The Pendulum Has Swung:

Why Private Investors Will Outperform Institutions in Private Equity

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Private equity has long been one of the most exclusive and difficult to access asset classes. High investment minimums, long fund terms, future capital commitments, etc., all meant that only the biggest institutions, with the longest investment horizons, were invited to the table.

In addition, with the growing popularity of the asset class, managers have become even more selective with their investor base. Prestigious institutions had access to the best funds, but private investors rarely made the cut.

However, more recently, certain issues have begun to surface that could change these dynamics and allow newer investors – private investors in particular – to benefit the most.

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Managers Seek New Investors

Following several years of record fundraising activity for PE firms, fundraising activity has since slowed considerably.

Of course, the macro backdrop – inflation, slower economic outlook, Russia-Ukraine war, etc. – has played a big role. This uncertainty, alongside higher interest rates, has caused many institutions to pull back from making new investments to riskier strategies, including private equity.

In contrast to 2021, when institutions were clamouring to get into funds, many of these investors have gone to the sidelines and/or are focusing on alternative strategies, such as private credit.

▼45%
Funds Closed
2022 v. 2021

For managers that were getting accustomed to raising ever bigger funds and turning away interested investors once they hit their hard caps, this can be a rude awakening.

Suddenly, they need to rebuild a large portion of their investor base. Many are turning to individual investors, and wealth management firms, to fill the gap left by the drop in demand from institutions.

Source: Pitchbook, 2022 Annual US PE Breakdown

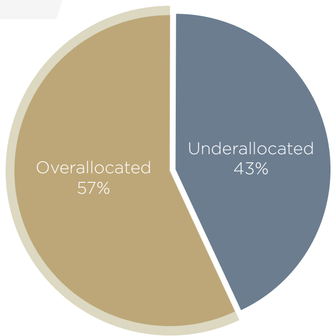
Institutions Have Too Much Private Equity

Following the strong outperformance of private equity in the years leading up to late-2021 (numerator effect) and the dramatic drop in value of other asset classes in 2022 (denominator effect), the asset allocation imbalance for many is now considerable.

By Overbay's estimate, 57% of institutions are overweight private equity relative to their target asset allocation. This represents ~$1.1 trillion in excess private equity exposure.

In addition, as the macro picture has deteriorated, private equity exits have slowed and many institutions are struggling with less cash coming from their portfolios. This has made their allocation imbalance even more pronounced.

Institutions - PE Exposure vs. Target Allocation*



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* Overbay estimate based on Preqin data..

Secondary Funds to The Rescue

Secondaries will be the private equity strategy that will benefit from this overallocation. Secondary funds purchase mature private equity fund commitments from investors that want or need liquidity. Typically these transactions are completed at a discount to the funds' reported value.

As more and more institutions face immediate pressure to sell, secondary funds are positioned to buy higher quality private equity funds and/or pay lower prices for such assets.

This, in turn, affords secondary fund investors an opportunity to buy into private equity at compelling valuations.

Unlike institutional investors, private investors have both the appetite and the capital availability to increase their private equity exposure. This puts private investors in the fortunate position of ramping up their private equity programs, just as many institutions are trying to reduce theirs.

In addition, secondary funds offer distinct benefits that come from buying more mature funds – namely, they can provide instant diversification and they can dramatically shorten investment duration. On balance, secondary funds tend to be much better suited to the risk tolerance and time horizon of most private investors.

Winners in 2023: Private Investors + Secondary Funds

Private equity has long favoured the biggest and most prestigious institutional investors, but times have changed. While the fundraising environment is proving difficult for private equity managers and institutions are looking to pull back from PE, there is a tremendous opportunity for individual investors.

The opportunity is two-fold: first, these dynamics allow private investors access to better quality funds as they are being raised (primary investing); and second, and perhaps more excitingly, these investors can take advantage of the dislocations in the private equity asset class by investing through secondary funds.

The Pendulum Has Swung Learn how Overbay delivers the benefit of private equity, while mitigating many of its shortfalls.

We offer secondary funds in innovative structures, designed for multi-family offices, OCIOs and private investors.

Speak with our team

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The following summary is subject to the express provisions of the applicable securities laws, regulations and rules, and reference is made thereto for the complete text of such provisions. Such provisions may contain limitations and statutory defences not described here on which the issuer and other applicable parties may rely. Purchasers should refer to the applicable provisions of the securities legislation of their province for the particulars of these rights or consult with a legal advisor.

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This right of action is subject to the following limitations: (a) no action shall be commenced to enforce these rights more than: (i) in the case of an action for rescission, 180 days after the date of the transaction that gave rise to the cause of action; or (ii) in the case of an action, other than an action for rescission, the earlier of: (A) 180 days after the plaintiff first had knowledge of the facts giving rise to the cause of action, or (B) three years after the date of the transaction that gave rise to the cause of action; (b) a person or company shall not be liable where the person or company proves that the purchaser had knowledge of the misrepresentation; (c) the amount recoverable under the above provisions shall not exceed the price at which the securities were offered under the document; and (d) in an action for damages, the defendant is not liable for all or any part of the damages that the defendant proves do not represent the depreciation in value of the security as a result of the misrepresentation.

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