Private Markets: The New Traditional Asset Class

WHITE PAPER

How private and public markets have changed roles in financing the real economy and what this means for the future

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PARTNERS GROUP

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Important information

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Introduction

For generations, public markets have been the beating heart of capitalism, reaching their zenith in the latter part of 20th Century, when stock markets in Wall Street, the City of London, Hong Kong, and others were the great centers of capital raising, corporate investment and growth.

Out of that financing model emerged the industrial giants – from the Ford Motor Company to General Electric and, later on, the likes of Microsoft and Amazon.

These companies were the foundations of the modern economy, providing the infrastructure of society as well as the products and services that provided security and quality of life and drove the global economy.

Today, we are in the midst of a profound change. Many of the great industrial groups forged over the past 100 years are still cornerstones of public markets and can offer great value to investors and to society. But where are the foundations of the future economy being built? Where is the new engine room for creating value? The answer is private markets.

While public markets have become dazzled by the IPOs of high-profile but unprofitable companies, private markets are hard at work – investing in assets, in growth and in building businesses.

This is a shift we believe is not well documented. The purpose of this paper is to demonstrate that this transformation is real and that it represents a significant opportunity.

In the following pages, we will examine the hard evidence found in market data, analyze the trends in capital formation and describe the perception and psychology of investment shaping the future economy.

And, of course, we will examine what this profound change means for both investors and for private markets firms.

A guide to reading this paper

Our approach in this paper has been to examine the historical trend step by step – describing the developments of the recent past that have brought us to the current moment, analyzing how those trends will continue and, finally, providing our vision for investment in this changed world.

Importantly, the aim of this paper is not to demonstrate that private markets outperform public markets – though that is typically the case – and explain how. Our previous White Paper, *The Rise of Governance Correctness: How public markets have lost entrepreneurial ground to private equity*[1], explores in more detail how superior governance in private markets is the key to that outperformance.

1 Meister, S. & Palkhiwala, R., 2018. The rise of Corporate Correctness - How public markets have lost entrepreneurial ground to private equity. Partners Group.

Chapter 1: Changing Places

Our first chapter looks at how the roles of public and private markets are switching. Once, the corporate IPO was the sign of a mature business coming to market, offering investment in a growing and profitable enterprise with a long-term strategy. In contrast, private markets were the venue for opportunistic transactions and speculation. In our view, these roles have now reversed.

Today's high-profile public market IPOs are often young and unprofitable businesses – upstarts that may or may not prove successful. Meanwhile, private markets have increasingly turned their attention to profitable, established businesses. Leverage is no longer the dominant force in transactions and private markets investment horizons have lengthened. This chapter examines the causes of this shift and explains why it is set to continue.

Chapter 2: The 'Foundations' and the 'Spotlight'

Psychology and perception are crucial factors in this role reversal. No two companies or transactions are alike, but we have identified two types of business that represent the opposite ends of a spectrum – foundational and spotlight companies.

As their name suggests, foundational companies are those that provide the bedrock of the economy. They deliver the products, services, and infrastructure that are essential to society. They are typically rich in assets, both tangible and intangible, while barriers to entry are high and workforces are usually skilled. Often unseen by the consumer, they remain nonetheless an essential part of people's lives.

In contrast, spotlight companies are higher profile and, as the term suggests, are 'in the spotlight'. They mostly operate under the glare of public attention and are sometimes described as 'disruptors' or 'challengers'. They are often perceived as 'sexy' businesses.

There is value in both types of business, and many companies are a mixture of the two. But rather than taking a 'bet' on spotlight businesses, we argue the more significant opportunities for long-term value creation – and especially the opportunity to build scale – lie increasingly in foundational businesses, as these represent the activities that underpin our current and future economy.

Chapter 3: The Fabric of the Economy

This chapter looks at two specific types of assets: infrastructure and real estate. Both are model examples of foundational businesses/assets – they keep the lights on, the water flowing, and provide factories, warehouses, offices, shops, and homes.

Both these sectors have traditionally been regarded as relatively lower risk and lower return. In the 20th Century, infrastructure was often state-operated. Most infrastructure has passed into private ownership and both infrastructure and real estate are facing new challenges – not least that of adapting to climate change. Both these sectors require transformational investment, either in new climate-friendly energy capacity, new technological innovation or, in the case of real estate, major renovation and renewal.

The withdrawal of state actors from much of the developed world's infrastructure, and public markets' increased focus on spotlight investments, means this task of transforming infrastructure and real estate will increasingly fall to private markets. This responsibility and opportunity reflect how private markets have become stewards of the future economy.

Chapter 4: Capital Formation

This section examines how the trends already outlined can be seen in the hard numbers. Fundraising by private markets has been rising since the turn of the millennium. In 2016, capital raising by private markets overtook public market equity issuance and has continued to do so ever since.

Surveys of institutional investors show that the trend will accelerate toward 2030 and retail investors are also showing a rising appetite for private markets. Regulation of both retail investors and pension funds is widely expected to adapt to this demand and so release further capital for private markets investment.

Chapter 5: Active and Passive Private Markets Capital

The fundamental shift described in the preceding chapters will drive an equally important change among private markets firms, especially because the rising significance of private markets will see new entrants to the market, including major established financial groups looking to benefit from this growing segment.

This chapter examines how private markets firms will need to differentiate themselves in a growing but also more crowded market. Naturally, private markets firms will distinguish themselves by their offerings, cost structures and client service, but most importantly they must become differentiated by their approach to investment.

Active and passive investment are familiar terms in public markets. A similar distinction will be key to the differentiation between private markets practitioners; some will be more passive, while others more active. But in private markets this distinction will mean something quite different. In public markets, an 'active investor' is a stock-picker who targets outperformance by choosing the right stocks at the right time.

In private markets, being active means far more. Active private markets firms are those that roll up their sleeves and truly engage with their portfolio companies – analyzing, guiding, strategizing, and transforming businesses.

"Active private markets firms are those that roll up their sleeves and truly engage with their portfolio companies – analyzing, guiding, strategizing, and transforming businesses."

Chapter 6: Business Building

This chapter investigates potential models for how active private markets firms should operate. With a parent holding group and multiple portfolio companies, private markets firms are beginning to resemble a diversified industrial group.

While there are clear differences between the two models, active private markets groups can learn valuable lessons from the conglomerate model – both positive and negative.

Success will involve leveraging the positives of the conglomerate model – shared resources, strategic vision, applying proven business building techniques or playbooks, using scale and brand to attract talent, and driving excellence in operations across the portfolio.

At the same time, private markets firms are well-equipped to avoid the pitfalls which many conglomerates have succumbed to, such as over-centralized control, cross-subsiding of businesses, and hubristic chief executives.

Chapter 7: Transformational Investing

Transformational investing is built upon two pillars: thematic investing, which seeks to identify the sectors and individual businesses that are best placed to benefit from the transformative trends that are driving change in our economy, and entrepreneurship at scale, which aims to provide governance structures and approaches that will empower portfolio businesses to create value and realize their full potential.

This chapter looks at what these two pillars mean in practice, how the lessons identified in the previous chapter apply to these approaches and how the crucially important dimension of environmental, social and governance (ESG) is built into the investment process.

Chapter 8: The Investor Perspective

Institutional investors are already aware of the growing role of private markets as illustrated by their rising allocations to private markets. Retail investors are also showing an increasing interest in private markets.

In this final chapter, we look at how we expect regulation to evolve to allow a broader spectrum of investors to access private markets and align their investments with the foundations of economic growth.

Alongside changes in regulation that will enable the democratization of private markets, we also expect the allocation strategies of large institutional investors to evolve and become more sophisticated.

While today private markets are typically grouped per asset class in investor portfolios, we expect to see increasing differentiation between allocations to active and passive private markets investing.

Overall, we believe the rate of allocation will exceed current expectations, as the role of private markets in the foundations of the economy becomes ever clearer to investors of all types.

Chapter 1

Changing Places

How public and private markets are swapping roles

The financing of business has undergone a major transformation over the past decades. At one time, IPOs were the pinnacle of corporate development – a signal that a business had proven its value and truly come of age.

Today, this no longer appears to be the case. The companies that come to public markets are not necessarily mature businesses, often they are young companies, driven by opportunism, hope, and speculation. These are essential characteristics for a young business, but they are not the traditional territory of IPO financing.

Meanwhile, private markets have also shifted their attention. Once known as a venue for opportunism and event-driven strategies, creating returns through buying, dismantling and selling assets, private markets have increasingly turned to financing mature enterprises, building businesses, and creating value through organic growth and operational excellence.

Public and private markets have swapped roles. This trend has been underway since at least the turn of the millennium and is now reflected in the landscape of both public and private markets. The IPO market is dominated by young, low-profit or even loss-making businesses. Their potential may be great, but that potential is often yet to be realized.

Private markets, on the other hand, are mostly supporting established and profitable businesses – companies and assets that provide core products and services to the wider economy. These changing roles have been accompanied by a dramatic growth in private markets activity and in private markets' share of business and asset finance.

Many observers have pointed to the macro-economic environment of the past two decades as significant, having driven a search for yield or security, forcing capital owners to think and invest more creatively. But the transformation of private and public markets has been underway for decades through many different economic environments. We believe this is not a passing phase nor temporary phenomenon; it is a secular change in how business is financed and embedded in the shape of our economies.

We will investigate the causes and patterns of this transformation in Chapter 2. But we will begin here by reflecting on the journey that both private and public markets have taken up to this point.

Opportunism versus investment – how it used to be

In the 1980s, private and public markets had distinct roles. Public equity markets were the home of mature businesses with long heritages, and wide, sometimes global, footprints. Equity markets and the flow of IPOs included companies from every industrial sector, from retailers to heavy industry, and from manufacturers to utilities.

IPOs were typically of well-developed, profitable businesses such as Nike, which had been trading successfully since the 1970s, and which by the 1980s, when it came to market, had grown to become the largest athletic shoe brand in the US.

In the 1980s, even technology companies coming to public markets were assessed on the same criteria as a traditional corporate entity. It is easy to forget that Microsoft came to the public market as a mature business. Immediately before its IPO in 1986, Microsoft's pre-tax profits were 34% of revenues, it had booked an annual net profit of USD 24 million, and it had USD 38 million cash in the bank[2].

In other words, public markets were regarded as a place for companies that were proven enterprises with clear visibility of their potential to deliver bottom-line success. Public markets investment was seen as a tool for strategic growth, raising capital to invest in corporate development and achieve that potential.

In the 1980s, public markets investors expected companies coming to market to have a demonstrable track record of growth, financial stability, and profitability. By these basic criteria, some of the IPOs we see today would quite simply have been unthinkable in the 1980s.

2 Microsoft Corporation, 1986. Prospectus - 2,795,000 shares common stock, s.l.: United States Securities and Exchange Commission.

Private markets were quite different. Private buyouts were niche strategies with an event-driven character and as such were much more opportunistic. Private equity bought up businesses that were undervalued by public markets – often where the stock price for an aggregate business was lower than its sum-of-the-parts valuation and the typical sectoral focus was on consumer and industrial businesses. The other common ingredient of private markets investments in the 1980s was debt. Private markets transactions were typically heavily leveraged, with 80-95% of the capital deployed in private buyouts funded by debt[3].

The other essential role of private markets in the 1980s was in venture capital (VC). Young and start-up companies depended on VC capital in the early stages of their development and, in those days, there was no ability to raise venture capital on public markets. This distinct type of finance developed in parallel with the rest of private markets. Private markets were the only way in which a young and potentially innovative company could invest, develop market share, and bridge the gap between the early days of loss-making to (hopefully) eventual profitability.

The VC market has long since been highly professionalized. Commonly seen as a speculative activity, successful VC finance has, in truth, long been immersed in operational detail and analysis. These differences between public and private markets were also reflected in the typical investors in each respective market. IPOs attracted the deep pockets of institutional money or the largest family offices. Private

3 Partners Group research (2023). Figures shown are for buyouts and exclude venture capital transactions.

markets were the realm of more adventurous private offices and high-net-worth individuals (HNWIs). There were also a handful of progressive institutions such as certain banks and a number of universities that pioneered the so-called 'endowment model', most notably David Swensen, manager of the university endowment fund at Yale in the 1980s[4]. Aside from such progressive investors, mainstream traditional financial institutions were largely absent in private markets, where the culture

4 Wigglesworth, R., Kasumov, A., 2021. David Swensen, the Yale pioneer who reshaped investing. Financial Times.

IPOs and private markets investments in the late 20th Century

Public markets in the 1980s: Nike IPO[5]

Founded in 1964 as Blue Ribbon Sports, a distributor for the Japanese athletic shoe market, Nike rebranded in 1971 with the launch of its first line of footwear using the Swoosh. The company leveraged the fitness boom of the 1970s and grew its revenues to USD 70 million by 1977.

After a successful expansion to Europe in 1978, Nike gained further scale and reported revenues of USD 270 million in 1980, generating a gross profit of USD 73 million. While the company had net assets of USD 111 million, it recorded only USD 29 million of equity. To finance the long-term growth of the company and maintain its ability to invest in new production sites, Nike was required to strengthen its balance sheet with additional equity capital.

In December 1980, as an established company with a successful track record and almost 17 years of operations, with a reputable and well-recognized brand and occupying a market share of c.50% in the growing US athletic shoe market, Nike went public on the NASDAQ.

Private markets in the 1980s: Safeway[6]

In 1986, Safeway was the largest global food retailer, operating 2,365 stores and employing 164,385 personnel in the US, Canada, and the UK. After years of deteriorating financial performance and a hostile takeover attempt by the Haft family, private equity firm KKR sensed an opportunity to acquire Safeway in a leveraged buyout (LBO) transaction. Offering an attractive management package and a c.49% premium to the share price, the investor was able to complete the public-to-private transaction, which was structured as a two-tiered LBO with a cash tender offer for the controlling stake, and an exchange of high-yield bonds and warrants for the remaining shares.

The transaction amounted to total funds of USD 4.9 billion, of which only USD 130 million was equity (3%), with debt financing arranged for the remainder (97%). In the three years following the buyout, the new owner closed unprofitable stores and divested operations for cash proceeds of USD 2.4 billion. Safeway went public again in 1990 in what would become a successful opportunistic buyout of a slow-growth and undervalued, but resilient, consumer staples company.

5 Knight, P., 2016. Shoe Dog: A Memoir by the Creator of Nike. s.l.:Simon & Schuster. Nike, 1981. Annual Report.
6 United States General Accounting Office, 1991. Leveraged Buyouts - Case Studies of Selected Leveraged Buyouts, Washington D.C.: United States General Accounting Office.

was typified by opportunistic investments and a willingness to accept high levels of leverage. In the 1980s, private equity truly was 'alternative'.

While all transactions are unique, the broad pattern of the 1980s is clear. Public market financings were more commonly in profitable, asset-rich businesses that were creating tangible products or core services. Private markets were typified by ailing businesses, ripe for break-up with the application of leverage rather than growth, or investment in young businesses that might (or might not) perform. Targets for buyouts were mostly in the consumer or industrial sectors.

Turn of the millennium and a turning of the tide

The role reversal of public and private markets began to take hold in the late 1990s and accelerated in the 2000s as the typical strategies of public and private markets came closer together. Private markets began to institutionalize their investment processes and move away from opportunism towards being an institutionalized alternative asset class.

Public markets, however, developed an appetite for 'hype' companies: businesses that were generating almost feverish excitement, and with that excitement the scale of the valuation arbitrage available in public markets grew rapidly. The depth of the capital available in public markets would typically lead to higher valuations, especially for unproven and unprofitable business models.

The hype became a self-fulfilling cycle. Higher appetites for hyped IPOs increased the valuation arbitrage. In turn, that valuation arbitrage fueled the appetite for opportunism. The result was that public market IPOs began to creep into the space previously dominated by venture and growth capital.

"The role reversal of public and private markets began in the late 1990s as the typical strategies of each came closer together."

The rising appetite in public markets for opportunism and arbitrage was inextricably linked to technology companies. The firms that typified the millennium tech bubble were not established, profitable companies, as Microsoft was when it came to market in 1986. The tech firms of the millennium were typically young, unproven businesses – big on (perceived) innovation, but short on profits.

Back in the 1980s, such companies were model examples of businesses in need of VC, but by the turn of the millennium they were seen as companies in need of an IPO.

As a result, the risk-reward profile of IPOs began to change. While a few of the millennial tech firms proved highly successful, such as PayPal, most, including the likes of Worldcom and Pets.com, failed.

Venture capitalists, meanwhile, found that the new market for opportunistic IPOs allowed them to monetize early-stage companies far earlier, as public markets were willing to take on the risk of financing young, loss-making companies. Public markets' rising appetite for risk in effect reduced the risk involved in VC compared to the 1980s and early 1990s. This also enabled the VC industry to grow substantially around the turn of the millennium.

While public markets got carried away by their opportunism, private markets were shaking off their speculative reputation. Private equity firms began to shift their attention from underperforming or undervalued assets and event-driven strategies to buy-outs of more solid and promising companies.

Opportunism continued, but it did so alongside longer term strategies and investment for growth. From an initial focus on consumer and industrial businesses, private markets also broadened their investment universe, reaching into new sectors, including technology, media, financial services, and healthcare.

In parallel, numerous studies by industry groups or academics have highlighted the historic outperforming returns that have been delivered by private markets[7]. With these

7 Harris R., Jenkinson T., Kaplan S., 2012. Private Equity Performance: What Do We Know? National Bureau of Economic Research.

Regulation – a catalyst for change

The turn of the millennium saw another change in the financial market environment – expanding regulation. A series of scandals in the early 2000s raised questions about corporate transparency and governance. The collapse of Enron and the ensuing scandal surrounding Arthur Andersen, the accounting scandal at Worldcom and the bursting of the dotcom bubble, all prompted a major reappraisal of regulations.

In the wake of these scandals, a degree of regulatory soul searching was inevitable. The result, however, was to accelerate the transformation of both public and private markets.

The key regulatory change was the US Sarbanes-Oxley Act (SOX). Some provisions of SOX applied to private businesses, but the most onerous of its effects fell on public companies. Directors of public market businesses were faced with a swathe of new responsibilities, including accepting criminal liability for signing off corporate accounts. Directors and auditing firms were required to assess, report on, and certify all internal financial controls. Off-balance sheet items came under scrutiny and any such instruments or vehicles material to the company had to be made public.

While SOX was a US law, its reach extended beyond US borders. Many major corporates in other jurisdictions were also traded on a US exchange – usually through a depository receipt. This brought those companies under the purview of SOX.

SOX was a major regulatory development and it was echoed globally as various stock exchanges instituted their own regulatory changes to toughen up disclosure requirements. Accountancy regulations were reviewed, and the role and process of auditing came under scrutiny.

This regulatory flurry was also part of a wider effect – the emergence of corporate 'governance correctness'. This phenomenon, which we examined in detail in our previous historic returns in mind, and often based on advice from investment consultants, institutional investors began to adopt allocation strategies that included a small but meaningful percentage allocation to private markets. Indeed, the world's biggest institutional investors have steadily increased their allocations to the asset class. In the seven largest pension markets in the world (Australia, Canada, Japan, the Netherlands, Switzerland, the UK, and the US), pension fund allocations to alternative assets in 1980 were negligible; by 2000, they had risen to 7%[8].

8 Willis Towers Watson, 2022. Global Pension Assets Study 2021.

The combination of these effects was that private markets have gradually become a more institutionalized asset class, although they are still regarded by most as an 'alternative' asset class.

All these changes to the respective roles of public and private markets were also reflected in leverage. By the 2000s, private investments were becoming less debt-fueled and, during the first decade of this century, debt often accounted for about half to just above two-thirds of private buyout capital[9].

9 Partners Group research (2023). Figures shown are for buyouts and exclude venture capital transactions.

White Paper, *The Rise of Governance Correctness: How public markets have lost entrepreneurial ground to private equity*, saw major corporates swept up in a culture of 'codes' and 'best-practice' guides. While doubtless with the best of intentions, too many boardrooms switched to focusing their attention on ticking the correct boxes, and so became distracted from the task of creating value and fostering entrepreneurialism.

As well as creating an administrative burden and a distraction for management, SOX and the wider regulatory agenda in public markets has added further to the costs of being a public company. Along with other factors, this financial burden has significantly eroded the appeal of a public market listing to businesses, tipping the scales still further towards private markets and accelerating the role-reversal already underway. It is also not altogether clear if regulation in public markets has achieved as much as might have been hoped.

Ironically, this flurry of regulatory interventions and the new governance culture of the early 2000s did not stop Lehman Brothers from using off-balance sheet accounting to hide the scale of its banking book[10]. But they did significantly reduce the attractiveness of public markets, particularly for mid-sized businesses. The relatively easy access to capital that had previously made public markets appear attractive to such companies now had to be offset against the cost and discomfort of SOX and other regulations[11].

For mid-sized businesses that needed to raise funds, but had no other strategic reason to go public, there was even more incentive to look to private markets.

10 Bushee, B., Siegel, J. & Herring, R., 2010. Lehman's Demise and Repo 105: No Accounting for Deception, s.l.: Knowledge at Wharton.
11 Kaserer, C., Mettler, A. & Obernberger, S., 2008. The impact of the Sarbanes-Oxley act on the cost of going public, Munich: Center for Entrepreneurial and Financial Studies (CEFS).

The role reversal is almost complete

Today, the roles of public and private markets fundraising have almost completely reversed from those in the 1980s. When it comes to raising new capital, public markets are in the realm of opportunistic IPOs, while private markets are in the realm of real economy investment and strategic growth planning.

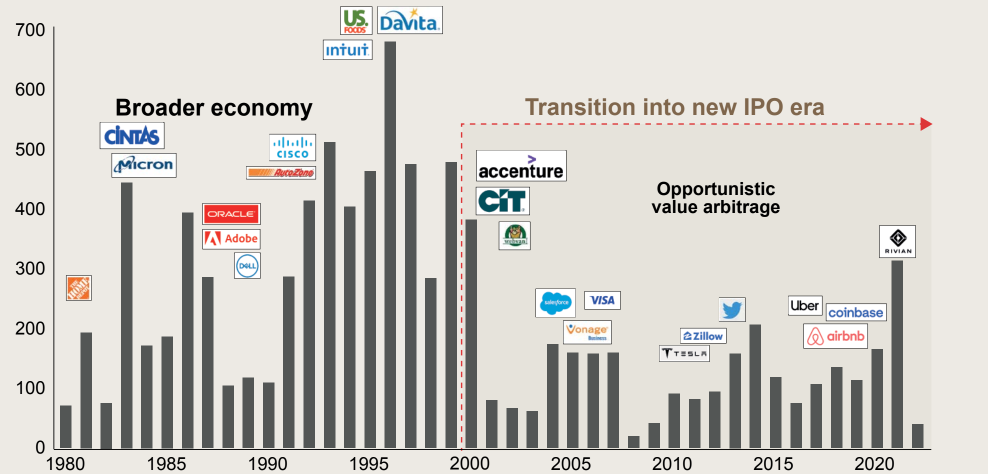
Of course, public markets are still home to large and profitable corporate groups – the likes of Nestlé or Unilever, for example. However, these groups represent the past success of public markets and regarding them as reflective of the current role of public markets is like looking in the rear-view mirror to assess the road ahead. The most relevant role of financing markets is in raising new capital for businesses building their future success; looking at public markets from this perspective, we see a quite different story.

Public offerings over the past 20 years have been dominated by 'hype assets.' Companies coming to public equity markets are often loss-making and public markets are fascinated by technology, by high-profile businesses and founders, and by the potential for speculative and outsized growth.

The changing role of IPOs can also be seen in the number of businesses coming to public markets. As the graph below on the number of IPOs between 1980 and 2022 shows, the absolute number of IPOs has risen and fallen with market cycles, but there has been a clear downward trend since the turn of the millennium.

The same period has seen a flurry of mergers between publicly listed companies and, of course, a growing number of public-to-private transactions. A study by Morgan Stanley in 2020 found that the number of public compa-

NUMBER OF IPOs, 1980-2022[12]



Includes IPOs with an offer price of at least USD 5, excluding ADRs, UTRS, closed-end funds, REITs, natural resource limited partnerships small best efforts offers, banks and S&Ls and stocks not listed on CRSP.

12 Ritter, J. R., 2023. IPOs: Updated Statistics, Gainesville: Warrington College of Business, University of Florida.

nies in the US had halved since 1996[13].

Meanwhile, the type of companies that are coming to public markets have changed. In the 1980s and 1990s, IPOs were still dominated by profitable, asset-rich companies.

Since the millennium, asset-light, low-profit or loss-making businesses have become more prominent. And in 2020-21, traditional businesses – such as consumer-facing companies, healthcare, or industrial assets – accounted for just 26% of US IPOs. Ironically, 89%[14] of those more traditional company IPOs were of businesses previously owned or financed by private markets firms.

The most remarkable example of the success of speculative businesses in IPO markets is the rise of Special Purpose Acquisition Companies (SPACs) – listed vehicles with no assets, a vaguely defined initial growth strategy and, naturally, no earnings. SPACs are, however, a recent phenomenon and are not the cause of the long-running trend we are describing. Their rise

13 Mauboussin, M. J. & Callahan, D., 2022. Public to Private Equity in the United States: A Long-Term Look, s.l.: Morgan Stanley Investment Management.

14 S&P CapitalIQ, 2021. Figures shown represent IPOs from 2020 to 2021.

The rise and fall of SPACs

SPACs epitomize the transformation of public markets from a venue for long-term investment in growth, to one of speculation and intangibility. The number of SPACs has surged over the past few years in the absence of more traditional IPO offerings. In some cases, SPACs have helped fill investor demand for IPOs, whilst also offering the opportunity to use regulatory arbitrage to gain access to private markets investments through listed vehicles. Looking back over the first decade of this century, the number of IPOs by SPACS on US public markets was modest.

As a proportion of all public issuances, the year with the most SPAC IPOs in the early 2000s was 2007, when they accounted for 13% of funds raised on US public markets. It was not until much more recently that SPACs really gained prominence. In 2021, they accounted for almost half (49%) of all capital raised[15].

The SPAC bubble is now unwinding. The AXS De-Spac ETF (a fund based on listed companies that went public through a merger with a SPAC) fell by almost 75% in 2022. Meanwhile, many SPACs have liquidated after their window for making an acquisition passed.

The liquidations are set to continue. Around 300 SPACs with USD 700 billion in trust face deadlines to invest in the first half of 2023[16].

Naturally, one would expect that the rise of SPACs would lead to a fall in the overall profitability of companies coming to market. But the decline in profitability among IPOs is much greater than can be attributed to SPACs alone. SPACs are not included in the graph on the percentage of IPO-ed companies in the US with positive earnings on page 16.

15 PwC, 2022. Global IPO Watch.
16 Coben, C. & Fischer, H., 2023. The special purpose acquisition company fallout is going to be SPAC-tacular, s.l.: Financial Times.

is just a visible symptom of the much deeper change that has taken over public markets.

The change we have witnessed in public markets has not happened at a consistent rate. The dotcom bubble saw a drop in profitable IPOs and, on the eve of the Great Financial Crisis, the profitability of IPO-ed firms was better. But these are acute moments and should not confuse our view of the clear downward trend in IPO company profitability, which has been underway for the past three decades.

Looking through the inevitable ups and downs of economic and market cycles, the structural change has been clear to see. While public markets have turned away from profitability as a vital feature for IPOs, VC and growth investing has always represented about a third of private markets activities, but the focus has remained primarily on profitable companies. Furthermore, transactions up to a value of around USD 10 billion, which covers the vast majority of all businesses and assets in this world, can typically be financed by private markets, so there is simply no need for IPOs at that scale.

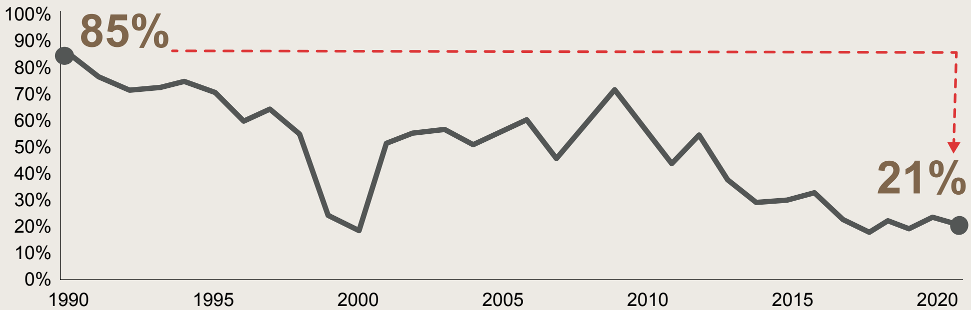
At the same time, private markets have turned away from the dominant use of debt in capital structures. Leverage is still a valuable tool for private markets, but is no longer the defining feature, and leverage in today's private markets buyouts is typically less than 50%[17].

There is a further development in understanding what is driving the private markets and that is the growing recognition from company founders, owners and management that their own interests are not necessarily served by an IPO. The IPO was seen as the pay-off – the moment when owners and managers monetized the value they had created.

Some still think in these terms, but there is also an increasing understanding of how private equity can provide a superior return to management, by longer term and incremental value creation. Private markets offer management a stake in the future that can be far more valuable than a speculative IPO payday.

17 Partners Group research (2023). Figures shown are for buyouts and exclude venture capital transactions.

PERCENTAGE OF IPO-ED COMPANIES IN THE US WITH POSITIVE EARNINGS[18]



18 Ritter, J. R., 2023. Initial Public Offerings: Updated Statistics, Gainesville: Warrington College of Business, University of Florida.

IPOs and private markets transactions in the 21st Century

Rivian IPO (2021)[19]

Founded in 2009, Rivian is a company striving to develop a next-generation electric truck. After delivering its first pickup to a customer in September 2021, Rivian went public on the NASDAQ two months later. In an opportunistic, valuation arbitrage-driven move, the company generated proceeds of USD 12 billion in what would become the largest US IPO since 2014 and the largest global IPO in 2021. For fiscal year 2021, Rivian reported total revenues of USD 55 million and a loss of USD 465 million[20].

Yet Rivian's shares surged 53% in its trading debut, closing nearly 30% above the offering price. After its first trading day, Rivian was valued at USD 106 billion, making the company the second most valuable US automotive OEM after Tesla (USD 1.06 trillion), ahead of both General Motors (USD 86 billion) and Ford (USD 66 billion).

In 2021, Rivian produced a mere 1,015 vehicles, 920 of which were delivered to customers. Meanwhile, General Motors delivered more than 2.2 million vehicles to customers in 2021, including over 750,000 trucks[21]. Rivian increased its production in 2022 and was able to deliver 20,332 vehicles to customers, which, however, is still only a fraction of the 2.3 million vehicles delivered by General Motors.

Foncia acquisition and re-underwriting (2016 and 2021)[22]

In 2016, Partners Group led a consortium that acquired Foncia, the leading French provider of residential property management services. At the time of the acquisition, the company operated a network of over 500 branches and managed a portfolio of properties across Central Europe, employing more than 8,000 people and generating annual revenues of approximately EUR 700 million.

Partners Group applied its playbook transformational ownership approach to growing the company. It started by setting up a strong board and management team to lead the company in its next phase of growth. Together with the management team, it heavily invested in making Foncia a best-in-class industry leader in digital operations, increasing efficiency in what had historically been a highly manual, paper-based industry. This was a case in which digitization represented a real overhaul and transformation of operations. With this setup, Foncia was able to focus on building out its platform, further accelerating the consolidation of the French property services market. By 2021, it had grown to 12,000 employees and 600 branches, generating sales of EUR 1.25 billion. That year, following five years of transformational growth, Partners Group expanded Foncia's shareholder base, selling a 25% stake to TA Associates.

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19 Rivian Automotive, 2021. Filed pursuant to Rule 424(b)(4), s.l.: United States Securities and Exchange Commission.
20 Rivian Automotive, 2022. Q4 2021 Shareholder Letter.
21 General Motors, 2022. Refers to Chevrolet Silverado and GMC Sierra LD and HD.
22 Partners Group portfolio company.

This growing understanding is also reflected in the psychology of owners and managers. As much as it was a financial transaction, an IPO was once regarded as the ultimate validation – a very public proof of success. As private markets have advanced in their sophistication, their scale and their profile, winning the backing of a leading private markets firm such as Partners Group is seen as a comparable success.

Thirty years ago, entrepreneurs typically dreamed of the day they would IPO. Today, they are just as likely to want a phone call from a leading private equity firm.

Private markets have become long-term oriented and for many private markets firms, including Partners Group, investment activities are centered on operational value creation, and on building large teams of operators with deep industry knowledge and the relevant experience to steer their portfolio companies strategically. Approaches to valuations have become more consistent and professional, with valuations typically reviewed and audited on at least a yearly basis. There is also a large and highly professional secondary market that has developed over the years.

The largest private markets firms have become like corporations and many have themselves listed on public markets, either due to their size, or, in a supreme final irony, because public markets offer them a higher valuation.

If we look today at the typical IPOs that dominate public markets and the transactions being led by private markets firms, we can see that the role swap between public and private markets is now almost complete.

Macroeconomics is not the determining factor

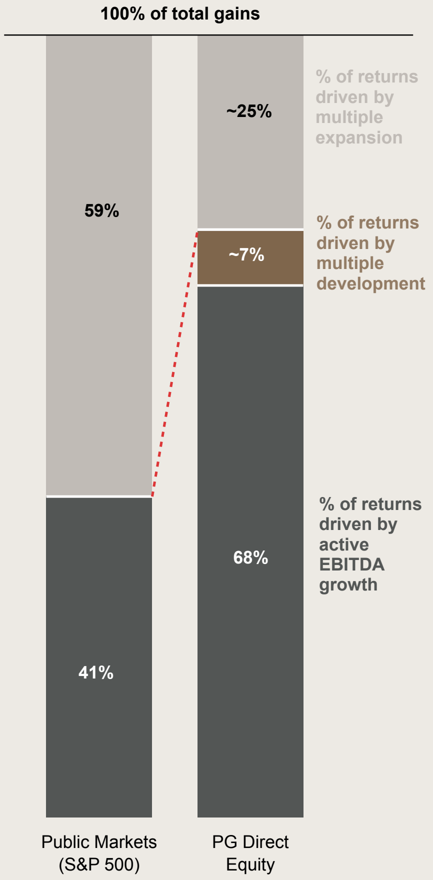
The macroeconomic environment plays a crucial role in the cycles of both public and private markets, and some observers attribute the shift from public to private markets to cyclical macroeconomic effects. This would be wrong. The transformation reflects a change in attitudes to value and risk in these markets.

Leverage has declined in private markets transactions, from an average of more than 90% in the 1980s to today's average of usually less than 50%. This has occurred despite a historically low interest rate environment over the past two decades, particularly in the ten years to 2022.

The speculative nature of IPOs has risen with a far wider valuation arbitrage. This was underway even before the turn of the millennium and first came to prominence in the late 1990s dotcom boom.

Earnings multiples in public markets have risen and stayed high and the dotcom bubble was an extreme and early sign of this trend. Multiples have fallen back since the dotcom bubble burst, and were trimmed again after the Great Financial Crisis, but the long-term picture is still clear. Up to 2021, the trend rate of P/E ratios on the S&P 500 was still higher than its rolling average in the 1980s. In fact, while the environment – in particular lower rates – has helped most asset classes perform well over the past decade, public markets may have been among the biggest beneficiaries of this trend. Over the ten years to 2021, multiple expansion in public markets

PRIVATE MARKETS DRIVE OUTPERFORMANCE THROUGH ACTIVE EBITDA GROWTH VS VALUATION CHANGE



Source: Partners Group research (2023). Data for period December 2011-December 2021. Based on index gains, and not reflecting that PG Direct Equity has outperformed.

has been much higher relative to earnings growth than in the private markets industry.

At the time of writing this White Paper, we are about 12 months into a more volatile environment characterized by rising interest rates, higher inflation and lower economic growth prospects. Looking forward, it appears very likely that this more challenging macroeconomic environment will continue to slow down all global financing activities and dampen returns, in both public and private markets.

Amid this more challenging environment, some observers have warned that private markets are particularly exposed and that we are at the end of the era for buyouts. We disagree, not least because we have heard this tale before. Such predictions were heard in 2000 after the strong rise in technology media and telecoms buyouts, when private markets were valued at about USD 1 trillion. No such bust took place and a decade later private markets had tripled in size to about USD 3 trillion. And again, after the Great Financial Crisis, it was predicted that private markets had peaked. Since then, private markets have more than tripled again to USD 10 trillion.

The predictions of decline were wrong then, and we believe that they are wrong now.

“After the Great Financial Crisis, it was predicted that private markets had peaked. Since then, private markets have more than tripled again to USD 10 trillion.”

As we have seen in previous downturns, we believe that private markets will continue, on a relative basis, to outperform public markets and a more difficult market environment will not reverse the trend we have been describing, but rather the contrary.

This trend has been sustained over a prolonged period, from 1990 to 2022. The path has not been smooth, but the direction of travel is clear. The switching of roles between public and private markets is not cyclical; it is a structural change that has been underway for the past 30 years.

Financing the real economy

The relevance of the role reversal between public and private markets to the wider economy is far more profound than simply the ups and downs of the cycle.

IPOs were once a bellwether for financing in the wider economy, while private markets were the domain of financial engineering and the quick flip, and appropriately classified as an 'alternative' investment. Today, private markets have evolved to fill a mainstream place in investor allocations as a significant means of investing into the real economy. Meanwhile, IPO markets have increasingly become home to much more speculative investments.

As these roles have reversed, so have the respective roles of public and private markets in the wider economic structure. Public markets transactions are often examples of opportunism, while private markets have become the custodians of the economy's foundations.

Chapter 2

The 'Foundations' and the 'Spotlight'

Perceptions of value in public and private markets

In Chapter 1, we described the changing roles of public and private markets. But what does this new world of public and private markets look like? Each transaction is, of course, unique, but if we take a step back, there is a broad yet clear trend in the types of company that characterize public market IPOs and private markets transactions. The key to this distinction lies in the psychology of these markets and in their participants' perceptions of value.

Psychology and perception are not the kind of terms typically used in the financing of business, but we believe they are crucial factors in understanding how the roles of public and private markets have reversed in financing economic activities.

To explain further, we need to introduce two new definitions: foundational businesses and spotlight businesses. It is important to state at the outset that our distinction between spotlight and foundational companies is not a rigid definition with hard boundaries, and we recognize that it is a broad generalization.

While bearing this caveat in mind, we believe the foundation versus spotlight distinction is a valuable generalization to help understand the psychology and perception of value that has reshaped public and private markets.

Foundational companies

Foundational companies represent the infrastructure and core products and services of a modern economy, they manufacture its tangible products from food to pharmaceuticals, and from critical machinery to packaging. They provide essential or everyday services and processes. These companies often have clearly identifiable assets, from infrastructure to plants and machinery. Importantly, though, it is

"We believe the foundation versus spotlight distinction is a valuable generalization to help understand the psychology and perception of value that has reshaped public and private markets."

not only about tangible assets or more ‘traditional’ businesses; critical processes and services are also foundational.

Many services, technology and software businesses, for example, which have become highly embedded in B2B environments, also have strong foundational characteristics. Regardless of sector, foundational companies are often significant investors in their workforce, building skills and a strong corporate culture, and many invest significantly in research and development.

Many foundational businesses are invisible to the consumer, operating in the background, in specialist fields and in B2B markets. To today’s public markets, some of these foundational companies can also appear fairly mundane, being focused on the day-to-day provision of materials, products or services. But these are activities vital to the wider economy. Wastewater treatment operators, transport infrastructure, healthcare, education, manufacturing, software providers, contract research organizations, and countless others are examples of foundational businesses.

It is important to recognize that while some of these critical processes and services have been part of our ecosystems for a long time, they are no less a part of the future economy. They are entwined with the leading edge of digital technology, with digital technology itself having become core to the economy.

Foundational businesses also have another characteristic – they typically operate in markets where the barriers to entry for new competitors or market disruptors are high.

Foundational case study: USIC[23]

In 2017, Partners Group acquired USIC, a company that specializes in locating pipes and cables for utility customers across the US and Canada ahead of underground excavation works. At the time, the company employed a workforce of 7,500 technicians, performing 76 million locates a year, using the company’s infrastructure, its fleet of more than 9,000 vehicles and substantial equipment.

USIC performs a non-discretionary service and operates in a resilient yet structurally growing market with high barriers to entry and significant platform economies of scale. Partners Group’s operational value creation approach focused on the truly foundational elements of the company, transforming USIC into a technology-enabled platform, using software to optimize technician journey planning. Moreover, through targeted stakeholder impact initiatives – which we will touch upon later in this White Paper – and company culture programs, USIC significantly improved customer satisfaction and reduced staff turnover.

In August 2022, after a near doubling in EBITDA since its investment, Partners Group decided to expand USIC’s investor base, selling a 50% stake to Kohlberg & Company.

23 Partners Group portfolio company.

Spotlight companies

Spotlight companies are frequently focused on end-consumer products or services, rather than the manufacture of products or skilled services. Last-mile distribution or platform businesses, which link the consumer to foundational products or service providers, are typical examples of spotlight companies.

The value of a spotlight business often lies in intangibles and presentational effects, such as reputation and brand, as well as in its network effects. Intellectual property (IP) can be key to spotlight businesses, and often, the IP owned by a spotlight company is described as 'leading edge'. This can be a positive term, but it can also mean an IP that is commercially unproven or has yet to embed itself as an essential aspect of consumers' lives.

The vast and intangible asset known as data capital also falls into this category. That data covering the tastes, attitude and behavioral patterns of consumers might be valuable is without doubt, but much of the information currently being amassed in burgeoning data centers is not yet being used. It is an asset waiting for an application.

Spotlight companies are often associated with terms like 'disruptor' or 'challenger', and their strategies aspire to be 'game-changers'. In short, they are 'sexy'.

Spotlight companies play an important role in fast-moving developed economies and can have significant financial value. Many of the most successful companies of the 1980s and 1990s had spotlight characteristics. We have already mentioned Nike, which was propelled to success partly by its consumer-facing brand and high-fashion profile. However, the spotlight companies of the past were also typically underpinned by foundational qualities, such a manufacturing capability or deep and established supply chains.

Today, there is a growing number of spotlight companies that lack foundational qualities. They are still exciting and potentially valuable; they may still have many qualities of dynamism and innovation, and some of them will eventually realize their full potential and become great creators of value. But, in their early stages, such companies are more exposed to the vicissitudes of consumer confidence, to rapidly evolving technology and to potential challenges from the next upstart operator.

Such new upstarts pose a greater threat precisely because many spotlight companies operate in markets in which barriers to entry are much lower than is the case with foundational businesses.

"Public markets transactions have changed over the last few decades and are now more likely to place a premium value on spotlight businesses."

Spotlight case study: DoorDash[24]

In January 2013, four Stanford University students founded DoorDash, a mobile app-based, online food ordering and delivery platform.

In November 2020, after recording a net loss of USD 149 million in the first nine months of the year, DoorDash went public on the NASDAQ, generating proceeds of USD 3.4 billion.

The share price closed 86% up on the first trading day, valuing the company at USD 60 billion, or almost four times the valuation at the last financing round five months earlier.

While DoorDash is an extremely popular brand that is very well known by consumers – it was named the most popular e-grocery brand in the US, with an 81%[25] brand awareness in a September 2021 survey – the business fundamentals look less solid.

DoorDash has not yet recorded positive EBITDA for any fiscal year and, at the time of writing, was forecast by analysts to just nudge into profitability on a full-year basis in 2022.

The company does not have any meaningful assets nor a sustainable competitive advantage from IP. Investor capital flowing into the food delivery sector bets on a social network-like ‘winner takes all’ market structure, which may or may not happen.

24 Doordash, Inc., 2020. Form S-1 Registration Statement, Washington D.C.: United States Securities and Exchange Commission.
25 Spryker, 2022. US Online Grocery Report.

A vibrant, growing, and innovative economy will and must contain both spotlight and foundational businesses. And it is also worth repeating that this is not a rigid distinction and not all businesses fall cleanly into one camp or the other. But however hard the boundaries are to draw and however blurred the distinction becomes in specific cases, there is no denying the importance of this psychological dimension to market attitudes and to the perception of value.

Public markets transactions have changed over the last few decades and are now more likely to place a premium value on spotlight businesses. Foundational businesses are less likely to attract this premium and so have increasingly been drawn towards, and become more attractive to, private markets. We will explain in the following sections why we see this difference in approaches to valuations.

First, however, we should address the relationship between technology and other innovators and spotlight characteristics. A casual glance at our distinction between spotlight and foundational companies might leave the impression that we regard head-line-making tech firms as always being ‘spotlight businesses’. In our view, this is not the case.

Companies that are real tech innovators may have spotlight elements to their profile, but they will also represent a more significant development: a genuine advance that changes something about the foundation of their industry or even the wider economy. Such companies are also likely to have a culture that is constantly pursuing the next genuine innovation.

Big Tech – from spotlight to foundational

Not only is the boundary between foundational and spotlight companies sometimes hard to define, but it is also permeable. As companies change and develop, their foundational and spotlight characteristics can evolve too. Google/Alphabet and Amazon are examples of spotlight companies that have become increasingly foundational.

Both groups began as virtual platforms that very rapidly developed an extremely high public profile and disrupted markets. Profits were scarce and, in their early years, these businesses often ran at a considerable loss.

Each of these companies has its own story, but both are notable for how they have developed foundational features. One obvious development of this kind is data centers, which have become so foundational in the modern economy that they are considered infrastructure assets. Another is the development or acquisition of IP and research and development facilities, and, in the case of Amazon, warehouses and a logistics network. More prosaically, Amazon shifted into consumer products with the Kindle, while Google has also made forays into hardware with watches and with research and development into cars.

Why spotlight companies attract higher valuations in public markets

Following the rise of Big Tech, public markets have sought to replicate the 'winner takes all' success of companies like Amazon or Alphabet, throwing their capital support behind platform-based, data-rich, asset-light companies in the hope they too might achieve a quasi-monopoly competitive position.

Examples of this phenomenon include the ride-hailing, food delivery, and streaming industries, in which investors are willing to endure extremely high cash burn with limited visibility on the path towards significant profitability. The hope among investors in these businesses is that once competitors are crowded out, these companies will occupy a self-reinforcing leadership position. For many of these new spotlight companies, however, this investment thesis has not yet materialized.

While new entrants have benefited at least until recently from an abundance of speculative capital to acquire market share, competition is often fierce. Doubtless one or more of these spotlight platform companies will eventually emerge as winners. The difficulty is working out which one that will be.

Investments in these businesses are symptomatic of a much deeper trend that we believe has taken hold of public markets investors. The perceived value of spotlight companies that have increasingly dominated public markets transactions has driven demand from investors and pushed valuations ever higher. This leads some public markets investors to assume that successful businesses in the new economy will mostly be spotlight companies. We are of the view that this assumption is wrong.

Contrary to what many public markets investors may think, it is foundational

"The perceived value of spotlight companies that have increasingly dominated public markets transactions has driven demand from investors and pushed valuations ever higher."

companies that will be the more essential contributor to and component of the future economy. Over time, some spotlight companies might be able to develop foundational characteristics themselves. However, what is increasingly common is that spotlight companies exist as part of a smaller ecosystem of businesses. They sit on the top of a pyramid of other businesses that provide the foundations on which they depend – without those foundations, they would simply be unable to exist. The food value chain provides a vivid example of this structure.

Spotlight and foundational companies in the food value chain

The modern food value chain is one of the many theme clusters that Partners Group has researched extensively as part of its thematic investing approach. We will return to the subject of thematic investing later in this White Paper, but for now we will focus on the food value chain as an example of where we can see the foundation-spotlight story at work.

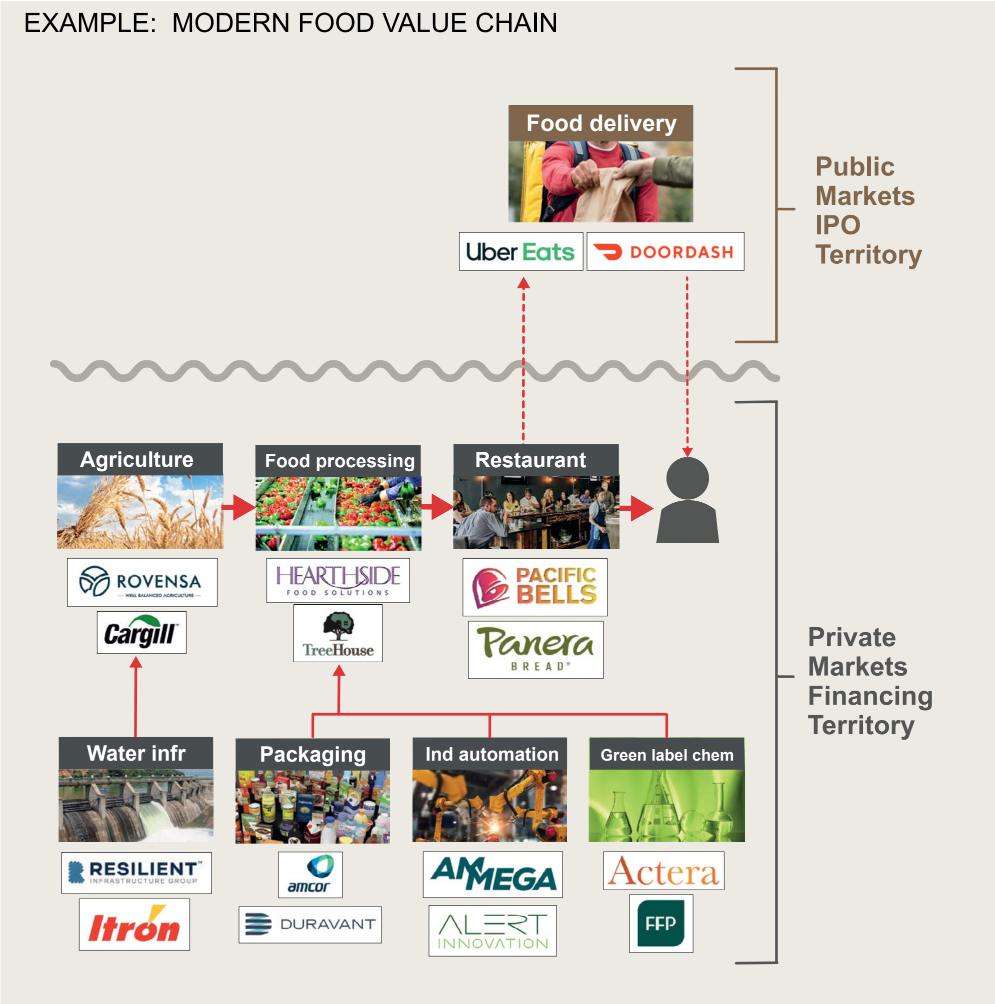
There are several groups in the food sector that combine both foundational and spotlight characteristics. Significantly, they are typically long-standing global corporates, whose establishment and critical period of growth predates the recent trends in financing discussed so far.

The global food group Nestlé is one such example, combining a portfolio of high-profile consumer-facing brands, where there is a perpetual need to sustain market share and brand value, and defend itself against challengers. However, Nestlé also has substantial manufacturing operations and deep roots in commodity markets, supply chains and agricultural production.

Nestlé and a small number of other groups with a similar depth and breadth are still public market companies, and represent the heritage of public markets in building such businesses.

However, the principal activity in public markets is no longer in bringing established companies with these foundational elements to market. The combination of both foundational and spotlight aspects that can still be found in Nestlé and other similar groups is rare. Instead, these various aspects are now typically separated in the food value chain. The modern food value chain in our current and future economy, which is where our investment focus should always lie, is already taking on a radically different shape.

A key factor has been the growth in outsourcing the foundational aspects of the business. The extraction and harvesting of



input commodities, the processing and packaging of finished products, and the logistics of distribution are rarely found in younger and next-generation consumer-facing food businesses and are completely absent in the last-mile food delivery companies that have come to be such a dominant feature of public market offerings.

Without going into too much specific detail, in the above illustration, which is highly simplified, we can see that the modern food value chain is divided into several broad sub-sectors. At the root of the food value chain lie extractive and infrastructure elements, the most basic being water infrastructure as well as agricultural production. Moving up, we encounter food processing, which in turn draws on foundational industries such as industrial automation, packaging, and other sectors. Through supply chain logistics, we reach supermarkets and restaurants. All these companies typically have very foundational characteristics – they manufacture, they own assets, and they provide essential services to other foundational companies. Importantly, these businesses are all very modern, driven by the forces underpinning today's economy, including digitization and automation, new consumer preferences and sustainability. Yet, most of these businesses are financed by private markets, unless their extraordinary scale demands public markets ownership.

As we move through the value chain towards the consumer, we enter the realm of spotlight companies; most notably companies such as DoorDash, UberEATS, and Grubhub. These are the companies with those 'sexy' characteristics valued by public markets – they are brand and reputation-driven, fast-moving, low on tangible assets, but often non-profitmaking.

So, looking at the modern food value chain and its related activities, we see a strong ecosystem of numerous foundational businesses performing highly specialized functions within the chain. Then, a handful of spotlight companies sitting on top of the pyramid. If we look at the ownership model of these companies, while there are some exceptions, the overall pattern is clear.

Many of the spotlight companies in the food value chain are listed in public markets, often following spectacular IPOs (and previous rounds of VC financing). Whereas the more foundational businesses within the chain are mostly owned by private markets firms, despite being modern, sustainable businesses focused on fulfilling the needs of our future economy.

"The foundational activities that will underpin the next generation of economic activities will increasingly be found in private markets."

Why is this the case? The answer is simple. With enterprise values in the order of magnitude of a few billion dollars, these foundational businesses can easily be financed by private markets. Their strengths and foundational aspects are very much appreciated and valued by private markets investors. On the other hand, in the absence of typical spotlight company ingredients, such as a well-recognized, consumer-facing brand, the public versus private markets valuation arbitrage is not worth it for these assets. In other words, public and private markets would likely value them at similar levels. And so, as the governance of private markets ownership is generally preferred by owners and management teams, these businesses are happy to stay private.

One example that illustrates this well is Partners Group portfolio company Rovensa, a modern biological product provider to the agriculture industry, which sits at the very root of the modern food value chain.

Case study: Rovensa[26]

Founded in 1926, Portuguese agricultural solutions group Rovensa is firmly embedded in the foundations of the food value chain. The company provides specialty crop nutrition, biocontrol, and protection products, and is committed to research and development in all these fields. It specializes in formulating sustainable products which reduce the environmental impact of agriculture and support the cultivation of healthy food. Its products are sold in more than 70 countries and generate an annual revenue of approximately EUR 360 million.

The group has long been supported by private markets investment and was acquired by Partners Group in 2020 with a vision to transform the business into a global leader in bio-solutions for the agriculture industry. It is a private markets investor, in this case Partners Group that recognizes the value in a foundational food value chain business.

Rovensa had no need to take the IPO route to attract investment, especially with the governance burdens that a public listing imposes and in an environment in which foundational businesses do not benefit from the public market valuation arbitrage in comparison with spotlight companies.

26 Partners Group portfolio company.

Foundational businesses will build the future economy

Looking at the example of the food value chain what becomes apparent is that the majority of economic activity is actually represented by foundational companies, rather than by the spotlight companies we might hear about more often in the news. In fact, the food value chain is not an example in isolation – what is true for the food value chain is also true across many of the other modern investment theme clusters Partners Group looks at. Across themes such as selfcare and fulfilment, industrial automation, best-of-breed software, and business efficiency services, to name a few, we see time and again that foundational companies represent the bulk of economic activity and are typically held in private markets. In contrast, spotlight companies only represent the tip of the iceberg and tend to be listed on public markets. In short, in our view, the idea that spotlight companies pursuing IPOs are the ones that will most shape our future economy is simply wrong.

Why is this so relevant?

While there are still many legacy foundational firms in public markets, due to the developments we have been describing, today, the financing of foundational activities primarily takes place in private markets. This means the foundational activities that will underpin the next generation of economic activities will increasingly be found in private markets. At the same time, the scale of private markets has expanded significantly and the industry can today finance all but the largest corporate enterprises and assets. In the decades to come, private markets will therefore take on an even larger role as the steward of our global economy.

In other words, the current role reversal between public and private markets in financing the real economy is not where this stops. There is a good chance that this development will accentuate further, with private markets becoming even more relevant for our future economic development.

Chapter 3

The Fabric of the Economy

Infrastructure and real estate are also foundational assets

The trends we have outlined so far extend beyond the corporate world and can be seen in the wider realm of markets and in what are typically called 'real assets' – notably infrastructure and real estate. These two sectors are quintessentially foundational. Factories, offices, homes, utilities, transport systems, and infrastructure such as health and education facilities are the bedrock of the economy and of society. Without these assets, there would be no current or future economy.

Infrastructure and real estate are not only deeply foundational sectors, but they are also both ripe for transformation to keep pace with the needs of our future economy. Due to the transformational changes facing these sectors, their needs can no longer be regarded as asset financing. These sectors are now the focus of strategic investment and, as such, they represent huge opportunities for value creation.

In the past, strategic investment in these areas, particularly infrastructure, fell into the domain of the public sector. Today, state actors no longer have the capacity to address all of the challenges inherent in these sectors, while public markets often lack the appetite for such investments. The task, and the opportunity, to finance and manage the transformations required will increasingly be taken up in private markets.

Infrastructure is undergoing a transformation

While in the past most infrastructure was typically government-owned for an extended period of time, since the 1970s, in many developed economies, a range of infrastructure or quasi-infrastructure businesses moved from the public to the private sector. Nationalized transport systems, energy generators and distributors, and telecoms groups were privatized. Some assets were privatized in sales

"Infrastructure and real estate are not only deeply foundational sectors, but they are also both ripe for transformation to keep pace with the needs of our future economy."

Foundational vs spotlight dynamics of telco privatizations

After 1984, most of the largest economies in Europe privatized their state-owned telecoms operators. The UK led the trend with the public market sale of just over 50% of British Telecom (now BT). Subsequent sell-offs eventually reduced the UK government's stake to zero.

Similarly, Gruppo TIM, formerly known as Telecom Italia, was created in July 1994 through the merger of several government-owned telecommunications companies. Meanwhile, Orange (formerly known as France Telecom) after becoming autonomous in 1990 was privatized at the beginning of 1998, though the government retained a 27% stake.

This wave of privatizations and the opening of previously state-run monopolies to market competition has been followed by another type of 'privatization' in which the assets of utilities have found their way into private markets.

Again, the telecoms sector provides a clear case study as European telcos have started to divest their infrastructure such as fiber networks ('fibercos') and telecom towers ('towercos').

For example, in 2012, in attempting to initiate a transformation towards a less asset-heavy business with a strategic focus on the consumer service business, France's Bouygues Telecom decided to carve out its tower portfolio in a sale to Antin Infrastructure Partners.

The investor initially took an 85% stake in the newly created company FPS Towers and acquired the remaining 15% in 2015. FPS Towers is the largest independent telecom tower company in France, operating a portfolio of over 2,400 towers and close to 20,000 rooftop terrace sites across the country.

to existing private companies in the same or closely related sectors, but privatizations often took the form of public markets listing, sometimes combined with public share offers.

This first privatization wave has been followed in many cases by a second phase in which some public market infrastructure businesses have chosen to slim down their asset-heavy operations to become more consumer facing. Private markets have been active in buying these assets and, in doing so, forming new private markets-owned foundational companies.

This development once again reflects our general distinction between spotlight and foundational assets. Among privatized utilities, the aspects of the businesses that have tended to remain in public markets have often been the consumer-facing activities, while the aspects that have found their way into private markets ownership have tended to be the foundational operations based around assets, often with quasi-monopolistic characteristics. The European telecoms industry clearly illustrates this trend.

In the past 20 years, the process of introducing private capital to publicly owned real assets and services has shifted, with private markets playing an ever-larger role. This is a trend that is set to accelerate.

"In the past 20 years, the process of introducing private capital to publicly owned real assets and services has shifted, with private markets playing an ever-larger role."

Developed economy governments are facing a challenge as state balance sheets are stretched to breaking point in several countries due to significant expenditure on welfare programs, such as healthcare and pensions. However, this comes at the cost of under-investing in vital physical infrastructure. Technological change and digitization are transforming how infrastructure operates and the commitment by almost all developed economies to reach net zero by 2050 requires huge investment. This includes building renewable energy sources from wind turbines to solar farms, upgrading and digitizing distribution networks, installing electric vehicle charging infrastructure, and much more.

Meanwhile, the infrastructure asset class is undergoing a fundamental transformation. While in the past, funding infrastructure was about providing asset-level financing, today, infrastructure assets often resemble corporate entities. Indeed, business activities in the infrastructure space are increasingly performed by large infrastructure 'platforms'. While these platforms have infrastructure-like characteristics, such as revenues secured by long-term contracts, implicit or explicit inflation protection, a portfolio of owned assets or exclusive service agreements, and high barriers to entry, they are essentially more like businesses than traditional infrastructure assets.

The changing nature of the asset class, combined with the need to invest in infrastructure at a time when government balance sheets are extremely strained, begs the question of who will finance and develop next-generation infrastructure platforms. We believe the task will and should increasingly fall to private markets.

If we look at the types of infrastructure activities needed to support the functioning of our future economy, we see a similar trend to that observed in the world of corporate assets: most of these activities will be performed by foundational assets as opposed to spotlight companies. This is true across a number of key infrastructure themes, including social infrastructure, water infrastructure, critical supply chain infrastructure, communication infrastructure, and energy infrastructure.

As a result, the opportunity to finance the renewal of the infrastructure asset class falls even more squarely to private markets. And given that we are likely facing the largest ever infrastructure (re-) building program in history, the potential for private markets investment in infrastructure will be unparalleled.

Real estate – in need of renewal

Beyond the private ownership of residential houses, real estate has always been a very distinct, or even unique, asset class. Ownership of large-scale residential, office, and other commercial real estate globally has been through a mixture of private and public markets, but the dominant players have been pension funds, other institutional investors, and real estate investment trusts (REITs). Family offices and private family-owned real estate businesses are also a notable presence in this market.

These traditional investors have been the principal owners of existing real estate, relatively passive holders of long-term assets requiring modest ongoing investment to maintain their value, often referred to as 'core' real estate. In contrast, new developments and real estate requiring major renewal or repurposing have been (temporarily) held by a different class of investor – developers, often in collaboration with private markets firms.

This is hugely significant, because renewal, repurposing, and transformation is the key to the real estate market as we head towards a future economy. Buildings have always required maintenance and updating, but real estate now requires a fundamental transformation.

The scale of this challenge is hard to overestimate. Digitization and rising e-commerce penetration is driving demand for last-mile logistics centers near urban cores. In many cases, these warehouses will also need to facilitate the increased use of robotics and automation in delivery processes. Within the residential sector, new living patterns and preferences mean tenants are likely to live alone and seek better amenities. Meanwhile, persistent working from home trends have changed how offices are used, with employers now dedicating more space to collaborative working and wellbeing.

Another aspect of this transformation is the need to future-proof buildings in terms of ESG and sustainability requirements. As much as 27% of the world's greenhouse gas emissions come from the use and operation of buildings, and a further 13%[27] come from current construction processes.

In developed markets, the challenge is even greater. The EU is planning to reduce greenhouse gas emissions by 55%[28] by 2030. With existing building stock responsible for 36%[29] of total greenhouse gas emissions, significant investments in energy efficiency will be unavoidable. The European Commission is aiming to double renovation rates in the next ten years, making 35 million existing buildings energy efficient. To stand any hope of meeting sustainability targets, new developments need to be built as sustainably as possible, and existing real estate needs significant investment in retrofitting. What is more, this is a transformation that must be carried out at speed – the world cannot wait for the natural

27 International Energy Agency, 2022. Global energy process emissions from buildings, including embodied emissions from new construction, 2021, s.l.: International Energy Agency.
28 European Commission, 2023. 2030 Climate Target Plan.
29 European Commission, 2023. In Focus: Energy Efficiency in Buildings.

"The renewal and transformation of real estate assets will be one of the greatest investment programs ever."

turnover of new property development to fix this problem.

The leading real estate asset holders, notably the large pensions funds, are not driven by strategies of business transformation. Many REITs would doubtless reject the suggestion that they are passive investors, but these things are relative. Maintenance and renewal of properties is one thing, the complete transformation of real estate and a willingness to reimagine how this asset class fits into a sustainable and digital economy with completely new consumer preferences requires a far more active strategy than has hitherto been typical among traditional real estate asset owners.

In the coming years, hundreds of billions of dollars of capital will be required to renew properties and make them fit for a future world, and the renewal and transformation of real estate assets will be one of the greatest investment programs ever.

In summary, we have seen how private markets will play a key role in developing the corporate assets of tomorrow given their strengths in financing and developing the modern, foundational businesses that underpin our economies. However, we also see that, if anything, the role of private markets will be even greater in the transformation of real assets that lies ahead of us. Infrastructure and real estate assets need to be transformed and reconfigured to cope with increasing demand, shifting consumer preferences, sustainability priorities, and technological advances. Private markets investment will provide the financing and asset development needed for these transformations, also opening up an unprecedented opportunity for investors.

Chapter 4

Capital Formation

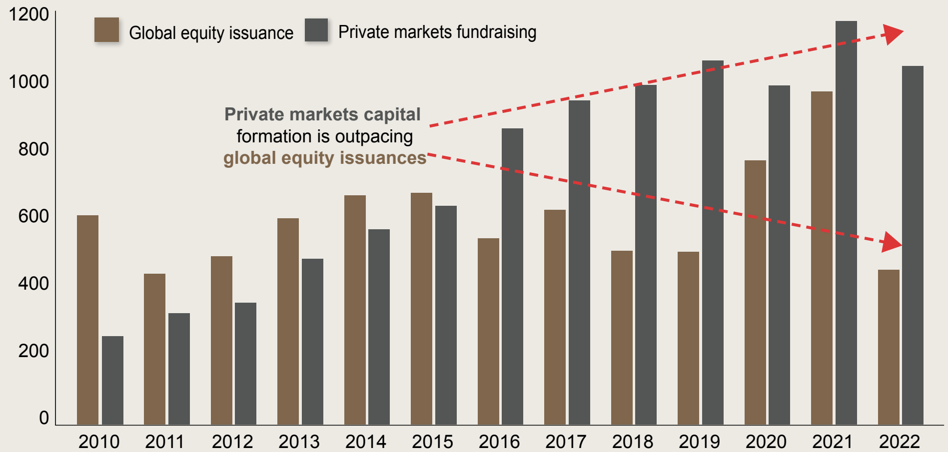
How private markets have overtaken public markets

The switch in roles that has taken place between public and private markets and the analogous developments in real asset finance leads to one natural and inevitable result – a change in the pattern of capital formation.

In the past, it was through the great public markets of the world – Wall Street, London, and Hong Kong – that the vast majority of capital was formed as companies raised money through issuing equity. This is no longer the case. Over the past decade, a major switch has taken place, and today most capital is formed and mobilized not through public markets, but through private markets. The figures speak for themselves.

In 2010, global equity issuance was worth more than twice the funds raised in private markets. As the graph below shows, this commanding lead was slowly eroded until, in 2016, private markets fundraising overtook equity issuance in public markets. Since 2017, annual global fundraising in private markets has approached, and often exceeded, USD 1 trillion.

PUBLIC VS PRIVATE CAPITAL FORMATION (USD BN)[30]



Sources: SIFMA, Dealogic and Preqin.

30 Global equity issuance includes rank eligible, non-convertible IPOs and follow-on equity investments; excludes preferred shares, rights issued, closed-end funds, business development companies, and special purpose acquisition companies. Private markets fundraising includes global private markets across private equity, private real estate, and private infrastructure. Private markets fundraising data: Preqin (dated 24 January 2023); global equity issuance data: Refinitiv (dated 24 January 2023).

Even in 2020, when the global pandemic prompted many private markets players to pause investing, fundraising still nudged the USD 1 trillion mark and exceeded the USD 800 billion or so raised in public markets. As the pandemic waned, private markets surged again, and private equity fundraising reached another all-time high in 2021. In the challenging macroeconomic environment of 2022, private equity fundraising dipped by an estimated 21.5%[31], but still exhibited greater resilience than public markets equity issuance.

While the rate of growth in private markets capital formation has varied through recent crises such as COVID and will doubtless not remain immune to the current turbulence in financial markets, the trend is persistent, and we strongly believe it will continue.

Growth ahead of us?

Private markets assets under management have tripled every decade since 2000, and we expect them to triple again from USD 10 trillion in 2020 to USD 30 trillion during the next market cycle. Let us explain this projection by looking at some of the available data.

A recent survey by private asset research group Preqin predicted that private markets would grow at a compound annual growth rate of 11.9% over the next five years, based on the target allocations of institutional investors. Even though this is a significant dip from the compound annual growth rate of 14.9% observed from 2015 to 2021, it will still add almost another USD 10 trillion in assets[32].

31 Preqin, 2022. Preqin Global Report.
32 Preqin, 2022. Investor Outlook H2 2022.

"Equally significant in terms of added scale, but even more transformational for private markets, is what some might call the 'democratization' of private markets."

Equally significant in terms of added scale, but even more transformational for private markets, is what some might call the 'democratization' of private markets. There are three parts to this: first, a growing interest in private markets within the wealth management segment; second, demand from retail investors; and, third, the potential for increasing allocations from defined contribution (DC) pension funds.

Wealth management firms have been increasing their private markets offerings to clients in recent years, seeking exactly the long-term growth that private markets investment can provide. The total financial wealth of HNWIs currently stands at around USD 86 trillion[33] and even a single-digit percentage increase in their allocations to private markets would be highly significant.

On top of this is the demand for private markets investment from retail investors, who are not blind to the returns available.

33 Capgemini, 2022. World Wealth Report 2022.

Total retail wealth currently stands at an estimated USD 42 trillion[34]. Growth from this segment will be partly dependent upon regulation, but the increasing recognition from governments of the importance of private markets investment provides fair winds for such regulatory evolution.

Another factor that will underpin the rise in allocations to private markets is DC pension fund portfolios. Allocations by DC funds to private markets assets have already risen in leading markets such as Australia. Meanwhile, markets such as the UK and the US are also adjusting their regulatory environment to accommodate the demand from DC funds for private markets investments. Total assets held by DC pension funds globally are now roughly USD 30 trillion[35].

Considering these factors, it seems credible to forecast that the private markets industry might reach a size of USD 30 trillion by the end of the next market cycle.

34 Boston Consulting Group, 2021. Global Asset Management 2021: The $100 Trillion Machine.

35 Aon, 2021. Global Defined Contribution Retirement study.

DC regulation around private markets investment eases

For decades, investments in private markets have been a performance driver for defined benefit (DB) pension plans.

However, despite private markets' academically validated positive contribution to DB returns, they have not yet been widely adopted as a component of an investment strategy for defined contribution (DC) pension plans.

At a point when DC pension plans may soon overtake DB pension plans as the predominant pension system globally[36], the regulatory environment for DC pension plans in the seven largest pension markets in the world (Australia, Canada, Japan, the Netherlands, Switzerland, the UK, and the US) is increasingly being reconsidered, reflecting the positive impact of private markets investments on the long-term returns of pension assets.

In October 2022, in an effort to boost DC plan investments in private markets, the UK Department for Work and Pensions proposed to remove performance-based fees from the current charge cap.

With DC pension assets in the UK expected to double by 2030, officials recognize that investments in private markets "can offer potentially greater returns for pension savers building towards retirement and can have the added benefits of improving the UK economy and society".

Meanwhile, in the US, the Department of Labor has taken the position that "a plan fiduciary of an individual account plan may offer an asset allocation fund with a private equity component", paving the way for the prudent adoption of private markets in DC plans.

36 Aon, 2021. Global Defined Contribution Retirement Study.

"With an estimated total capital value of USD 30 trillion by the end of the next cycle, private markets will be too big to be ignored by any relevant player in the financial services industry."

But this is still not the end of the story. Private markets' emergence as the leader in global capital formation goes hand-in-hand with an equally significant change in how capital will be managed. With an estimated total capital value of USD 30 trillion by the end of the next cycle, private markets will be too big to be ignored by any relevant player in the financial services industry.

Along with the institutional investors already increasing their private markets allocations, investment banks will focus more on private markets activities, which may even become more profitable to them than IPO markets. Traditional asset managers and, as we have discussed, private wealth managers, will also have to consider providing access to private markets if they are to gain exposure for their clients to the opportunity for returns in the future economy.

With this increase in scale, and the distinguishing DNA and investment approaches of the new entrants that will accompany it, we can expect to see private markets develop a greater range of strategies. Just as public markets investment has, over the past 40 years, developed a range of approaches – such as passive and active (or even activist) investment – private markets practitioners will also evolve a variety of different approaches.

Chapter 5

Active and Passive Private Markets Capital

Active private markets firms will develop the future economy

As private markets continue to grow, established financial institutions, such as traditional investment managers, will enhance their investment capabilities in private markets and some entirely new players will enter the industry. This will create a new competitive dynamic, as participants seek to differentiate themselves through the strategies they adopt. Different private markets providers will naturally strive to deliver outperformance against rivals, but will also try to differentiate themselves through factors such as ease of access and level of client service.

Traditional, large money managers entering or significantly expanding their involvement in private markets will have established systems and strategies from public markets investing. Many such participants may well attempt to replicate their models in private markets. But private markets investing is fundamentally different from public markets and one of the key differences lies in the distinction between 'active' and 'passive' investing.

Active and passive investment have well-understood meanings in public markets, but these do not translate straightforwardly into private markets. In fact, in some circumstances, they mean almost the exact opposite.

Active and passive investment in public markets

Passive investment in public markets is typically used to mean buy-and-hold strategies mostly linked to a market index. Some may also apply the term passive to slightly more selective approaches weighted toward certain sectors or geographies, but the essence of the concept remains the same – reduce or eliminate tracking error and replicate an index performance. Such strategies will, if successful, not underperform the market they are tracking, and neither will they exceed it.

Crucially, the passive investor is not event-driven. Their investment strategy is not driven by a search for transactions or for hidden value and growth potential.

In contrast, active investors in public markets are those involved in stock-picking, identifying specific companies where they believe potential is being undervalued and through which they hope to outperform the passive investment funds. However, evidence has been mounting for several years that active strategies show little or no outperformance[37]. Technology and the speed and accessibility of market data have contributed to this decline in active strategy performance as it has simply become harder to find an edge. Active strategies that do outperform are typically operating in niches of public markets that are less efficient, less intermediated, and rarely offer such outperformance at scale. While some outperformance will be due to rare investment talent, a lot stems from chance.

There is also a very small sub-group within active investment, so-called 'activist' investors, who use their holding to encourage events and transactions that they believe will unlock hidden value. Activist investors can often demonstrate outperformance, but whatever the performance, 'activism' is not a strategy that can be applied to a diversified portfolio. Instead, it is a form of event-driven investing, which bears a closer resemblance to the opportunism of early private markets buyouts than to a broad public markets investment strategy.

Introducing active and passive investment in private markets

In private markets today, few people make a distinction between active and passive, and many would simply argue that all private equity investment is active. We disagree.

The original driver of private markets returns was transactions – buying, selling, merging, or breaking up businesses to deliver rapid returns over a two- to five-year period, usually due to some kind of valuation and financing arbitrage. The industry has greatly evolved since then and today most private markets firms pursue a sector-based approach and ask their portfolio company management teams to deploy strategies to develop the operational profitability of their respective businesses. This type of private markets strategy can engender entrepreneurship at portfolio companies by setting stretching KPIs for performance and, in doing so, can create value. But in the context of private markets, we do not regard this as a fully active strategy, as it is still relatively close to the transactional 'Wall Street' approach it evolved from. Yet, some private markets firms take a meaningful step further into what we would call an active private markets strategy.

Truly active investing in private markets today is not about transactions – it is about owner- or governance-driven operational value creation. Active private markets firms are more than just business investors – they are the stewards or even operators of business growth.

While more passive private markets strategies are, in principle, comparable to active public markets strategies given the absence of strong, direct involvement in operational value creation, they are different in many aspects. This includes their longer term focus, as opposed to public markets' narrow focus on quarterly results, and a more entrepreneurial ownership mentality which allows management teams to focus on strategic value creation. Other factors include better

37 Ellis, C. D., 2017. The end of active investing?, s.l.: Financial Times.

alignment of incentive structures between owners, boards, and management teams, which enables portfolio companies to hire higher quality talent, as well as allowing for more flexibility in financing structures.

However, a truly active private markets strategy goes much further to generate superior returns. Active private markets investors aim for long-term outperformance through active value creation and a hands-on investment approach, bringing in their own organization and network to build a better business. This requires vast, specialized in-house resources as well as a strong and extensive network of industry advisors and external talent that can be leveraged to create best-in-class portfolio company boards and management teams. Management teams are not 'left alone', they are actively coached, supported, and led. Return expectations are therefore higher with an aim to generate stronger public market outperformance.

Private markets players will divide between active and passive approaches

Private markets already contain a wide range of different firms and strategies and, as we have described, this differentiation will accelerate as private markets consolidate their position as the custodians of the future economy. This landscape will be a rich and varied spectrum. At one end, there will be private markets firms that remain resolutely passive, being simply holders of assets through consortia structures without any controlling and directing party – a model often seen in core infrastructure assets. At the other end of the spectrum, there will be the truly active private markets firms that create value through entrepreneurship at scale and are more focused on businesses and assets they can develop and build.

Between these two poles there will be a range of firms with different degrees of active governance, various approaches to entrepreneurship, and different client service offerings. But the active and passive dimension will be key.

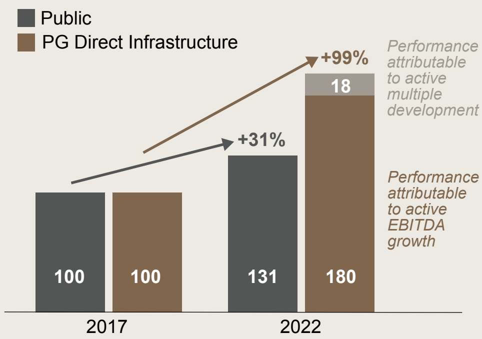
Passive private markets players will be driven by an asset allocation and transaction mindset. By plugging into the flow of transactions as companies come up for sale, they will buy into businesses or sectors based on their allocation targets, sometimes as part of a consortium of buyers. Often the companies targeted by this passive approach will be more established businesses, perhaps even resembling the larger enterprises in public markets; in other words, more 'core'-like businesses. These businesses will be less in need of business building. The aim therefore of passive private markets investors will not

"Active private markets investors aim for long-term outperformance through active value creation and a hands-on investment approach, bringing in their own organization and network to build a better business."

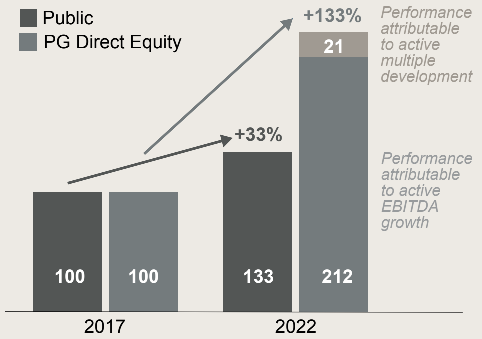
EBITDA-based outperformance through active investing

Partners Group follows an active investing approach across its portfolio, focusing on transforming companies and assets into market leaders through strategic value creation plans. As a result of this approach, our private equity directs portfolio has outperformed public markets over the last five years, delivering returns of 112%[38] from EBITDA growth alone compared to returns of 33% in public markets (see graph below). We also follow this active approach in real assets, with our private infrastructure directs portfolio returning 80% from EBITDA growth over the same period versus 31% for equivalent public markets. These returns from our portfolios do not include active value creation-connected multiple expansion, which would provide a further uplift. They demonstrate how successfully implemented active investing strategies can build businesses over time.

GROWTH-BASED ONLY REAL ASSETS INVESTMENT RETURNS excluding market valuation uplifts



GROWTH-BASED ONLY CORPORATE EQUITY INVESTMENT RETURNS excluding market valuation uplifts



38 For illustrative purposes only. Source: Partners Group research (2023). Public index for corporate equity selected as MSCI World. Public index for infrastructure is selected as a weighted average between S&P Global Infrastructure and Dow Jones Infrastructure Index.

be to actively manage or develop the business in question, but to 'hold' it.

Although we call this passive investing in private markets, it looks very much like the kind of investment strategy that in public markets would be called active. Because of this, in our view, there is a good chance that the outperformance of this particular segment of the private markets asset class compared to public markets will shrink over time.

In contrast, active private markets players will select and invest in companies to develop them. The aim of the active approach will be to build a winning business model in a sector or market. This will require a different scale of resources to the passive approach and the targeted outperformance will come with higher costs. Active investment will also require talent in the private markets company that is focused on business operations rather than simply finance.

Private markets firms with this active approach, such as Partners Group, are no longer 'financial firms', they are business builders and operators. The idea of private markets firms as a type of corporate enterprise is a theme we will expand on in the next chapter.

Governance is key

There are many aspects to the distinctions between active and passive across public and private markets, but the key driver is governance. Crucially, we are not talking about the 'governance correctness' that has, as described previously, dominated public markets boardrooms, but the real entrepreneurial governance of strategic oversight and active engagement.

Public markets, both passive and active, lack this type of real governance.
At best, active public markets investment involves proxy oversight by advisers, but ownership is widely dispersed and shareholders are inevitably distanced from the companies in which they are invested. Without having control of the companies, public markets investors cannot provide the vital governance needed to add value.

Passive private markets investment involves a degree of real governance, with private equity firms often taking controlling board positions. Entrepreneurship, however, is left to the management team.

Active private markets investment though requires fully engaged governance. Only

Active and passive lending

The distinction between active and passive extends into direct lending and other non-lead investment activities. The passive lender is a transaction-taker that will exercise no control, no governance responsibility, and provide no strategic input.

However, an active lender will have sourced the lending opportunity through its expertise and network, using its own industry specialists and a thematic approach. With a combination of this more active engagement in understanding the business, an owner's mindset, its position in the market and its business-building potential, the more active lender will be able to drive the financing proposal and the negotiation of the legal arrangements, exercising a degree of control over covenants. In effect, the more active lender is helping to shape the development of the business and is setting KPIs.

Furthermore, in the event of underperformance, the active lender is the one that will take a greater responsibility in leading any restructuring or any debt-to-equity arrangement – and, in extreme cases, must take over the ownership and control of a company and turn the business around.

In other words, the active lender may be a debt rather than an equity holder, but they will approach lending with the mindset of private equity – seeking in-depth understanding of strategy, actively shaping the business, and providing a degree of leadership in cases where credits face challenges.

ACTIVE AND PASSIVE PUBLIC AND PRIVATE MARKETS GOVERNANCE

	Public Markets	Private Markets
Passive	Asset allocation	Asset allocation
	Index-based	Sector-based, opportunistic exposure
	Buy and hold	Transaction-driven/buy and sell
	Limited tracking error	Solid outperformance vs public markets
	No control	**Control or non-control**
	No governance, or governance by proxy	**Partial governance – appointment of directors, but entrepreneurship stems from management**
Active	Asset allocation	Asset allocation
	Stock picking	Thematic investing
	Opportunistic/buy and sell	Owner- and management-driven operational value creation
	Target outperformance of the index	Strong outperformance of public markets
	No control	**Full control**
	No governance, or governance by proxy	**Entrepreneurial governance – appointment of board, owners bring shared resources and strategic planning, and drive strategy implementation with management**

Source: Partners Group research (2023).

then can the active private markets firm bring significant shared resources and strategic thinking to bear on portfolio businesses, directly drive results, and create a sense of ownership for stakeholders, while also empowering executives to be entrepreneurial. We call this ‘entrepreneurship at scale’.

The dimension of scale

In parallel with a distinction between active and passive private markets investment, there is a second dimension: scale.

At one end, there will be the very biggest financial investors, whose success hinges on their size and their brand, and who often focus on cost-effectiveness. These firms will always find it hard to be active private markets operators – their sheer scale, lack of operator DNA, and the type of investments they are involved in can present challenges when it comes to active management of the assets they acquire. It is likely that many new entrants to private markets will pursue a more passive approach and such firms will generally be satisfied with modest outperformance relative to public markets; they will resemble traditional large-scale asset managers, often because that is precisely their background.

At the other end of the scale, there are the

“The roots of private markets lie in the opportunism of Wall Street and a transactional approach to return generation. However, this mindset will be entirely inadequate for active private markets investing in the future.”

smaller operators, often working in specialist areas, which develop a niche field of expertise and a network of talent and partners in that specialist sector. Such firms are able to actively invest in and manage businesses, but only on a very modest scale.

Between the more passive mega firms and the more active niche specialists is a category of firm in which the capacity that comes with scale can still be effectively combined with truly active investment that creates operational value in businesses. If the biggest players can be defined by their size, and the smaller players by their specialization and expertise-driven returns, the private markets firms that occupy this middle ground are defined by institutionalized outperformance at scale.

It will come as no surprise that Partners Group sees itself in this middle ground. As a firm, we are dedicated to building our skills and resources for active investment to maximum effect. We call it ‘transformational investing.’

But developing a transformational strategy requires new thinking in the private markets space. Looking back, we have seen that the roots of private markets lie in the opportunism of Wall Street and a transactional approach to return generation. However, this mindset will be entirely inadequate for active private markets investing in the future. To build capability in transformational investing, we must look for insights and lessons from other corporate models.

Chapter 6

Business Building

Successful industrial groups and conglomerates provide vital lessons for active private markets firms

Private markets increasingly represent the real engine room of the economy, having become the largest source of capital formation, and outstripping the IPO market. Private markets firms are also becoming more differentiated across a spectrum of scale and specialization. And while private markets are inherently a more active form of investment than public markets, some private markets firms are more active than others – truly active firms are business builders that combine scale with management expertise and operational planning to deliver real value creation.

But what does this mean in detail? How do private markets companies go about developing this value creation strategy and what lessons can be learnt from elsewhere in business and industry?

When it comes to this challenge, there is little to learn from the heritage of private markets participants themselves. Private markets were rooted in Wall Street firms, where they developed a useful technique for applying leverage in transactions to enhance returns. The industry has clearly much evolved since then and, for the most part, as we have explained, this is not the model for active private markets now and in the future.

Where can active private markets players turn for the most valuable lessons? While this may come as a surprise to many, we believe we can learn a lot from successful, diversified industrial groups or, as they are sometimes known, conglomerates.

Similarities and differences

A classic conglomerate and a private markets group have more similarities than one might at first assume. In both cases there is an array of separate operating companies owned by an overarching entity. That centralized entity controls the operating companies and provides some shared resources and functions. Both have centralized investment and divestment decision-making processes; both typically have centralized talent management; and both also often have businesses in

“Active private markets participants must take the best that the conglomerate model has to offer, while studiously avoiding its mistakes and risks.”

different industry sectors operating under the same umbrella organization.

There are also similarities in the network effects that a conglomerate and an active private markets group can realize between their subsidiaries/portfolio businesses.

While there are clear similarities between private markets companies and conglomerates, there are also important differences. The most obvious is that portfolio companies in a private markets group remain distinct entities, in terms of both financing and governance. Each portfolio business is separately funded, has its own balance sheet and its own P&L account, and is fully independent from other entities in the portfolio. Capital and other financial resources are not shared between portfolio companies. Portfolio businesses have their own entirely independent board and governance structure. Executives at the portfolio company are, quite rightly, only concerned with the performance of the company over which they have control.

The conglomerate lessons for active private markets

The conglomerate model was imperfect. There were great successes, but these were eclipsed in notoriety by the failures, which often occurred because of the blurred boundaries in finance and governance between subsidiaries and the parent holding company. Such groups were regularly driven by the singular ambition of scale, and management teams, dazzled by their own visions of grandeur, often succumbed to hubris. As a result, the word 'conglomerate' now has a mixed or even negative connotation.

Nevertheless, there are valuable lessons to be drawn from successful conglomerates. Active private markets participants must take the best that the conglomerate model has to offer, while studiously avoiding its mistakes and risks.

Studying diversified industrial groups, the most successful rank very highly in five specific dimensions. These are the positive factors that must drive the development of active private markets firms.

Strategic rigor

Allocation of capital is the first aspect of strategic rigor. The most successful diversified industrial groups were those that most often effectively adjusted their portfolios of subsidiaries, applying rigor to the allocation of capital and investing and divesting according to their shifting strategic priorities.

Beyond asset allocation, group companies, or portfolio companies in the context of a private markets firm, must be run with strategic rigor based on the industrial logic of a particular business, its sector, and markets.

This requires a company to constantly challenge the status quo and look towards the future not only of its industry, but also towards developments outside its own field that could be transformational. Sometimes that will lead a company to adapt or disrupt its own business model in order to maximize opportunities for growth and efficiency.

Where is the industry going? What do consumers need or want? How is that changing? Where will the next disruption come from? What can be learned from other sectors or markets? In other words, what is the next winning business model in this field? Rigorous interrogation of these issues and more must be constant and relentless.

Strategic rigor has driven the continued success of online marketplace giant Amazon. One of its key strengths is the inherent strategic drive to continue questioning the status quo, challenge legacy assumptions, and consider all possible – even very unlikely – disruptions.

Entrepreneurial governance

Governance is too often regarded as an add-on or an extra layer in the business. We believe this is entirely the wrong way round and leads to the kind of 'governance correctness' we have previously described. Governance must be based on strategy and the objective of creating and sustaining a winning business model.

Boards and management teams must be designed from the outset to be best-placed to achieve this strategy and vision.

Leaders at portfolio company level must be empowered to use their talent and expertise, and must be supported from day one with the resources and strategic capability of their parent group, or, in the case of private markets, their owner. Putting the right team in place at the start will ensure the company has entrepreneurship that can create a dynamic relationship with its parent company or private markets firm.

Excellent governance cannot be an afterthought, it must go hand-in-hand with strategy and operational excellence. With this as a starting point, the entrepreneurship of the company and its governance are mutually supportive.

While many large conglomerates ultimately failed to achieve the right governance setup, with the boundaries between subsidiaries and the parent holding company becoming blurred, one category of conglomerates that has mostly avoided this pitfall is that of Asian conglomerates. Firms like Tata Group in India (founded 1868) and Doosan in South Korea (founded 1896) continue to exert significant influence over their domestic marketplaces, with recent data confirming conglomerates in Asia are, on average, not only outperforming conglomerates in other regions, but also standalone companies around the world[39].

They have been able to do so by maintaining their family-oriented business style, as the management company is kept legally separate from its subsidiaries. Unlike North American and European conglomerates of the past, each subsidiary company is governed by its own board of directors, raises capital on its own, and executes its own strategic initiatives. This allows subsidiary companies to be more autonomous and entrepreneurial than the traditional conglomerate, and to focus on truly achieving their strategic objectives.

39 Vijayaraghavan, N., 2014. Do Asian conglomerates offer attractive risk-adjusted returns? Singapore Management University.

“Real value creation is rarely about big M&A transactions. Instead, it is about organic growth, platform-building, and research and development.”

The Tata model in fact resembles in many ways an active private markets firm.

Operational excellence

Real value creation is rarely about big M&A transactions. Instead, it is about organic growth, platform-building, and research and development. Crucially, it is about having a culture of *creating* value and growth instead of trying to buy them, because most of the time you cannot buy value and growth at a reasonable price. A vital aspect of achieving operational excellence is identifying what a company is best at, because that is where excellence can be achieved. Elements of a company that are not key and which offer no opportunity to grow or excel can be outsourced, allowing management to focus on where real value can be built.

This is where the combined entrepreneurial spirit of both the company management team and owner can be unleashed. Innovation, strategic acquisition of young companies that will help develop that field of excellence, customer initiatives, investments in automation and digitalization, employing lean manufacturing principles and investigating new markets, are all potential aspects of operational excellence.

Tesla has combined its position in a new but fast-developing market with a focus on operational excellence. The company entered the US automotive OEM market as an outlier, with a strategy of developing all core components of the cars, including software architecture and batteries, itself. After years of investing in personnel, intellectual property, and production know-how, Tesla’s strategy has established a business with best-in-class operations. Margins are not the only measure of operational excellence, but in the case of Tesla they are the outstanding metric. In the third quarter of 2022, the group reported a gross margin in its automotive business of 28%, significantly stronger than competing automotive OEMs[40].

So, while Tesla is most commonly known for its leadership position in pioneering electric vehicle production, much of the company’s success stems from operational excellence.

Proven playbooks

A key part of aligned strategic thinking is playbooks for a range of processes. This includes how management teams are hired and how boards are constructed; how project management is handled; how procurement projects are designed; and the processes for Enterprise Resource Planning. The methods for incentivizing and evaluating talent are a vital part of creating entrepreneurship,

40 Tesla, Inc., 2022. Form 10-Q for the quarterly period ended September 30, 2022, s.l.: United States Securities and Exchange Commission.

business growth, and performance. Playbooks allow this to be implemented at scale and with consistency and rigor.

Similarly, financial reporting as well as operational ESG strategies and assessment are highly suitable for playbooks, which can provide the robust standards and KPIs that will drive the company to excel, while also bringing rigor and a firm methodology to these issues at the level of the parent group or private markets firm.

Importantly, these playbooks provide a framework and are intended to lead to best practices being established, but they should never be prescriptive. Their objective is not to tell companies how to do things, but to give them the tools to find the right solution for their specific business.

This objective can be seen at Danaher, one of the most value-accretive conglomerates of the 21st Century. It has been able to replicate success in each business line through the application of a rigorous framework, referred to publicly as the 'Danaher playbook'. While Danaher is selective about new business interests, it is fully committed to each of its segments. Danaher invests significantly to accelerate core revenue growth and expand margins. Once critical scale is achieved, the cost structure is improved to optimize free cash flow generation, which is then reinvested for growth.

The Danaher playbook has proved how this element of the conglomerate model can be highly successful. Between 1996 and 2021, Danaher outperformed the S&P 500 more than eightfold.

Talent strategy

Recruiting the best talent is key to all successful businesses. The private markets group needs to combine the strength of a conglomerate with the acquisition of the best talent for portfolio level companies.

A successful, active private markets group will leverage its brand to recruit. But it will do so not to fill a group-level C-suite with 'great names,' but to find the talent that can execute value creation.

The best talent will share the group's understanding of strategy and operational excellence, but will be hired, and crucially valued and rewarded, for their capability and performance at a portfolio company.

Talent strategy requires significant time and resources to be successful. General Electric in the 1980s was one of the better-known examples of a global group that used its brand and scale to excellent effect.

Under the leadership of CEO Jack Welch, the company disrupted the previous approach to talent management. Welch took full ownership of leadership development and was often quoted as saying he spent over half his time on people.

The company advanced employees through stretch assignments, making managers grow through responsibilities outside of their comfort zones, combined with a culture of radically open feedback.

It would also give leaders the opportunity to move and rotate across its different

“Success in private markets flows from managing, developing, and transforming businesses and assets in the real economy. It is not about being a Wall Street firm, it is about having an industrial mindset.”

entities. Not only did General Electric achieve tremendous success with this approach at the time, but it furthermore developed numerous future public company CEOs.

Across these five factors, the single unifying theme is an understanding of what real value creation looks like and where that value creation takes place in companies.

Modern and successful active private markets firms are not financial services companies. Astute acquisitions and financial efficiency are essential, but the modern private markets firm should not be focused on ‘doing deals’ or on financial engineering. Success in private markets flows from managing, developing, and transforming businesses and assets in the real economy. It is not about being a Wall Street firm, it is about having an industrial mindset.

Chapter 7

Transformational Investing

Applying the ‘best of conglomerates’ to private markets

At Partners Group, we have developed an approach that we believe allows us to apply the key strengths of successful industrial groups to private markets. We call it transformational investing.

This approach seeks to capitalize on transformational growth trends in order to identify attractive businesses and assets with the potential to be transformed into market leaders in their field. It is built upon two essential pillars already mentioned in this book: thematic investing and entrepreneurship at scale. Let us examine these in more detail and describe how they relate to the lessons we can learn from the most successful industrial groups on strategic rigor, entrepreneurial governance, operational excellence, proven playbooks, and talent strategy.

Thematic investing

Thematic investing is about identifying the most attractive transformative trends across sectors through teams of sector specialists and operators. This begins with three overriding investment giga themes that we believe will drive structural change and secular growth in our economies in the decades to come: Digitization & Automation, New Living – which encompasses trends generated by changing consumer preferences – and Decarbonization & Sustainability.

Although these giga themes guide our approach, we focus on the cascade of significant transformative trends that fall under these themes and drive change in

“Thematic investing is about identifying the most attractive transformative trends across sectors through teams of sector specialists and operators. This begins with three overriding investment giga themes that we believe will drive structural change and secular growth in our economies in the decades to come.”

Keeping a close eye on disruptors

Thematic investing is not just about identifying attractive themes and sub-sectors. It is also about identifying potential disruptors to these themes and sub-sectors and, specifically, to the ways in which companies operate. Looking ahead, we see three major disruptors on the horizon that have the potential to completely reshape the way entire industries do business.

The first of these is artificial intelligence (AI). We are not simply referring to the recent excitement about generative AI, as the real innovation in this field is likely to have taken place five to ten years ago. We are referring to the imminent mass adoption of AI in everyday business. With relatively little effort, AI sub-fields such as natural language processing and computer vision could completely change how we create, analyze, and code. The speed with which we are seeing this technology spread is impressive, ranging from elite programmers in Silicon Valley basing large portions of codes on Copilot, to farmers applying for subsidies by talking to government chatbots via WhatsApp in rural India. Akin to how the smartphone and social media changed our lives, AI is on the brink of becoming the ‘operating system’ of how we work. For example, looking at our own portfolio companies, we see potential for a traditional toy maker to vastly extend its customer interaction with hyper-personalization powered by recommendation engines and image generators; or for chains of dermatology and physical therapy clinics to offer remote diagnosis and treatment powered by computer vision.

The next major disruptor is the metaverse. Here, we are referring to the next generation of internet-based interactivity that will be built around an immersive virtual environment. Thirty years ago, the internet revolutionized the way we interact with each other. Today, the metaverse has the potential to do the same, disrupting the interfaces of our whole digital ecosystem. While we are not yet seeing the same breadth of use cases as with AI, it is fair to assume that many interactions that take place via internet platforms today – along with many others that are still in-person – will eventually take place in some form of metaverse framework. Our portfolio company Breitling is already offering digital watches in the metaverse to be paired with physical watches.

Lastly, decentralized ledger technology has the potential to reshape the future transaction backbone for information, data, and currency exchange, just as internet protocols have provided the basis for web-based interactions in the last 30 years. Although the prevailing technology is still open to question, it may not be blockchain due to its clunky computation. HashGraph or similar algorithms could be a nimbler option. There will be many cycles along the way, as we have seen with the recent bursting of the crypto bubble, which will refocus resources on real-world applications of decentralized ledger technologies. At Partners Group, we currently use blockchain to send certain client information securely, but we are exploring more widespread use cases to identify an inflection point for this disruptor.

Because of the potential these three disruptors have to reshape the way companies operate, it is crucial to keep them front-of-mind across our investment activities and constantly ask ourselves: how could we benefit from these disruptors, and how well equipped are we to manage the changes they will bring?

different industry sectors. We then aim to identify the companies and assets within each sector that benefit from these transformative trends and have strong development potential. It is important to look beyond the top layer to identify companies operating in less obvious underlying sub-sectors. This second-, third-, and even fourth-order thinking often provides exposure to growth trends with a much lower risk profile, but higher value creation potential.

An example of our second- and third-order thinking can be found within the modern food value chain theme described in Chapter 2. A key growth area in this theme has been the trend towards healthy and sustainable food manufacturing. The second order from this trend might look at the supply of healthy and sustainable ingredients, with the third order encompassing the production of sustainable agricultural products for these ingredients. At Partners Group, we have been looking one step further than this at specialty crop nutrition, biocontrol, and protection solutions that support sustainable agriculture. We believe this fourth-order sub-sector is well-positioned to benefit from the transformative trends driving growth across the broader modern food theme.

Another example can be found within pharmaceuticals. A key theme cluster in this sector is the reconfiguration of product supply chains. Taking a step down, many of these supply chain changes have been focused around the production of new therapies, especially in biologics and large molecules.

The third order from this trend might include the rise of new approaches towards contract research and manufacturing for these products. Our fourth-order thinking has led us to the digital applications that can accelerate the overall development and commercialization of next-generation therapies.

The concept of taking a sectoral growth theme and then cascading down through significant underlying trends is a key part of our thematic investing approach. It is applied in the same way across private equity, private infrastructure, and private real estate themes.

This approach typically requires multi-year preparation and research work before a target business within an attractive segment becomes available for investment. At any point in time, we typically pursue more than 50 investment themes across our private equity industry verticals – Goods & Products, Health & Life, Services, Technology – and a similar number across real assets. If we look at

“The concept of taking a sectoral growth theme and then cascading down through significant underlying trends is a key part of our thematic investing approach.”

Re-underwriting thematic winners

A robust thematic investing approach can drive growth at portfolio companies beyond the traditional four- to seven-year holding period, giving rise to new and attractive opportunities to reinvest in an asset and enter a second phase of transformational ownership. These opportunities, which we at Partners Group refer to as 're-underwriting' an asset, require strong thematic conviction. They involve the re-formulation of the strategy that will create or build out the 'winning business model' in the respective thematic ecosystem, including the development of a new business plan. New leadership resources are assessed and added to accomplish the newly set strategic objectives, and a material new and credible shareholder is onboarded. In short, the investment is newly underwritten.

To qualify for a re-underwriting, the first phase of ownership and value creation initiatives at an asset must have been successful, meeting our ambitious target returns for investors. A re-underwriting must then meet three principal requirements before it is considered: we still have strong thematic conviction in the transformative growth trend supporting the asset's potential growth; we believe the asset remains the best opportunity to maintain exposure to that particular transformative growth trend; and we have full clarity around the asset's next phase of transformational value creation and confidence that our internal team, the management team, bench of operating directors (Board), and network of advisors can achieve this.

A re-underwriting requires a significant new assessment and commitment towards an asset. This is the key difference between asset re-underwritings and continuation funds, which do not usually represent a 'new' transaction in the same way. Continuation funds, where an asset is sold to a special purpose vehicle managed by the same GP, are mostly undertaken so that a manager can gain further exposure to an asset or complete previous value creation initiatives.

Whilst we acknowledge that not all continuation funds are the same, there are very few parallels to asset re-underwritings as we approach them. Ultimately, the pre-conditions we impose, the rigorous thematic, strategy, asset, and leadership due diligence we undertake, and the strict processes we adhere to around pricing and management of potential conflicts set our asset re-underwritings apart from the broader market of ownership extension transactions.

It is also worth noting that in order to create re-underwriting opportunities in the first place, regular and diligent review of asset allocation is essential. This has always been a distinguishing feature of the best industrial conglomerates and does not just refer to investing in market-leading assets, but also working out which assets to hold and where there is potential to develop them further. In this way, the assessment of a re-underwriting situation is consistent with strategic rigor in asset allocation.

how the lessons we can learn from diversified industrial groups apply to thematic investing, there are several areas that are highly relevant to this approach.

First, thematic investing is all about strategic rigor. It requires a search for those areas of the economy where transformative trends present an opportunity for business building. Rigorous analysis is needed to develop a hypothesis that can deliver a winning business model in these areas. And while the main focus is on opportunities for growth, disruption risk, cross-sector dynamics, and other factors can pose challenges to any business and also need to be carefully analyzed and addressed by the business plan.

Second, operational excellence also comes into play. The process of thematic investing involves not only identifying opportunities, but also an analysis of the feasibility of a business transformation within a specific sector. This requires a deep understanding of the relevant sector and the specific asset, including the learnings from past successes and failures, to assess whether the strategic journey that has been developed is realistic or not.

Finally, thematic investing is also about having a leading talent strategy. Understanding the trends of our future ecosystems and their related opportunities and risks, and crafting the hypotheses for winning business models, comes down to people: only the combination of a deep bench of industry specialists and operators, combined with large in-house sector specialists, can lead to success. Having adequate programs in place to hire, train, and retain these people is key to ensuring they can use their knowledge and skills to identify and invest in those businesses and assets with the strongest development potential.

Entrepreneurship at scale

In order to capitalize on transformative trends, thematic investing must go hand in hand with the second pillar of transformational investing: entrepreneurship at scale. While it is vital to build a deep understanding of industry themes, potential disruptors, and transformational opportunities, it is just as vital to create and actively manage a governance structure for the companies in a portfolio that will support them in driving forward their strategy and enable them to focus on realizing their full potential.

Board construction is, therefore, critical. The board of a Partners Group portfolio company is chaired by a Lead Operating Director (LOD), who is an experienced entrepreneur, operator, and boardroom member, and a sparring partner to the CEO. The chairperson is complemented by two to three Operating Directors (ODs), who bring deep industry and functional expertise. Typically, these ODs invest alongside management and shareholders. The CEO and other directors are carefully selected to ensure their talents and experience are those that will best suit the opportunities and challenges of the company.

“The process of thematic investing involves not only identifying opportunities, but also an analysis of the feasibility of a business transformation within a specific sector.”

Board members are selected based on their ability to support and drive forward the main strategic pillars that have been defined for a company. During their board tenure, they are assigned specific value creation projects in their area of expertise and, together with the leadership team, have full responsibility for and ownership over these projects.

The five lessons we can learn from conglomerates are all strongly connected to entrepreneurship at scale. Strategic rigor is key to both board design and board room discussions. The transformation needed to achieve a winning business model is what drives the design of the board. A constant questioning of the business hypothesis and a culture of 'positive paranoia' are central to board room discussions and underscore the strategic rigor with which the board moves towards achieving strategic business objectives.

Once a business has been acquired, achieving operational excellence is a key goal for each business and the board is charged with driving forward the transformational strategy we have designed for that business to enable it to achieve this goal.

Entrepreneurship at scale is also clearly about having the highest entrepreneurial governance standards, which was one of the key issues addressed in our White Paper, *The Rise of Governance Correctness: How public markets have lost entrepreneurial ground to private equity*.

As we saw in Chapter 6, this was an area where industrial groups and conglomerates have often gone awry, by failing to establish clear boundaries between different entities.

Learning the lesson of this, it is important to establish boards at portfolio companies that are accountable to the private markets group and investors, but have the autonomy needed to be entrepreneurial. To drive value creation, they need to be able to apply their expertise and knowledge of the company and industry in which it operates.

The balance of centralized resources and autonomy that creates entrepreneurial governance is reflected in the fourth lesson we can learn from conglomerates – proven playbooks. Rather than providing a set of predetermined answers, a playbook is more a set of questions and techniques for finding solutions.

By drawing on the range of businesses in a portfolio that have faced familiar challenges and opportunities, it is possible to describe management processes that lead, not to the same answer, but to the right answer for each business.

The final lesson we can learn from industrial groups – talent strategy – is just as

"Another lesson we can learn from the best industrial groups is the importance of being a great employer and partner for our people, both at group and portfolio company level."

key to entrepreneurship at scale as the others. Talent at the group level is vital to entrepreneurship at scale, providing shared resources and strategic input. Equally important is the talent within the portfolio. The leadership teams at portfolio companies are the talent that drives operational excellence.

While recruiting C-level leadership for portfolio companies is a major task, building a broad bench of up-and-coming managerial talent for them can be even more complex. That is why, at Partners Group, we have developed our own Private Markets Operator Development Program. The program aims to hire top talent under the Partners Group brand and rotate that talent across our portfolio companies. By staying close to participants through our mentoring, coaching and training programs, we hope to eventually prepare them for senior roles either at portfolio companies or at Partners Group.

In sum, entrepreneurship at scale is built upon the combination of talent at the group level and at the portfolio company level and a dynamic interaction between the two.

ESG and stakeholder impact

In the past, the private markets industry has outperformed by focusing on providing returns for its investors, but it has not necessarily focused on ensuring it has a positive impact on all stakeholders involved in a transaction, including portfolio company employees.

Today, this has changed dramatically. Another lesson we can learn from the best industrial groups is the importance of being a great employer and partner for our people, both at group and portfolio company level.

This is where our ESG strategy and stakeholder impact initiatives come into play.

Partners Group’s Stakeholder Benefits Program

Initiated in 2020, our Stakeholder Benefits Program is a strategic initiative aimed at building better businesses by reinvesting up to 10% of profit growth into initiatives that further the professional, personal, and financial growth of the 250,000 employees within our portfolio of controlled companies. Such initiatives include building learning and development programs, providing tuition reimbursement, establishing financial participation plans for staff other than just leadership teams, and offering enhanced health and benefit programs. All these measures are taken with the resilience, collaboration, engagement, and effectiveness of employees in mind, which makes the firm not just better, but more valuable for investors.

The program is also part of our vision to ensure the employees of our portfolio companies share in the value we create. We hope that, along with similar initiatives that have been launched across the private markets industry, these types of programs can chart a path for private markets firms to share success with a broader set of stakeholders, and re-set the bar on what it means to care for employees at portfolio companies.

ESG issues are fundamental to both thematic investing and entrepreneurship at scale and are built into the five lessons we can learn from industrial groups. While playbooks can be helpful for more standardized questions or routine operations, such as measuring carbon footprint and developing approaches for the effective use of resources, there can be no 'one-size-fits-all' ESG strategy. Each company must apply strategic rigor to understand its own distinct ESG issues and must then tackle them with tailored solutions.

If ESG is built into the strategy, it becomes part of a company's governance model. Its talent strategy will then be aimed at recruiting teams that will help build a company culture with ESG and stakeholder impact at its heart.

This is also because ESG and stakeholder impact are vital elements in creating value in a business. Engaged and incentivized employees are the cornerstone of productivity, talent retention, and organic growth. Projects that aim to invest in employees' engagement in the business – their training, growth, wellbeing, and development – should be a standard element of private markets ownership.

As private markets have become the custodians of the real economy, owning and building foundational companies, real estate assets and infrastructure, they have taken on the mantle once mostly held by public markets groups.

This represents a significant opportunity, but also a responsibility to rethink the models of

Case study: Ammega[41]

Positive ESG and stakeholder impact are at the core of Partners Group's investment strategy and this can be seen in practice at our portfolio company Ammega. Ammega was created by Partners Group in 2018 through the combination of Ammeraal Beltech (conveyor belting) and Megadyne (power transmission).

During the acquisition and onboarding process, we conducted ESG due diligence, including analyzing ESG data and feedback from staff and management. Based on this assessment, we identified three areas of focus, each requiring significant investment. These comprised creating a unified health & safety system for the company, establishing a program for employee financial participation, and improving the company's carbon footprint.

Since this initial assessment, a strategy has been developed to address each of these three pillars. According to our entrepreneurship at scale approach, for each pillar, we have assigned a board member, management team member and an operational director to be responsible for driving forward the strategy and tracking progress. To date, major progress has already been made in each area, and therefore Ammega has been awarded Ecovadis Platinum status in April 2022, two years ahead of plan.

41 Partners Group portfolio company.

“ESG and stakeholder impact are vital elements in creating value in a business. Engaged and incentivized employees are the cornerstone of productivity, talent retention, and organic growth.”

the past, shedding their weaknesses, learning the lessons of their mistakes, and embracing their best practices.

We are convinced that transformational investing can provide a useful model for the modern, active private markets firm dedicated to business building and real value creation. It combines private markets discipline with the best practices demonstrated by successful industrial groups – benefiting investors, our employees, and portfolio-level stakeholders alike.

Chapter 8

The Investor Perspective

What the new landscape of private markets means for investment allocation

An entirely new landscape of public and private markets is taking shape. As our discussion has shown, private markets have increasingly taken on a role that was previously the main function of public markets transactions – investing in foundational businesses and building value in companies that reflect the real future of the economy.

Active private markets firms themselves will need to evolve in this new environment and a focus on entrepreneurship and value creation in portfolio companies is key. Success will be achieved by taking the best from the top industrial groups and blending it with the transformational power of active private investment.

But this evolution of private markets will naturally lead to changes in other aspects of the financial system, notably in regulation and, of course, in asset allocation.

Private investors and regulation

Private markets investment is growing and evolving rapidly, and attracting greater investment as institutions raise their allocations and new entrants recognize the fundamental role that private markets now play in the economy.

This will change the way regulators regard private markets. It is in the interest of every kind of investor to be invested in the businesses and assets of the real economy, and those businesses and assets that can and need to grow should have access to that investment capital.

When private and public markets played different roles in supporting companies, offered different risk-reward profiles, and attracted different types of investors, identical regulation regarding access was not necessarily appropriate. But as private markets have become home to foundational business that are the bedrock of the economy, the regulation of access will need to adapt as broader segments of the investor market seek to increase their involvement in private markets.

For example, DC pension funds are likely to be a major new force in private markets if, as widely expected, regulation in various markets loosens the constraints on where and how these funds can invest.

It is too early to tell exactly how regulation will develop in the future, but as long as regulators recognize the role that private markets now play in the real economy and the importance of enabling investment in private

"The regulation of access will need to adapt as broader segments of the investor market seek to increase their involvement in private markets."

markets from across the investor community, there is no reason to expect it to hamper private markets' continued expansion.

The one area where there are likely to be changes is the retail market, which has previously been highly restricted in its access to private investment. Regulation will doubtless adapt as private investors take a greater interest in private markets seeking, quite rationally, to align their own investment portfolios with the foundations of economic growth.

Such an evolution has already been underway for many years, even if only fully recognized more recently. For more than two decades, we have been offering several open-ended programs targeted at the private wealth clients of leading financial institutions, including the largest and longest-standing private equity fund regulated by the Securities and Exchange Commission (SEC) and equivalent funds in Europe and Asia. Regulation still excludes many investors today, but we believe the powerful trends in private markets investing that we have discussed thus far will eventually lead to an opening up of access – a true democratization of private markets.

Institutional investors and future allocations

So, what does the new landscape of private markets mean for institutional investors? Most importantly, what is an appropriate private markets allocation for the future?

The answer we believe lies in two factors: the scale of private markets in the future, but also the types of businesses and assets to which private markets can provide access.

The size of private markets as a proportion of capital formation has been growing rapidly and will continue to grow for the foreseeable future. As we noted in Chapter 4, private markets already account for more new capital formation than public markets. Meanwhile, global institutional investors are expected to increase their allocations to private markets by almost 12% per year over the next five years.

But equally important to the sheer scale of private markets growth is the kind of investment and the type of returns that private markets are increasingly focused on. The attention of private markets on foundational businesses, profitable enterprises, infrastructure, and real assets means they are the venue for investment that is linked to and reflects the real, broader future economy.

Investors seeking to align their investment portfolio to these foundations of the future economy must increasingly consider whether, as we believe, private markets are the best route to many real economy assets. If so, then capital will need to be deployed into private markets in an even higher proportion than simple financial figures suggest. Not surprisingly, many of the largest investors globally, including several sovereign wealth funds, already have portfolio allocations of well above 20% or even 30% to private markets.

Varying return exposure characteristics

Public markets IPOs have become the domain of what we would call idiosyncratic returns. The success of many IPOs depends on company-specific factors that are often not closely aligned, if at all, with sectoral growth, or indeed, the economy as a whole. Spotlight businesses succeed or fail because of unique effects such as technological disruption or even fast-changing consumer fashion or brand reputation. Often success for spotlight companies depends upon achieving a threshold of market share that will establish them as sector leaders – some do reach such leading positions, others do not.

There is a place for such investments, but they are in a return class of their own. Broader public markets strategies, as opposed to the IPO market, are more likely to align with wider factors such as sectoral growth, usually by focusing on established public market companies and given that the large stock of legacy assets is still an important driver of sector returns at scale. Stock picking may aim to eke out slightly higher performance, but rarely does. In other words, active and passive strategies in public markets often yield a similar return profile.

"The success of many IPOs depends on company-specific factors that are often not closely aligned, if at all, with sectoral growth, or indeed, the economy as a whole."

The question then for investors, and institutional investors in particular, is how to access businesses and assets that offer a differentiated return profile that is aligned with the foundations of the economy? For most investors, public markets will continue to play a fundamental role in their portfolios, acting as a baseline from which they can start to think about a diversification in allocations that will enable them to gain access to incremental economic exposures and different return profiles.

For example, outside of venture and growth capital territory, private equity has historically been treated as one homogenous asset class in investor portfolios but, going forward, we believe this will no longer be the case. One change we expect to see is an increasing distinction between active and passive private markets players, offering very different return profiles. Another distinction that is likely to become relevant is that of core and non-core in private corporate assets.

Private markets players that follow a more passive private investment approach will still aim to outperform public markets, benefiting from their superior agility, long-term mindset, entrepreneurial culture, and financing efficiency. But they will often remain focused on 'finished assets', akin to the 'core investments' of real estate or infrastructure.

Core versus non-core assets

The concepts of core and non-core investments are familiar in real estate and infrastructure. Core investments are mature, needing little new development and providing stable income and relative security – they are often regarded as defensive investments. Non-core investments are those where there is the potential or need for development or transformation, and where there is higher risk but also the potential for higher returns.

These terms continue to be relevant for a good part of the real estate asset class. Infrastructure is, however, changing. Increasingly, an infrastructure investment is no longer a simple single asset. Infrastructure investments today often involve platform or network elements and a range of operations. More and more infrastructure investments look like corporate entities in a phase of dynamic change. In today's world, there is very little infrastructure that looks 'finished'.

We can see some parallels with the evolution of private markets, their relation to public markets, and the spectrum of active and passive strategies.

Core investments are mature, suitable for passive ownership, and generate stable income, but are less suitable for significant new value creation.

An example of a core investment is a toll road that is owned by multiple institutions in a passive way. Meanwhile, a non-core example is Partners Group's investment in a portfolio of logistics properties in Poland, which we plan to refurbish and redevelop to create high-quality, efficient logistics and warehouse spaces with robust ESG credentials.

Non-core investments are those in transformation, requiring active ownership and governance, strategic vision and entrepreneurialism, and which are likely to offer the best opportunities for outperformance.

There is one further intriguing angle to this – another reversal of received wisdom. In a world where sustainability is driving the investment agenda and where transformation is essential, what counts as a defensive investment?

Might it be that non-core investments that are being transformed and developed for the future economy are the real defensive play?

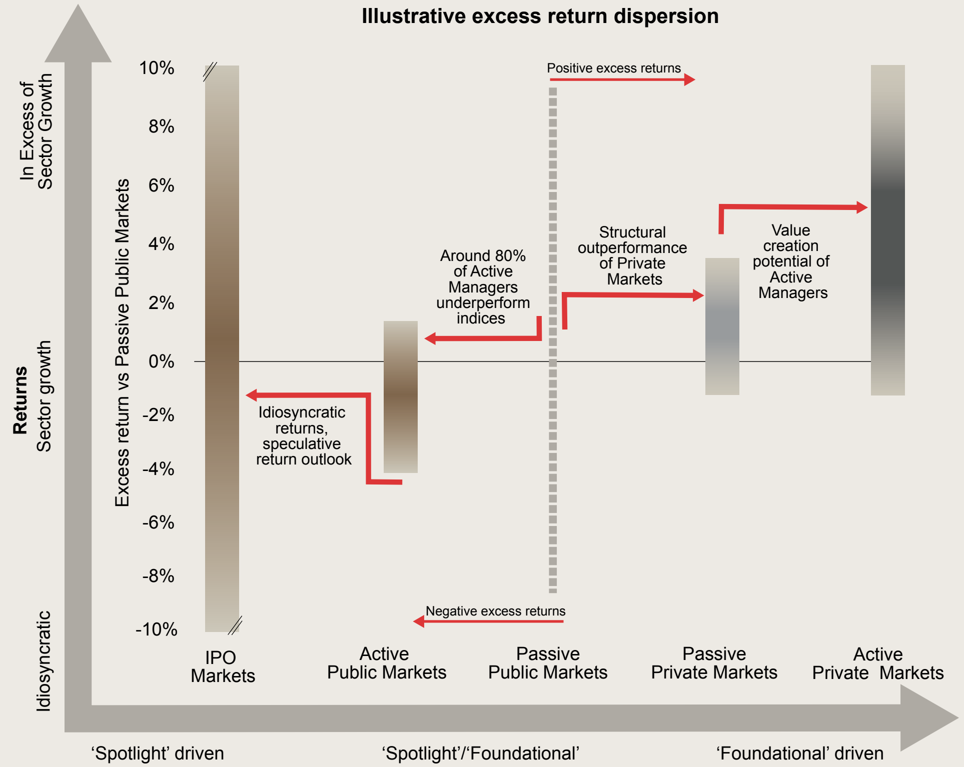
However, active private markets operators aim higher. The active approach is about business building and business transformation. It brings not only additional resources to bear, but also an unwavering focus on behalf of private markets owners on driving the implementation of strategy and operational excellence in portfolio companies to generate even greater outperformance.

The picture on returns, illustrated in simplified terms, can be seen in the graph on how active private markets managers offer above-sector growth potential.

While in the future, a typical sophisticated allocation will continue to be anchored by a passive index-tracking allocation to global public markets, there will also be a growing allocation to private markets and, crucially, within this, a separation between the more passive private markets firms providing a slight outperformance of sector returns and the active firms able to develop assets, build businesses and provide even greater upside for beneficiaries. Naturally, investors will look for lower cost programs in the absence of higher performing active strategies, and vice versa.

In other words, one of the significant differences between public and private markets will be the growing conscious allocation to active private markets that add additional returns to the portfolio.

ACTIVE PRIVATE MARKETS MANAGERS OFFER ABOVE-SECTOR GROWTH POTENTIAL THROUGH VALUE CREATION



Return dispersion is based on illustrative analysis of the annual returns for global public equities, and private markets buyout funds. Source: S&P SPIVA scorecard (2022). Partners Group research (2023).

Outlook

The onset of a new era

Private markets have been on a long journey over the last few decades. It has been steady and incremental, but it is now clear that this journey amounts to a transformation of the investment landscape and that we stand on the threshold of a new era.

At the same time, we believe we are entering a period of profound change that will completely reshape the ecosystems of today. The transformation and disruption we will see across industries over the next two decades will be unprecedented in terms of scope and speed.

We believe this is driven, on the one hand, by the three giga themes we have already mentioned in this White Paper: Digitization & Automation, New Living – which encompasses trends generated by changing consumer preferences – and Decarbonization & Sustainability. These giga themes will drive structural change and secular growth in our economies, generating new business models, and driving the transformation of the world's real assets.

On the other hand, next to these three giga themes, we believe there are also a number of potential disruptors that could impact how companies operate across industries. More specifically, the three super disruptors we have discussed in this White Paper – AI, the metaverse, and decentralized ledger technology – have huge potential to completely reshape many aspects of our lives, just as the internet has done. In doing so, we anticipate that they will significantly change the way most businesses interact with their customers.

Because of the profound changes that will disrupt our ecosystems, we will have to adapt our definition of resilience. Until recently, resilience was defined as something that was protected from disruption. In real estate, this might have meant having an asset in the right location or, in infrastructure, having a monopoly. While that may continue to be the case for select industries, in our view, that is not what resilience will mean for most businesses and assets in the future. Resilience will instead more often be defined as having the agility needed to adapt to an ever-shifting landscape. Being active, being dynamic, being transformational will be the new 'defensive' strategy.

This brings us to the evolving private markets landscape we have discussed in the last few chapters. We need to view the evolution we have described in private markets in the context of the massive changes and disruptions we will face as a society. Among active private markets firms, there is a focus on agility, innovation, and

“Being active, being dynamic, being transformational will be the new ‘defensive’ strategy.”

entrepreneurial ownership to keep pace with a changing environment. Active private markets players understand that a passive approach will only go so far when it comes to adapting and taking advantage of disruption.

So, what we want to invite readers to do with this White Paper is to look forward and take this as the context for the future. As humans, we naturally tend to be more focused on the past. That is why, even today, people still see public markets as the main engine for the real economy; private markets as an ‘alternative’ asset class; and private markets firms and their strategies as all the same.

As we see it, none of this is true.

Looking forward, you will see the strength and power of private markets. Active private markets firms in particular will be at the core of driving these new ecosystems, working with businesses to develop the agility and adaptability needed to build our future sustainable economy.

PARTNERS GROUP

Built Differently to **Build Differently**

Acknowledgments

There is hardly any accomplishment at Partners Group driven by a sole team member. This is also true of this White Paper. Thanks go to the colleagues who have helped through input and discussion, as well as with background information. Special appreciation is paid to **Jenny Blinch**, for overall organization, **Georgina Wood**, for her significant work in reviewing and editing the paper, **Simon Rupp**, for his help with research, as well as **Henry Weston** and **Pranav Muthigi**. Thanks also to **Simon Watkins** for his support in bringing my thoughts onto the page.

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