

Private Take

When I graduated college and started my career 40 years ago, there were only a handful of private equity funds over \$1 billion. The opportunity for them was clear: buy small- to mid-sized companies that were under-managed, run them better and sell them for a higher price. With equity often being less than 20 percent of the capital structure, even relatively modest increases in enterprise value could produce extraordinary returns to investors.

Recently, there has been a sense of pessimism creeping into conversations about private markets due to higher interest rates, bigger required equity contributions and the recent relative outperformance of the large public market indexes compared with PE median returns.

Even with this more challenging backdrop, I do not believe that PE is entering its twilight. Rather, it is coming of age. Over my time in the industry, the fundamental business model has not really changed – however, given these challenges, the most successful PE firms will have to rely even more on their ability to make significant strategic and operating improvements in businesses to generate strong investor returns.

I believe the best PE firms understand this and are already investing heavily in the resources, expertise and infrastructure that will benefit their portfolio companies and give them significant advantages over non-private equity-backed companies.

The role of private markets

I would argue that allocations to private markets are becoming an increasingly core part of any investment portfolio, both for diversification and attractive potential returns. Private markets have traditionally given investors greater access to small and mid-cap companies underrepresented in public markets; this is still true today. However, one of the biggest changes in PE since I started my career is that some of the largest and most consequential companies in the world can remain privately funded for decades, rendering them entirely inaccessible to public market investors.

The pipeline of mega-cap IPO candidates shows how far this shift has gone. These businesses create billions, or sometimes even trillions, of dollars of value for their private shareholders, reaching strategic importance and enormous financial scale long before public shareholders have an opportunity to invest in them. Public markets still matter enormously, but we believe the centre of gravity for company formation and growth has moved to the private markets. Investors who are not participating in private markets simply will not have access to these opportunities.

Said differently, private markets have evolved beyond their traditional role as a staging post for companies on their way to the public stock markets, and have become the main arena where major companies are built, financed and scaled.



Private capital's coming of age

Manager selection is becoming increasingly critical as private capital enters the next phase of its life, writes

Anthony Tutrone, global head of
Neuberger Private Markets

Public vs private

It is true that some of the public indices have outperformed PE median returns over recent years. However, for the most part, this outperformance has not been driven by poor performance of PE, but by the extremely strong performance of a narrow group of companies in larger public indexes related to the AI trade. Given this, most analysts are projecting more subdued returns for these public indices going forward.

The S&P 500 has become highly concentrated, with the top 10 companies representing nearly 40 percent of the index's value – up from just 16 percent in 2016. The top five stocks alone drove half of the index's year-to-date performance. That is not diversified market beta; that is a bet on a handful of mega-cap technology names.

Strip that concentration out, and you see something else: for example, if you compare European buyout funds against European public indices (which don't carry the same mega-cap distortion), you see that median PE returns have outperformed the public indices. What's more, even with the recent strong returns of indices like the S&P 500, public indices



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were still outperformed by first-quartile PE. This brings us to my next point: manager selection matters in private markets.

The environment in which private markets operate is evolving. PE firms can no longer rely on cheap debt and multiple expansion to generate high returns. Firms built for that world will struggle; meanwhile, firms that have deep industry expertise and real operational and strategic capabilities will lead the next era.

As the asset class matures, average exposure will increasingly deliver average, unremarkable outcomes. The dispersion between the best-performing managers and mediocre ones will continue to grow, making manager selection paramount for investors.

What about AI?

Much has been made of AI's potential to disrupt private markets, and software-focused investors in particular. These concerns are valid, but I believe the best PE firms are investing in AI resources and expertise to not only successfully navigate these risks, but to use these resources to give their portfolio companies significant advantages over their competitors. In a recent survey of Neuberger's GP partners, 90 percent said their portfolio companies were meeting or exceeding AI-driven efficiency targets, and 71 percent said the same for AI-driven revenue growth.

PE sponsors can leverage large investments in AI resources across their portfolios – a capability that we believe could give their portfolio companies advantages over their competitors, especially in small and mid-market companies that could not afford to build these resources on their own.

All this suggests the private capital growth story will likely continue as it moves into a more demanding, more differentiated and, ultimately, more interesting phase where we believe PE firms and investors willing to do the harder work of building real value-creating capabilities will be rewarded.

As I've already stated, manager selection is now more critical than it has been at any point in the industry's history. The firms that will define the next era of private capital are those that can create genuine value inside portfolio companies, manage liquidity intelligently across market cycles, deploy AI effectively rather than superficially, educate a new generation of investors honestly about what to expect, and stay disciplined precisely when capital is flooding into the asset class.

Private capital is not heading into retirement: it is entering the next stage of its career. It is more mature and more accountable, but with even greater opportunities ahead.

The industry may be a long way from where it started, but in many respects, it is still only halfway there. And as in any career, who you choose to work with will matter more than ever. ■

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