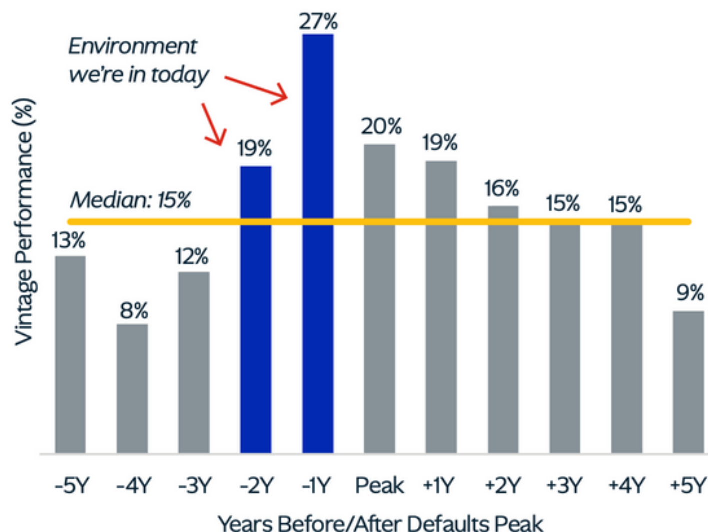
A fresh year brings a chance to step back and consider how the investing landscape might shift in 2024. One reliable source for clues on the year ahead are the annual reports put forth by economists and professionals at investment houses throughout the country. While we find their entire reports useful, oftentimes the best insights come from understanding what's just occurred in more detail.

To that end we've read through annual outlooks from Preqin (abridged), Apollo, KKR, and Cambridge Associates. We've selected our favorite chart from each below, alongside an explanation of why it influenced our thinking. The common thread across buyout, venture, private credit, and real assets is an expectation that 2024 hews closer to the mean than the extremes of the past several years. We look forward to bringing you similar insights across asset classes at a quarterly clip to highlight interesting insights we find across the private markets ecosystem and welcome your feedback as 2024 awaits.

-Logan Henderson, CEO

Private Equity

KKR's detailed outlook has a great graph on buyout performance relative to the credit cycle. The bars represent median net IRRs of private equity vintages from 1987 through 2014 indexed to the year of peak credit defaults. For example, a 2008 vintage would be -1Y as defaults peaked in 2009 while a 2010 vintage would be +1Y. Somewhat counterintuitively, the strongest performing vintages are not those raised when defaults are highest (and when valuations are usually at their lowest). Rather the strongest vintages are raised a year or two beforehand. This is because of the long drawdown structure inherent to Private Equity funds, where commitments are called over 3-5 years and returns delivered another half-decade or more after that. In this analysis those funds raised before the trough had capital ready to deploy and targets picked out through the most attractive deployment environments, while funds closed during or after that point delivered good but less spectacular returns, potentially because they could only deploy so much of their funds before valuations recovered.



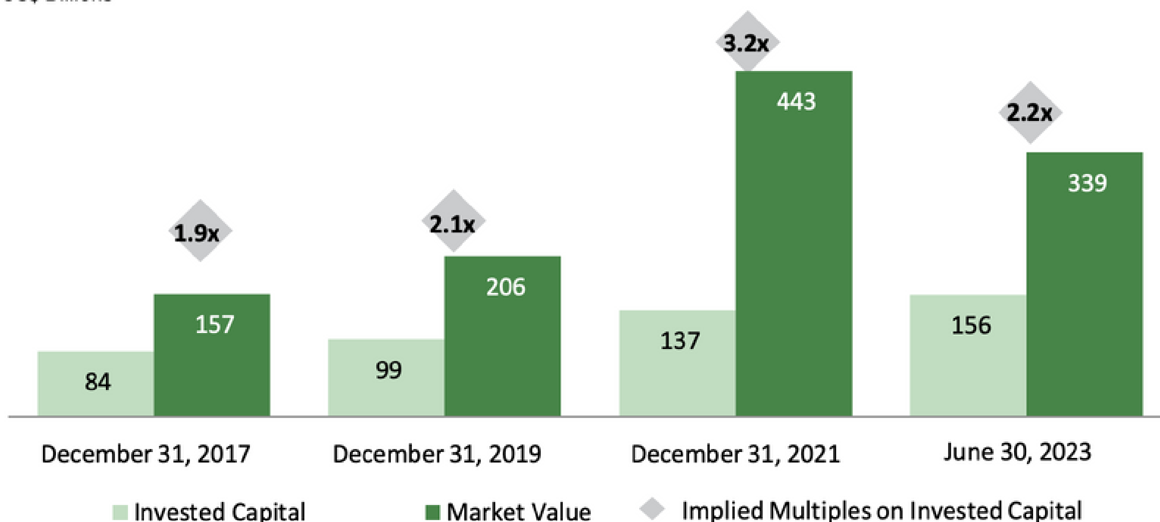
Data as at March 31, 2023. Source: Federal Reserve Board, Preqin, KKR Global Macro & Asset Allocation analysis.

Takeaway

The economists at KKR happen to have a forecast that aligns with a default peak in ~18 months followed by a recovery, which would bode well for 2024 vintage buyout funds. Our takeaway is more broad, that allocations to private markets should be strategic rather than tactical. Said differently, because managers control how quickly they call down capital, timing private markets is even more difficult than timing public ones. To materially benefit from market timing in this data series, investors would need to forecast a default peak 3 or 4 years out, a tall task when most recent downturns have been relatively sudden. Investors would do well to formulate a desired private allocation, and path towards achieving it, than attempting to wait until the cycle is behind them to allocate to private markets.

Venture Capital

Cambridge Associates' outlook included a good analysis of the ups and downs of the market through COVID, shown below. The lighter green bars represent all the capital invested in US VC funds, while the darker green bars represent those funds' assertion of what the investments are worth. Astute viewers will note the almost twofold increase in capital invested in US venture from 2017 to 2023, lured by strong returns. This is overshadowed though by the almost threefold rise in market values, as at the top of the venture bubble, funds estimated that the companies they owned had grown in value by ~220% since investment.



Takeaway

Most of the venture valuation crunch has already happened. As of June 30th, 2023 venture investors' estimates of the value of their stakes reached a more normal 2.2x from 2021's inflated 3.2x. Even a reversion to 2017 levels of 1.9x implies that over three quarters of the value compression has already occurred. The size of fundraising in 2021-22 means that funds have plenty of dry powder to deploy to promising startups, and the proliferation of AI tools has many excited to allocate more capital in 2024.

Private Credit

Apollo's chartbook has perhaps the simplest graph we show, featuring the yield on loans financing large buyouts in 2023 relative to each of the 15 preceding years. Put simply, looking at the yields in each year shows the talk of a golden age of Private Credit is not misplaced. The Federal Reserve's rapid rate increases and the risk-off bank behavior post SVB collapse have made this a lender's market.

Takeaway

This chart shows just how attractive a starting point private credit is in right now, making current vintages robust to marginal increases in defaults or Fed rate cuts. We think it actually understates the pricing power of private credit providers at the lower end of the middle market, who have benefited more from the pullback of smaller banks than the largest private credit providers. Taken together with Golub's latest report showing robust performance from middle-market firms, we are believers in the effectiveness of smaller private credit shops on a risk-adjusted basis.

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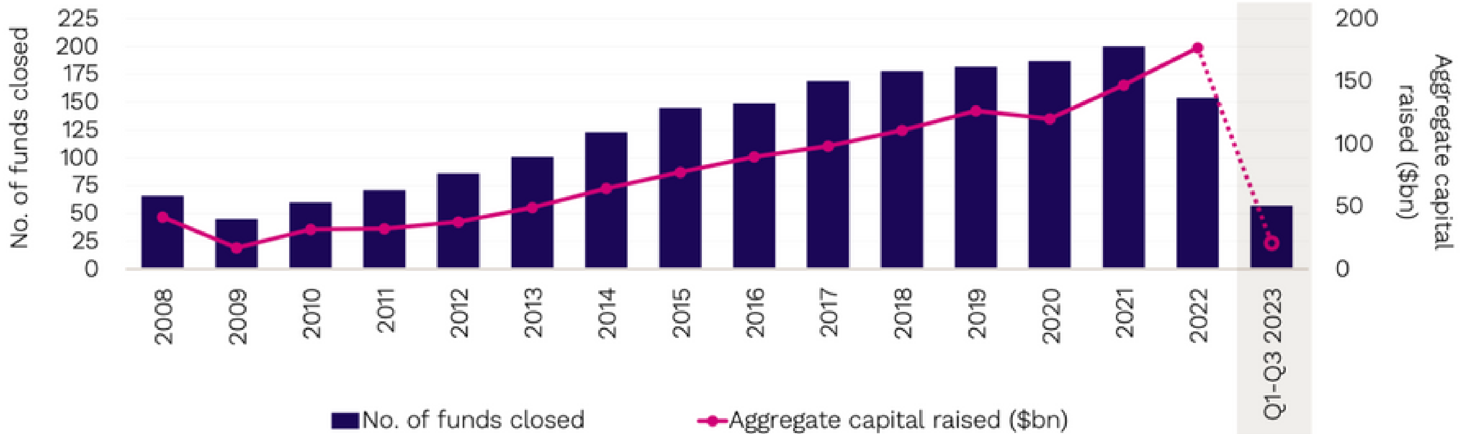
Real Assets

Preqin's shortened outlook (the full version is reserved for dues-paying members) is heavy on fundraising figures, and by far the most striking graphic was in infrastructure, shown below. The navy bars show the number of private infrastructure funds closed each year, while the pink line shows the total amount of capital raised. Either way you slice it 2023 was a brutal year. Through three quarters the dollars raised were down 88% from 2022 and over 80% from the 5 year average. Some of this decline in dollars is likely down to the closure of a few mega-funds in 2022 that have not quickly reopened, but Preqin also cites "growing concerns about performance gaps with public benchmarks" as a reason for trepidation on additional infrastructure funding.

Fig. 6.1: Stark contrast in fundraising after 2022

Unlisted infrastructure funds closed by primary geographic focus



Source: Preqin Pro

Takeaway

Investors have voted with their feet on infrastructure in 2023, and we do not expect infrastructure mega-funds to come back into vogue in 2024. The successful closure of a few funds on smaller dollars points to the importance of niche strategies in 2024.

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