

Alternative Investments 2020

The Future of Capital for Entrepreneurs and SMEs

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Executive summary

Over the past decade, the external environment for alternative investments has seen enormous changes. The areas affected the most are start-up capital and venture funding for entrepreneurs, crowdfunding and marketplace lending for small businesses, and private debt for mid-market enterprises.

In all three cases, a set of interlocking factors is driving the emergence of new capital sources:

- 1. Regulation:** where regulation constrains a capital flow for which there is demand, a new source of capital will emerge to fulfil that demand;
- 2. Changes in demand for capital:** where capital destinations develop demand for new forms of funding, investors will innovate to meet it;
- 3. Technology:** where technology enables new types of origination, investors will take advantage of those opportunities.

Each area of the financial system is affected differently by these factors. In the case of start-up capital, it's becoming easier to invest in seed and early-stage start-ups, lowering barriers to entry for high-net worth individuals to make angel investments. Meanwhile, regulations incentivizing start-ups to stay private longer have created demand for high volumes of late stage funding, which asset managers and institutional investors have recently been providing alongside venture capitalists.

In the case of crowdfunding, at the same time that regulators are encouraging traditional banks to pull back, online marketplace technology is enabling lenders to provide loans to currently underserved borrowers.

Lastly, the growth in private debt to mid-market businesses is predominantly fuelled by regulations restricting bank activity, creating a gap in the market that is addressed by alternative investors.

The results in each of these areas are similar: traditional players find themselves flanked by new entrants providing products and services that are either complementary to traditional offerings (such as late stage venture funding) or in direct competition (such as private debt lending).

The effects will impact key stakeholders in different ways.

- **Alternative investors (GPs):** New players increase competition and drive existing GPs to consolidate and differentiate. This trend can be observed in venture funding and the issuance of private debt.
- **Capital providers (LPs):** New types of destinations for capital become available to LPs, offering different return profiles.
- **Society (broader economy and the public):** The three cases we examined are generally positive for the broader economy and public. Increased funding for entrepreneurs and businesses generally results in more economic activity.

This report describes the principal new capital sources that have emerged over the past decade, examines their drivers, and explains their effects and importance for society.

Introduction

The alternative investments industry is reshaping and, with this, new sources of capital are emerging.

Those new capital sources have significant effects on both the capital supply side – by shaking up existing industry structures – and the capital demand side – by enabling products and services that better meet the needs of new and existing customers.

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Innovation in capital supply does not happen in a vacuum. The emergence of new sources of capital is occurring against the backdrop of broader trends affecting the entire alternative investment industry, which over three decades has evolved to become an integral part of the financial system and global economy.

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The objective of this report is to highlight new alternative sources of capital and examine their potential for broader industry disruption in the future. Not all of the trends highlighted in this report will find broad adoption, but collectively, they hold lessons that could point towards the future shape of the whole industry.

Throughout this report, the nomenclature below will be used to describe capital providers and investors:

Term	Description
LPs (Limited partners)	Asset owners that provide capital to alternative investment firms or divisions to invest on asset owners' behalf
GPs (General partners)	Firms that deploy capital in companies or securities on behalf of LPs/capital providers (such as private equity buyout or venture capital firms, or hedge funds)
Institutional investors	A subset of LPs comprised of institutions that invest capital with GPs (such as pension funds, endowments and foundations, and financial institutions)
Retail investors	A subset of LPs comprised of individuals that invest capital with GPs (such as high net worth or non-wealthy individuals or family offices)
Investors	An inclusive term that includes both GPs (who invest in securities and companies) and LPs (who may invest with GPs or directly in securities or companies)

1.1. Background

Innovation in capital supply does not happen in a vacuum. The emergence of new sources of capital is occurring against the backdrop of broader trends affecting the entire alternative investment industry, which over three decades has evolved to become an integral part of the financial system and global economy. Figure 1 shows how the evolution has taken place, with regulatory changes, economic cycles, and technological developments all playing critical roles.

The alternative investment industry has grown from a relatively small part of the financial system in the 20th century, to an influential part of the global economy in the 21st century. Total assets under management (AUM) have soared from \$1 trillion in 1999 to more than \$7 trillion in 2014 (Figure 2), twice the rate of traditional assets from 2005-2013¹. Furthermore PWC expects AUM to nearly double again to \$13 trillion by 2020.²

Broadly, three factors – monetary policy, social system sustainability, and emerging markets (Figure 3) – have been particularly influential in shaping the industry as a whole, while technological developments continuously shape the capabilities of the players in the system. Those themes are discussed in detail in another report in the Alternative Investments 2020 series, *The Future of Alternative Investments*.⁵

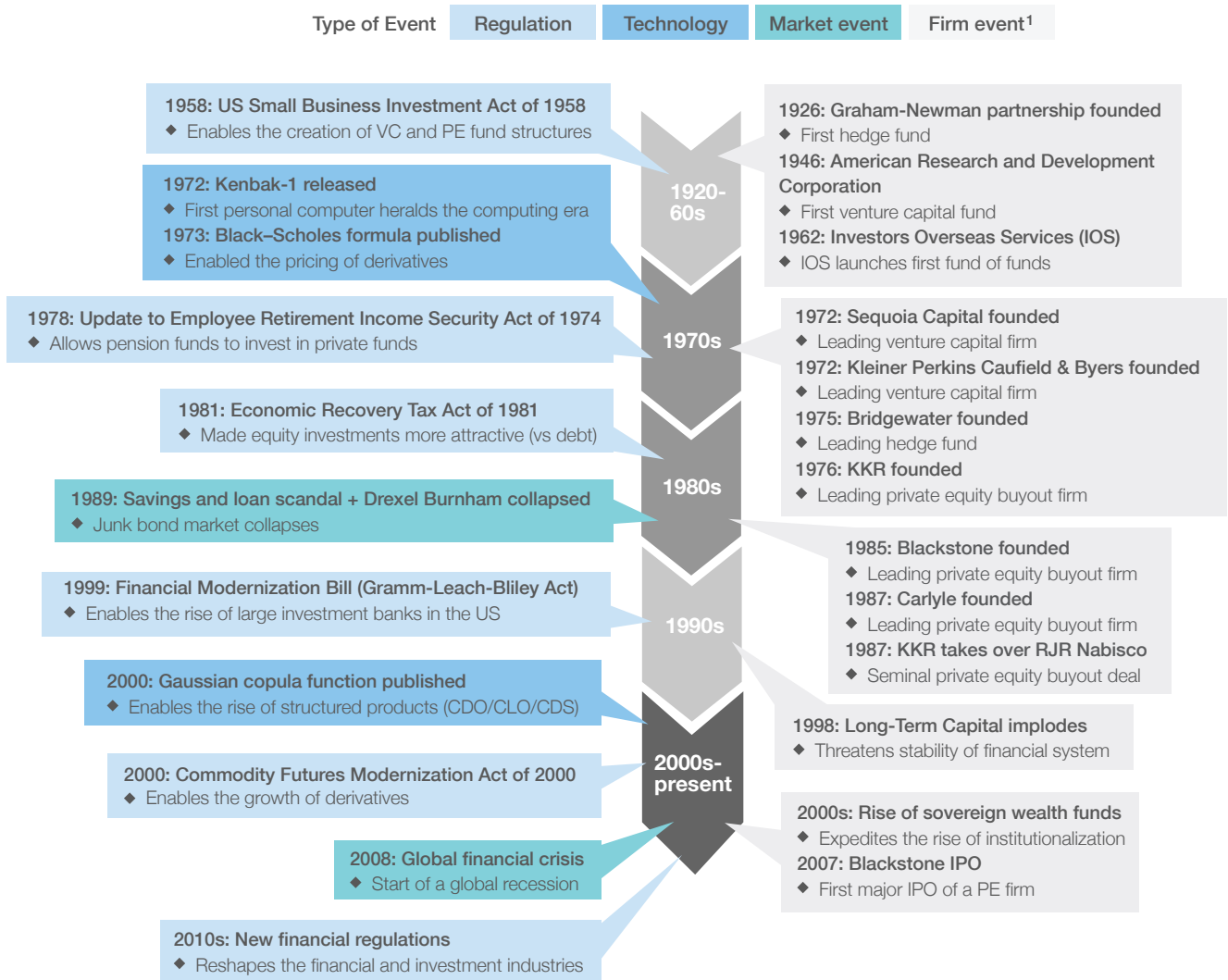
1.2. Scope

This paper explores how these trends could influence the future flows of alternative investment capital to entrepreneurs, start-ups, and SMEs. We identify three themes:

- **start-up capital:** the changing flows and nature of venture capital alongside growth in “angel investing” by high net worth individuals and institutional investors
- **crowdfunding and marketplaces:** new sources of capital for entrepreneurs and small businesses from online marketplaces. In particular the growth of marketplace lending (also known as peer-to-peer lending), offer new investment products and opportunities to alternative investors
- **private debt:** the role and rapid growth of private debt funds that offer debt capital to small medium-sized businesses and present new investment opportunities for LPs

Each theme is discussed in a section of this report, and for each we determine its current significance, drivers of growth, and implications for the industry and society. Lastly, in the conclusion, we draw broader lessons for the industry. In doing so, we hope to start a lively discussion around the future of the alternative investment industry.

Figure 1: Key moments in the history of alternative investments

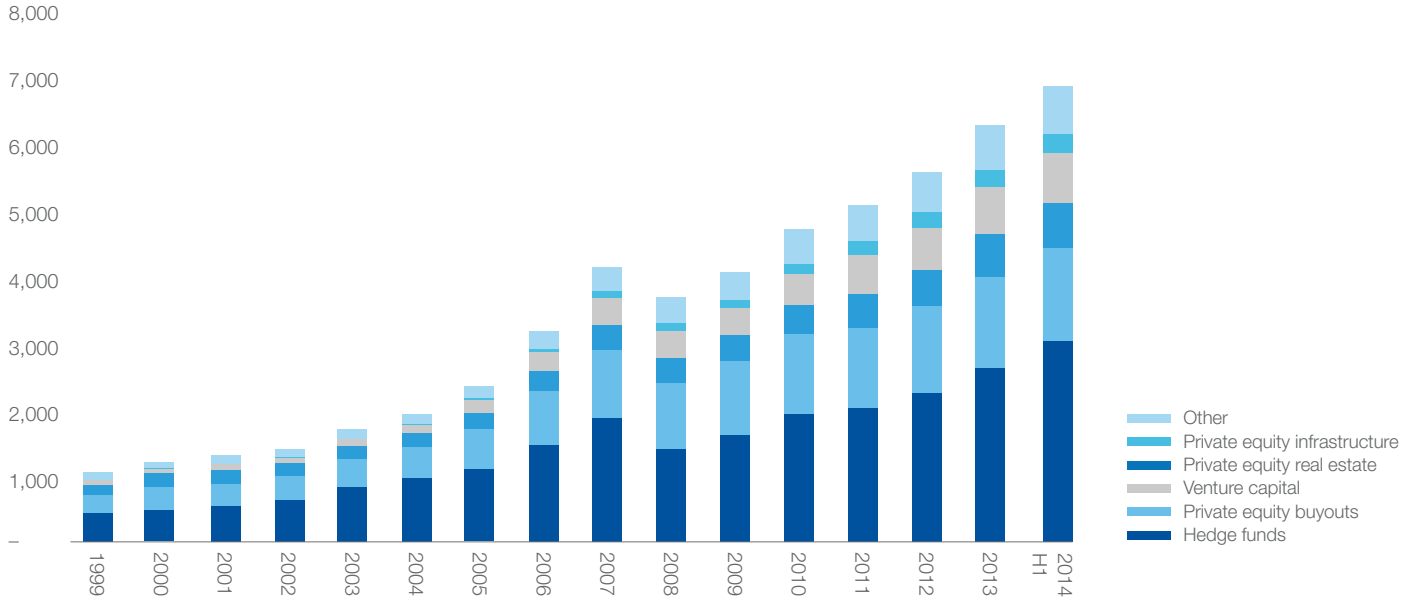


¹ The firms referenced here are illustrative examples – only space constraints prevent us from mentioning the many other outstanding firms that played important roles throughout the history of alternative investments

Source: World Economic Forum Investors Industries

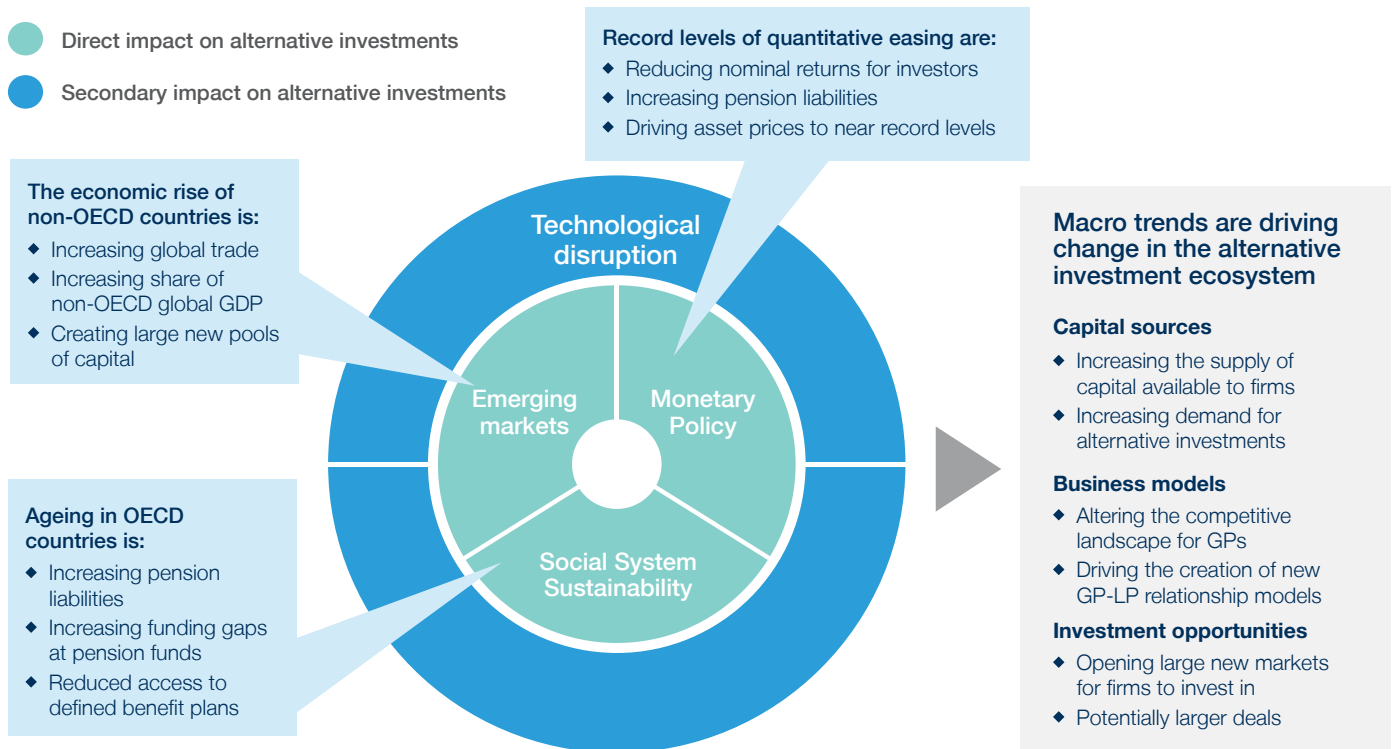
Figure 2: Growth in assets under management by asset class^{3,4}

Total alternative assets under management, \$ billions



Source: Preqin, Hedge Fund Research

Figure 3: Overview of key macro trends affecting the alternative investment ecosystem



Source: World Economic Forum Investors Industries

The shake-up of traditional start-up capital

2.1. Overview

The financing landscape for start-ups has changed considerably in recent years. In developed markets, the total number of VC firms has fallen over the past decade. However, the number of angel groups in the US increased by more than 30% from 2009-2013,⁶ while the number of individual angel investors increased by 22%⁷ over the same period.

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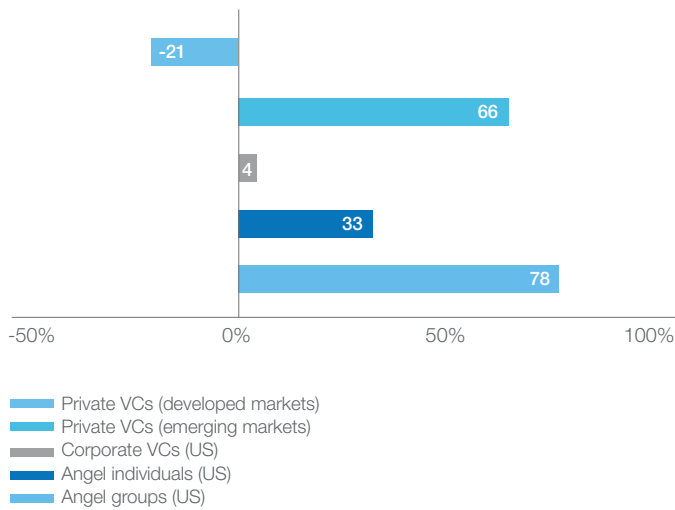
In emerging markets a VC boom has seen 150 net new firms entering the market for startup funding.

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Recently, corporate VC arms investing in US companies have returned to historical levels, with 51 net new arms emerging over the past five years.⁸ Comparatively, in emerging markets, a VC boom has seen 150 net new firms entering the market for startup funding. Figure 4 summarizes how the number of investors has changed in recent years across groups and regions.

Figure 4: Most investor types have seen growth in numbers^{9, 10, 11, 12}

Change in the number of investors in start-up companies from 2004-2013¹, %

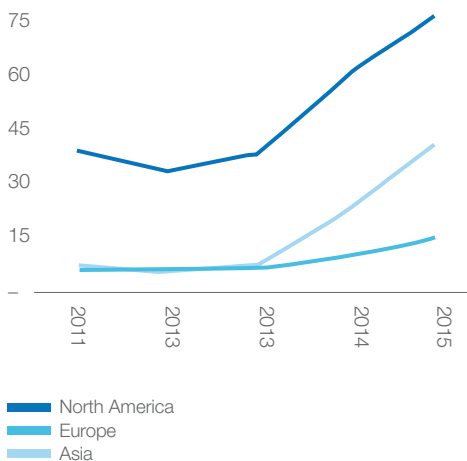


¹ Developed markets includes the US, Canada, Europe, Australia, and New Zealand
 Source: Prequin, Center for Venture Research, Kauffman Foundation, PWC, NVCA, Thomson Reuters, World Economic Forum Investors Industries analysis

This growth is reflected in the money being put to work by VCs across the world. As shown in Figure 5, VC investments have more than doubled in North America and Europe and grown 5x in Asia.

Figure 5: The amount of venture capital has increased significantly in all major regions in recent years¹³

Total amount invested in VC, \$ billions

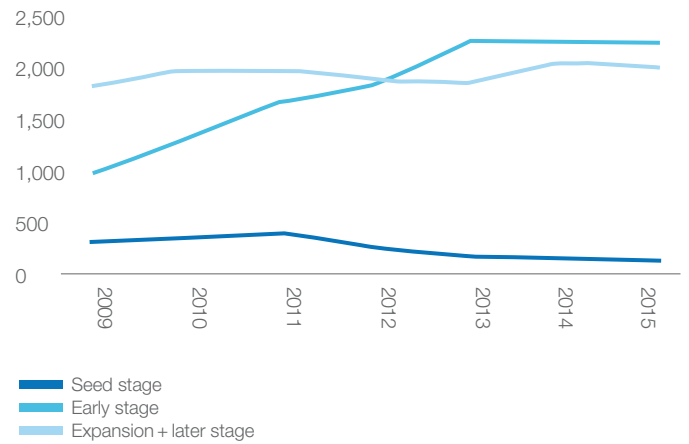


Source: NVCA/PWC Moneytree

For early-stage investments, this growth is a reflection of an increase in the number of deals, while for late and expansion stage investments, average deal sizes have grown (Figures 6 and 7).

Figure 6: The number of early stage deals has doubled since the financial crisis¹⁴

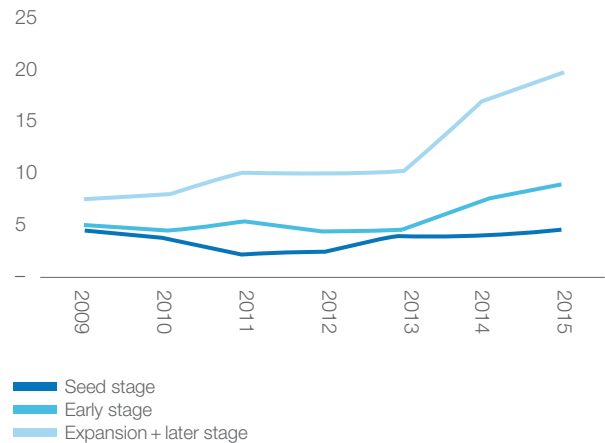
Total number of deals in US VC



Source: NVCA/PWC Moneytree

Figure 7: The average deal size has nearly doubled for late stage deals¹⁵

Average deal size for US VC, \$ millions



Source: NVCA/PWC Moneytree, World Economic Forum Investors Industry analysis

2.2. What you need to know

Overall, we see three main trends in the VC industry: 1) the funnel for startups is broadening as more startups seek and find funding in the early stages; 2) the time before a start-up seeks an exit through an IPO or acquisition by a company is lengthening; 3) Asia is emerging as an important hub for VC due to the globalization and localization of venture capital and the scale of China as a new potential market for firms.

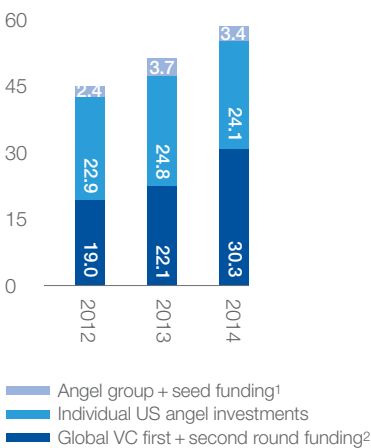
2.2.1. The funnel is broadening

The number of start-ups being funded is growing for several reasons. First, the number of wealthy private individuals, which have historically been an important source of capital for start-up companies, increased dramatically over the past decade. The growth in emerging markets generated enough private wealth to nearly triple the number of individuals worth more than \$100 million from 2004 to 2014, from ~3,300 to ~9,800, with China accounting for 33% of this total.¹⁶ Though the growth rate in emerging markets was lower (~40%), the absolute increase (~8,400) in the number of similarly wealthy individuals in developed nations was even larger.¹⁷

Despite the decline in the number of VC firms in developed nations, globally the amount of capital invested startups has grown by about 30% between 2012 and 2014 (Figure 8).

Figure 8: Capital invested in start-up entrepreneurs globally^{18, 19, 20}

Capital invested in start-up entrepreneurs, \$ billions



¹ 2014 is extrapolated from data for the first 3 quarters

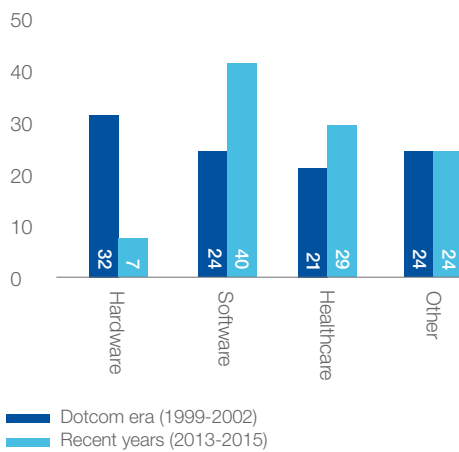
² Includes corporate venture capital investments

Source: Center for Venture Research, CrunchBase, EY

Second, technological developments have significantly reduced the cost of starting a business, which has reduced barriers to entry for entrepreneurs around the world. This is true especially in software, where – thanks to cloud technology – it is now possible to start a business without even owning a server. Figure 9 shows how funding trends have subsequently skewed heavily towards the software sector in the last decade.

Figure 9: Capital invested in start-up entrepreneurs²¹

Share of capital invested in US VC, % of all capital



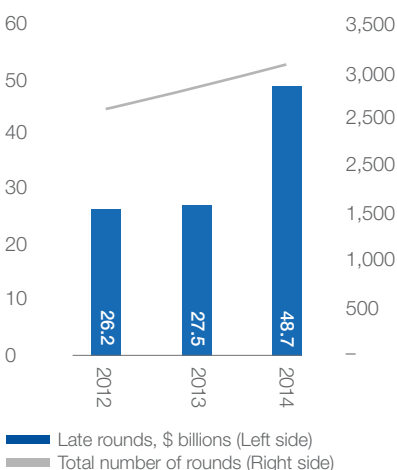
Source: NVCA/PWC Moneytree, World Economic Forum Investors Industries analysis

2.2.2. The runway is extending

The time a company remains private prior to becoming a publicly listed firm or acquired by another company more than doubled between 2001 and 2014.²² More recently, there has been a significant increase in the number and value of investments made in late stage funding rounds, driven by some highly-valued deals in 2014 (Figures 10).

Figure 10: Global investment in late stage VC nearly doubled from 2012 to 2014²³

Global¹ venture capital investment for late² stage companies, \$ billions and number of rounds



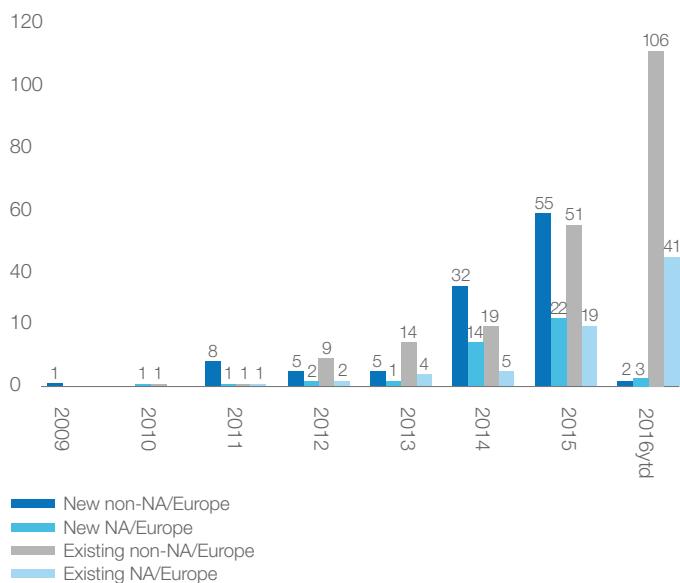
¹ Global total includes the US, Europe, Canada, China, Israel (all site) and India only.

² Includes rounds 3 or later

Source: EY

This trend has contributed to the creation of a record number of “unicorns,” private VC-backed companies valued at \$1 billion or more. The phenomenon has been global, with 152 companies worth an estimated \$532 billion passing this threshold (Figure 11), including 14 estimated to be worth \$10 billion or more.²⁴

Figure 11: The number of private VC-backed companies worth more than \$1 billion has increased to record levels²⁵
 Number of private VC-backed companies valued at \$1 billion¹ or more



¹ Through 9 Feb 2016

Source: CB Insights

A number of factors are driving this trend – both on the capital demand side, as companies want to stay private longer, and on the capital supply side, as more money is flowing in to late stage investments. On the demand side, start-up companies in the US have long complained that the Sarbanes-Oxley Act of 2002 significantly and unnecessarily increased the regulatory burden and associated cost of becoming a publicly listed company.²⁶ The government sought to address such complaints when it passed the Jumpstart Our Businesses (JOBS) Act in 2012. While the law has reduced the cost of going public, it also made it easier and less costly to remain private by raising the maximum number of shareholders that a company can have from 500 to 2,000. Above this threshold it would have to begin meeting SEC registration and reporting requirements.²⁷ Consequently, there is an incentive for companies to remain private longer in order to avoid additional expenses and the short-term pressure associated with having public shareholders.

On the supply side, the growing scale of allocations to alternatives by many institutional investors makes it inefficient to deploy capital with small VC funds focused on early stage deals. However, LPs are allocating more money to late stage venture, which allows them to invest in the asset class at scale.

Aside from LPs, hedge funds, asset managers and private equity firms are also pushing in to the space. Figure 12 lists some of the firms that have invested in late stage venture capital, showing that unicorns can now attract capital from a wide range of investors (either directly or as a broker on behalf of clients). This can be seen by the fact that nearly half of the unicorns noted earlier have received capital from non-traditional investors.

Figure 12: Non-traditional investors that have provided capital to unicorns^{28, 29, 30, 31}

Type of investor	Number of investments in unicorns ¹	Examples
Asset managers	27	Fidelity, Blackrock, Franklin Templeton, T. Rowe Price
Hedge funds	25	Tiger Global Management, Coatue Management, Farallon Capital
Investment banks	14	Goldman Sachs, J.P. Morgan, UBS, Credit Suisse
Private equity	12	KKR, CVC Capital, GSO Capital
Sovereign wealth funds	12	Temasek, Kuwait Investment Authority, GIC, CIC
Pension funds	2	CPPIB, OMERS
Total number of unicorns with non-traditional investors	74	
Total number of unicorns²	152	

¹ Not all investments are known, so the number for each type of investor could be higher

² Data as of 9 Feb 2016

Source: CB Insights, Venture Capital Journal, Capital IQ

2.2.3. The playing field is leveling

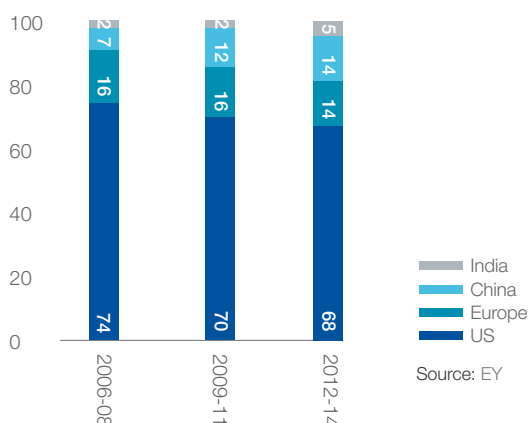
Venture capital is evolving from an industry dominated by the US, and the Silicon Valley area in particular, to one with multiple hubs spread across the globe. This is both due to saturation of the asset class in developed markets and significant growth in emerging markets.

With regards to developed markets, institutional investors such as pension funds, endowments, and foundations – which have historically been a key supporter of venture capital and early stage companies – responded to poor performance and growing funding gaps by reducing allocations to early stage venture capital. The Kauffman Foundation issued an influential report in 2012 which noted that only 38 of their 100 venture fund investments did better than public markets, and just 20 did so by 3 percentage points or better.^{32, 33, a} Meanwhile, the increase in the pool of high net worth individuals across the world has made it easier for entrepreneurs to start and grow businesses in their home region, rather than relocating to traditional hubs in California and Boston.

China and India, in particular, have emerged as new hubs for global venture capital. Together, they now attract more investment than Europe (Figure 13). In addition, more than 25% of the unicorns are not based in North America or Europe, and half of those are based in China. VC in the US remains highly concentrated, with only 23% of capital in 2014 going to businesses outside of California, New York, or New England.³⁴ In contrast, 57% of angel funding went to companies outside those three areas during 2014.³⁵

Figure 13: China and India account for a growing share of global VC^{36, 37}

Share of global VC for top regions, %



^a Using much larger data sets, academics reached similar conclusions and found that venture capital underperformed in the 2000s, with median and average public market equivalent returns (PME) of only .84 and .91 (a number below 1 denotes underperformance relative to a comparable public equity market equivalent).

2.3. What to look out for

Taken together, these trends spell a shift in the investment landscape for the venture capital industry. We believe three effects can be extrapolated from these trends.

2.3.1. GPs will become more specialized

Most GPs, traditional or otherwise, will pursue the specialist model. Private VC firms, corporate VC arms, private equity firms, and hedge funds in developed markets have sought to specialize by focusing on a particular set of industries (such as mobile internet, pharmaceutical, or energy) and often in a single stage of funding (early or late). A similar pattern can be found amongst VC firms and hedge funds in emerging markets and angel funds in the US, where they usually focus on investing in a particular state (angel funds), country, or region (other investors).³⁸

2.3.2. Increased competition will drive consolidation amongst VC firms

VC firms will face increasing pressure from both LPs and other GPs in the coming years, with fewer firms attracting a greater share of the capital. A prolonged period of disappointing returns, coupled with research indicating that past returns are still predictive of future returns,³⁹ is leading LPs to focus on investing with elite firms or in late stage (and less risky) deals. Similarly, the broadening of the opportunity set noted earlier has attracted a larger and more diverse pool of GPs to compete for both deals and capital.

By 2007, US venture capital as an industry had provided institutional investors with poor risk-adjusted returns for more than five years.⁴⁰ Most LPs reacted by reducing their allocation to the asset class, with total AUM for US VC firms falling 25%⁴¹ from 2007-2012 and the number of principals in the industry falling by 33%.⁴² LPs also began to concentrate their funds with fewer VCs. Geoff Love, head of venture capital at the Wellcome Trust, notes that this is because “the bulk of the rewards will only consistently fall to those at the top...it is not about being in the top half or top quartile, it is much more than that.”⁴³ Many veteran GPs upsized their funds when LPs consolidated their relationships. The result was a doubling of the average fund size raised from \$123 million in 2002 to \$287 million in 2012.⁴⁴ The realignment of capital towards late stage investments has largely proved successful. In recent years, US VC funds have returned to outperforming relevant benchmarks, but it remains to be seen whether this is a cyclical or structural trend.⁴⁵

2.3.3. Venture capital will see a “locally-driven” globalization

Venture capital is already well on its way towards globalizing and this trend will only accelerate slowed only by the fact that start-up focused capital does not scale very efficiently.⁴⁶ In addition, the partnership structures and proprietary networks are much more entrenched than in other alternative asset classes, which make it difficult for firms to grow rapidly. As a result, leading firms such as Sequoia Capital, Accel Partners, and Kleiner, Perkins, Caufield and Byers (KPCB), are expanding internationally, but the business models employed by those firms are more akin to franchises. In this respect, they differ notably from leading global private equity buyout firms, which typically invest heavily in their institutional architecture, thereby enabling them to support deep and bespoke relationships with LPs and the ability to go public. Consequently, venture capital ecosystems will be organically grown and led by local principals, even if many of the firm names are globally recognizable.

2.4. Take-away

More capital for start-ups is a double-edged sword. On the one hand, more investors and capital mean that more entrepreneurs are likely to receive funds, which broadly translates into more innovation. On the other hand, the same effect leads to higher valuations, which – taken to the extreme – can result in equity bubbles that are bound to burst. Whether we are in a bubble today remains a matter of debate.

The impact of companies electing to remain private longer is an issue that may affect the broader public as well. This is because returns from investments in high-growth companies fall primarily to investors in private markets, rather than investors in public markets. Historically, much of the public was able to financially benefit from start-up companies, either indirectly through their pension funds, as institutional investors were key investors in VC firms, or by investing in public stocks after a start-up exited through an IPO or sale to a public company. The share of the US population that has access to a pension fund continues to decline and with it the number of people that can indirectly invest in venture capital.⁴⁷ In addition, much less of the potential upside is available to non-high net worth individuals if companies elect to remain private significantly longer. However, the general public may be able to indirectly benefit from privately held companies by investing in mutual funds that invest in these companies.

The spread of venture capital across the globe benefits not just entrepreneurs, but society as well. Once entrepreneurs in China, India or Africa start building global companies – as in the cases of Alibaba or Xiaomi – we can expect to see the breadth and depth of innovation increase, yielding positive societal impact not only for the origin countries, but across the globe.

The rise of crowdfunding

3.1. Overview

Crowdfunding platforms, also known as marketplaces, bring together capital supply (investors) and demand (businesses) to interact directly with each other, rather than through traditional intermediaries, such as banks. Instead of providing investment advice or marketing investments in equity or debt, alternative funding platforms: 1) aggregate investment opportunities; 2) provide a standardized view of the opportunities; and 3) facilitate legal structuring of equity or debt issued.

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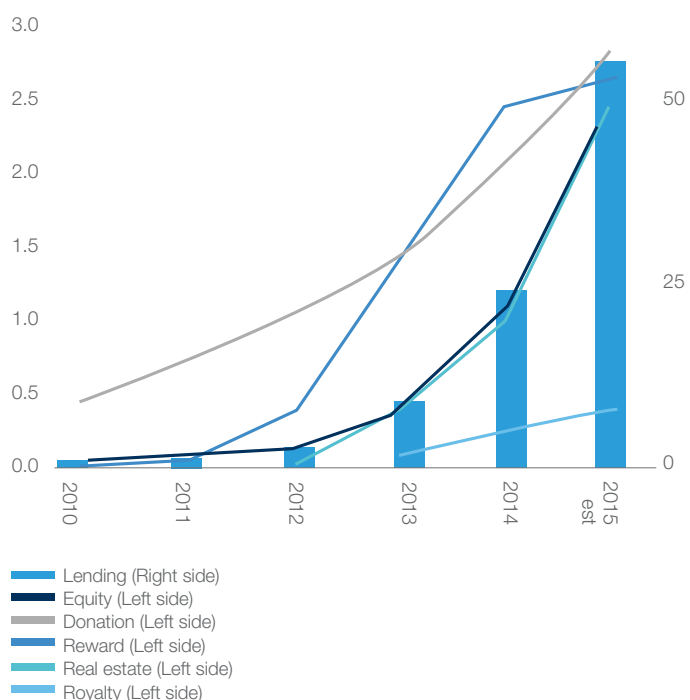
Crowdfunding platforms have grown dramatically in recent years.

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Crowdfunding platforms have grown dramatically in recent years. Since 2010, funding levels have grown at an annual rate of more than 110%, reaching a projected total volume of new issuance of almost \$70 billion in 2015 (Figure 14). This number falls into six types of crowdfunding detailed in Box 1, the largest of which is marketplace lending (also known as peer to peer or P2P lending).

Figure 14: Global crowdfunding by type has grown rapidly in recent years ^{48, 49, 50, 51}

Global crowdfunding by type, new issuance in \$ billions



Source: Massolution, World Economic Forum Investors Industry analysis

Box 1: Different types of crowdfunding

Marketplace (peer to peer) lending

Marketplace lending encompasses a new wave of non-bank, tech-focused, typically web-based loan originators.⁵² Crowdfunding firms provide a platform through which non-banks can loan money to borrowers. Most of these loans are unsecured personal loans. Other forms include student, commercial and real estate, payday, and secured business loans, and business leasing and factoring.⁵³ The interest rates are set by lenders who compete for the lowest rate on the reverse auction model or are fixed by the intermediary company on the basis of an analysis of the borrower's credit.⁵⁴

Equity crowdfunding

Equity crowdfunding provides a new channel for entrepreneurs and small businesses to raise equity capital for their businesses. If marketplace lending serves as an alternative to traditional bank lending, then equity crowdfunding offers an alternative for those seeking angel or venture capital funding. A key distinction between this model and the other two is that non-high net worth

individuals are now permitted to provide equity to private businesses, which dramatically increases the number of potential investors an entrepreneur can seek capital from. However, it is worth noting that raising capital in this manner does not provide the entrepreneur with the operational, organizational, or financial expertise or access to business networks that VC firms and angel investors typically provide to the companies they invest in.

The amount of capital raised to date has been rather modest. However, it is expected to increase significantly in coming years.⁵⁵ Historically, the model was constrained due to legal limitations intended to protect unsophisticated retail investors, but as was mentioned earlier, that is no longer the case. Only \$110 million was raised in 2012, but that total is projected to soar to more than \$2.5 billion globally in 2015.⁵⁶ Continued growth could help to counteract the trend of the general public increasingly losing access to high growth investment opportunities. Equity crowdfunding is also being used outside the United States, with the United Kingdom being one of the other hubs for the model. The amount invested has grown 20x since 2012, from £3.9 million in 2012 to £84 million in 2014.⁵⁷

Real estate crowdfunding

Real estate crowdfunding is a real estate focused version of the equity model, in that it provides a new avenue for developers seeking to raise capital for their projects. Like equity crowdfunding, the growth of the segment is affected by the implementation of the JOBS Act, particularly since 56% of funds raised in 2014 were in the US.⁵⁸ Total funds raised have soared from \$19 million in 2012 to \$1 billion in 2014 and the total funds raised in 2015 are projected to reach \$2.5 billion.⁵⁹ In 2014, nearly 100 platforms were engaged in more than 500 campaigns that ranged in scale from less than \$100,000 to more than \$25 million, with projects including multi-family dwellings, hotels, and office buildings.⁶⁰

Rewards-based funding

Rewards-based crowdfunding seeks to generate an investment return for investors in the form of rewards or discounts related to the products or services that are being funded by their capital. Most of the underlying projects are small scale or related to the arts, and resemble those supported by donor-based funding.

Funding for this model has also grown rapidly in recent years. In 2011, \$59 million was raised this way, but \$2.47 billion was raised in 2014. The growth has been strong enough to attract the attention of the European Commission, which is considering applying a 23% value-added tax to all rewards received by those providing capital.⁶¹

Donor-based funding

Donor crowdfunding seeks to provide funding for individuals and projects on a charitable basis, with donors not expecting an investment return for their contribution. Unlike traditional charitable donations, which are typically dedicated to social or religious causes, crowdfunding donations usually go to support businesses that might not otherwise be able to attract capital from traditional sources. In particular, donor-based crowdfunding often focuses on entrepreneurs, social entrepreneurs and small businesses in fields that are deemed too risky for bank lending, such as the arts or music, and too niche to attract angel or venture funding.

The origins of the donor based segment, and crowdfunding more broadly, can be traced to the dotcom era, when UK rock band Marillion used the internet to raise the \$60,000 necessary to launch a concert tour in North America.⁶² They subsequently helped to support the founding of rewards-based crowdfunding in 2001 when they pre-sold their album to fans in exchange for the funding required to produce it.⁶³ During the same era ArtistShare, the first of many crowdfunding sites dedicated to funding musicians, was launched. Since then, funding platforms have been established to help fund projects, events, and awareness campaigns in areas such as film, literature, fashion, photography, video game development, and science.

The segment continues to experience robust growth. Platforms such as Indiegogo raised more than \$2 billion in 2014, up from \$470 million in 2010.

Royalty-based funding

From the perspective of an entrepreneur, royalty based fund raising is similar to marketplace lending. The entrepreneur is able to raise capital without relinquishing an equity stake and potential control of the business, while the lender receives a stream of pre-profit income. The model is the newest of the six highlighted and unlike other models, regulatory agencies such as the US Securities and Exchange Commission (SEC) have not yet weighed in on how to regulate the segment. Funding levels remain modest, but growing, with \$60 million raised in 2013 and \$270 million in 2014.⁶⁴

3.2. What you need to know

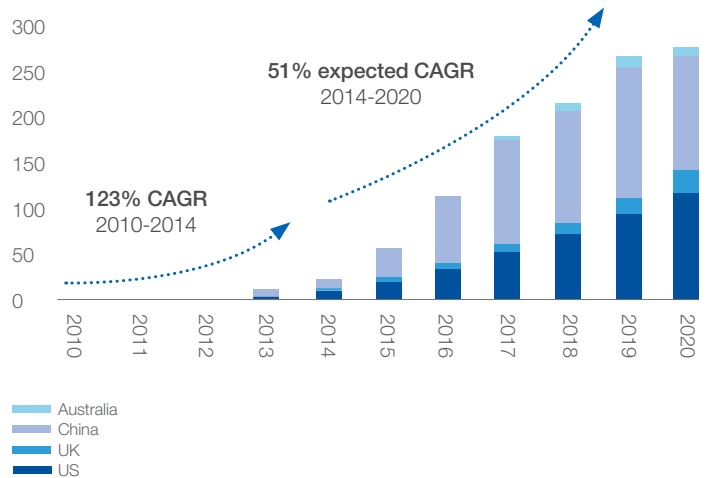
Three insights emerge from our analysis of the crowdfunding space: 1) marketplace lending makes up most of crowdfunding and that will likely hold true for the foreseeable future; 2) China is helping to lead the creation of the market, which stands in contrast to other financial products, where it followed the lead of the US or Europe; and 3) the “crowd” behind crowdfunding is actually made up mostly of institutional investors and that is unlikely to change in the future.

3.2.1. Marketplace lending makes up most of crowdfunding

From 2009 to 2014, marketplace loans, the largest-volume type of crowdfunding, grew from less than \$1 billion in 2009 to over \$20 billion in 2014 (Figure 15). The growth in the number of crowdfunding platforms has been equally robust, with the market growing from 450 platforms at the end of 2011⁶⁵ to more than 2,500 platforms by the end of 2014.^{66, 67}

Figure 15: Global marketplace lending has risen rapidly and that is expected to continue in the coming years⁶⁸

Global marketplace loan issuance, \$ billions



Source: Morgan Stanley, company data

Marketplace lending firms seek to provide competitive rates to borrowers and access to those who might not be able to obtain loans from traditional banks. They are able to compete with traditional banks because they utilize a lower cost structure. They only maintain an online presence and use algorithms in place of large numbers of retail or commercial lending staff. It is estimated that operating and marketing expenses are 2% of outstanding loans, compared to 6% for traditional banks.⁶⁹ Additionally, regulatory changes since the financial crisis have incentivized banks to reduce capital intensive activities which include SME loans.⁶⁹ The same regulations do not apply to marketplace lending firms, which allows them to provide capital to SMEs without facing similar disincentives.

Marketplace lending firms also seek to maintain rates of return that are attractive to investors. They accomplish this by rigorously vetting borrowers with their algorithm based screening processes and focus primarily on prime and near prime borrowers.⁷⁰ Many firms report that only 10-20%^{71, 72} of applicants qualify for a loan, while approval rates for small business loans by banks and credit unions typically range from 20-50%.⁷³ The average default rates, at 0.35-4%^{74, 75, 76} are lower than the typical default rates of 1.5-14%^{77, 78} for credit cards or small business bank loans, but it remains to be seen what the long-term default rates will be for marketplace lending. Applicants that qualify are offered highly variable interest rates that typically average 6-13%^{79, 80} but that may range up to 35%.⁸¹

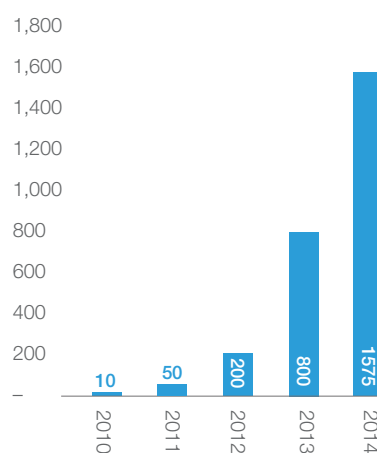
The result has been annualized returns of 5-9%.⁸² In order to reduce the volatility associated with these returns, many platforms automatically pool loans, which reduce the impact of defaults on any given investor.⁸³ The yield potential has attracted the attention of family offices, credit funds, hedge funds, and even sovereign wealth funds.⁸⁴

3.2.2. China stands out as the leading market

China drives a significant part of crowdfunding's global growth. While marketplace lending originated in the US, entrepreneurs in China were quick to realize its potential and adapt it to the local market. It has grown rapidly since its introduction in 2010 and today there are more than 1,500 platforms operating in China, up from almost none four years prior (Figure 16).⁸⁵ Moreover, Morgan Stanley projects that loan originations in China by marketplace lenders could grow from \$9 billion in 2014 to \$128 billion by 2020⁸⁶ The immense demand and market potential stems from the fact that "only 3 percent of China's 42 million small and midsize businesses can get bank loans, while 36.7 trillion yuan (approximately 5.75 trillion USD) of household savings sits in bank deposits," according to Citic Securities.⁸⁷

Figure 16: Marketplace lending has grown rapidly in China⁸⁸

Number of marketplace lending platforms in China

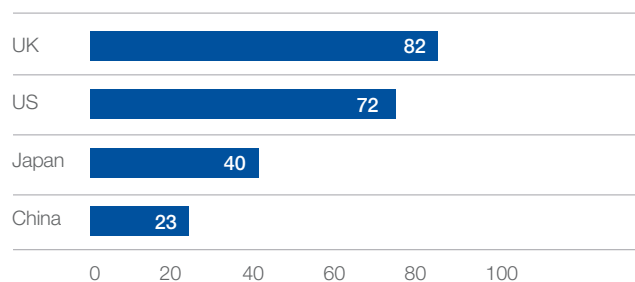


Source: Morgan Stanley Research estimates

Much of this growth is driven by marketplace lenders targeting a market currently not served by banks. This means the potential for growth is significant, given China's fast growing – but comparatively still low – consumer debt. In developed economies, such as the US and the UK, consumer loans as a share of GDP are more three times the rate of China's (Figure 17). This means there is enormous potential for growth, and given that China's rate has almost doubled since 2008, it is on a trajectory to exploit this potential (Figure 18).

Figure 17: Consumer leverage in China remains low compared to the US, UK, and Japan⁸⁹

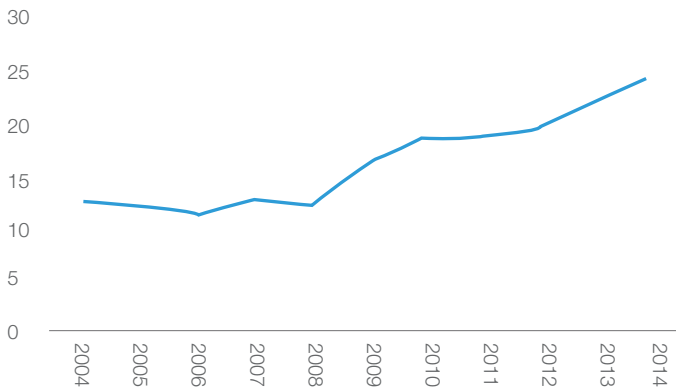
Consumer loan as a share of GDP, %



Source: CEIC, Morgan Stanley Research estimates

Figure 18: China's consumer leverage has doubled over the past decade⁹⁰

Consumer loans as a share of GDP, %



Source: CEIC, Morgan Stanley Research estimates

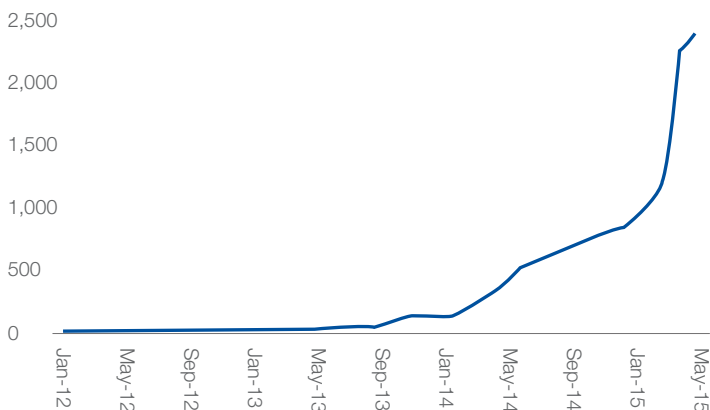
3.2.3. Crowdfunding is a misnomer

Crowdfunding conjures up an image of individuals providing capital to a single entrepreneur or business. In reality, the capital usually comes from large institutional investors, not individuals. Demand by institutional investors is so strong that an estimated 80-90% of all loans originated by Prosper and the Lending Club, leading marketplace lending platforms, are purchased by institutional investors. Figure 19 shows that institutional investors have invested at least \$2.5 billion into marketplace lending.⁹¹

Investors utilize a variety of methods for investing in marketplace brokered loans. GPs, such as hedge funds, typically invest using their existing pool of assets. However, some GPs have created funds dedicated to investing in marketplace loans.⁹² Institutional investors also partner with platforms and provide them with capital to lend out on their behalf.⁹³ They have, in fact, become active in marketplaces to the point that Morgan Stanley recently proclaimed peer-to-peer lending to be a misnomer.⁹⁴

Figure 19: Publically disclosed institutional fund flows into marketplace lending⁹⁵

Total institutional funds invested, \$ millions



Source: Company data, P2PFI, Victory Park, British Business Bank, Morgan Stanley Research

3.3. What to look out for

3.3.1. Crowdfunding will go mainstream and international

Crowdfunding may have its roots in the US, but it has quickly spread to Europe and Asia. PWC, the World Bank, and Morgan Stanley estimate that marketplace lending could provide \$150-\$490 billion in funding by 2020-2025.^{96, 97, 98,99}

3.3.2. Traditional banks will re-intermediate marketplaces

Marketplace lending platforms are also partnering with traditional banks. The largest marketplace lending firm in the US, Lending Club, recently partnered with members of BancAlliance, an organization of 200 community banks, wherein the banks commit to purchasing a certain amount of loans processed by the platform.¹⁰⁰ Another firm, CircleBack Lending, entered into an agreement with the Jefferies Group, the investment bank, to securitize up to \$500 million of unsecured consumer loans.¹⁰¹ Other notable partnerships exist between Santander UK and Funding Circle¹⁰², Citigroup and Lending Club¹⁰³, Citizens Bank and SoFi.^{104, 105} Other incumbents have opted to develop their own platforms: Goldman Sachs recently introduced a marketplace lending platform focused on consumer oriented loans.

Rather than marketplace lending platforms disintermediating incumbents, the trend towards partnerships shows that traditional players have adopted and identified marketplaces as a distribution channel. Meanwhile traditional banks can help marketplaces with lead generation. Consequently, the future of marketplace lending could be one not of disruption, but of co-competition and complementation.

3.4. Take-away

The rise of crowdfunding has implications for all actors in the alternatives investments industry. Importantly, it offers financial products and services to currently unbanked populations. This strategy follows the classic disruption playbook. Whether traditional banks will be disintermediated, however is doubtful. Instead it appears more likely that marketplaces will ultimately become another distribution channels for incumbents. Figure 20 summarizes the main implications for actors across the ecosystem.

Figure 20: Implications for Society ecosystem actors

Actor	Role of crowdfunding
Small businesses	New source of capital, particularly in emerging markets
Entrepreneurs	New source of seed capital prior to VC rounds
Retail lenders	New source of returns for retail investors
Traditional banks	New channel for issuing loans
Institutional investors	New source of returns and potential diversification benefits
Regulators/policymakers	Governments will need to assess the industry and identify to what degree it should be regulated

Mid-market capital

4.1. Overview

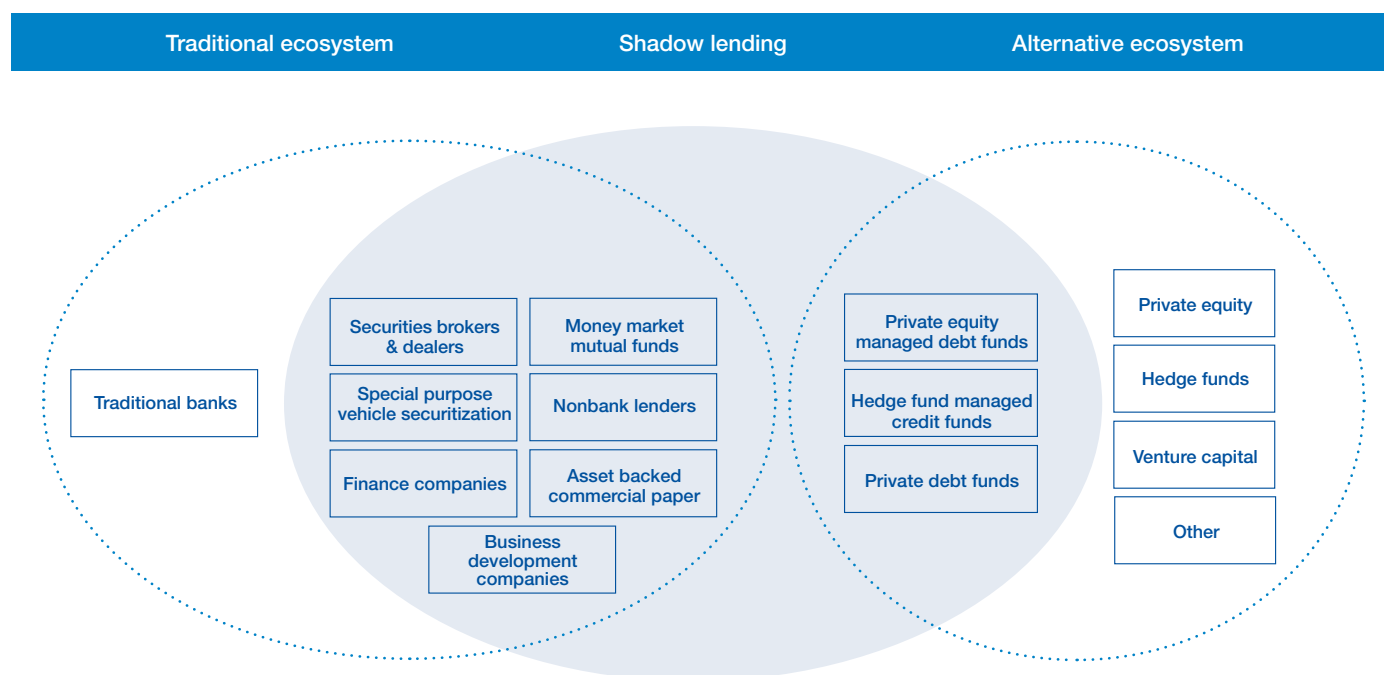
The private debt market largely consists of three forms of debt: mezzanine debt, distressed debt, and direct lending. Private debt is primarily offered to small and medium sized enterprises by private debt funds, private equity managed debt funds, or hedge fund managed credit funds (Figure 21). The funds invest directly in the debt, with little or no leverage involved in the transaction. Given that most funds expect to hold their investments for multiple years, the former two types of GPs rely on traditional 10-year investment structures, while hedge funds often require lock-up periods of two or more years.¹⁰⁶

“

Alternative investment funds dedicated to investing in private debt have soared in number and volume in recent years.

”

Figure 21: Overview of key actors in the shadow lending system¹⁰⁷

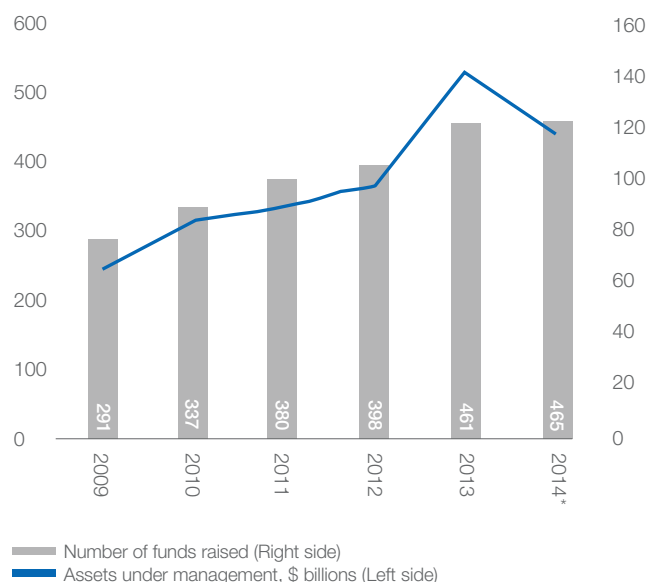


Source: World Economic Forum Investors Industries

Alternative investment funds dedicated to investing in private debt have soared in number and volume in recent years (Figure 22). The fastest growing segment, direct lending funds, is also considered to be one part of the wider world of shadow lending because debt investors are supplanting the role of regulated lending banks. Figure 23 contrasts the traditional bank lending process (blue boxes) with the more complex non-bank intermediation processes often referred to as “shadow banking” (dark grey boxes). A critical difference between private debt lending and other forms of shadow banking is that the former does not involve maturity transformation – i.e. the practice by financial institutions of borrowing money on shorter timeframes than they lend money out at – as most such investments involve a straight-forward investment of equity in debt. Moreover, private debt transactions are not typically characterised by large amounts of leverage, short-term financing, or the use of sophisticated financial instruments, as is common in other areas of shadow banking (light grey boxes).

Figure 22: The size of the private debt fund industry has increased significantly since the financial crisis¹⁰⁸

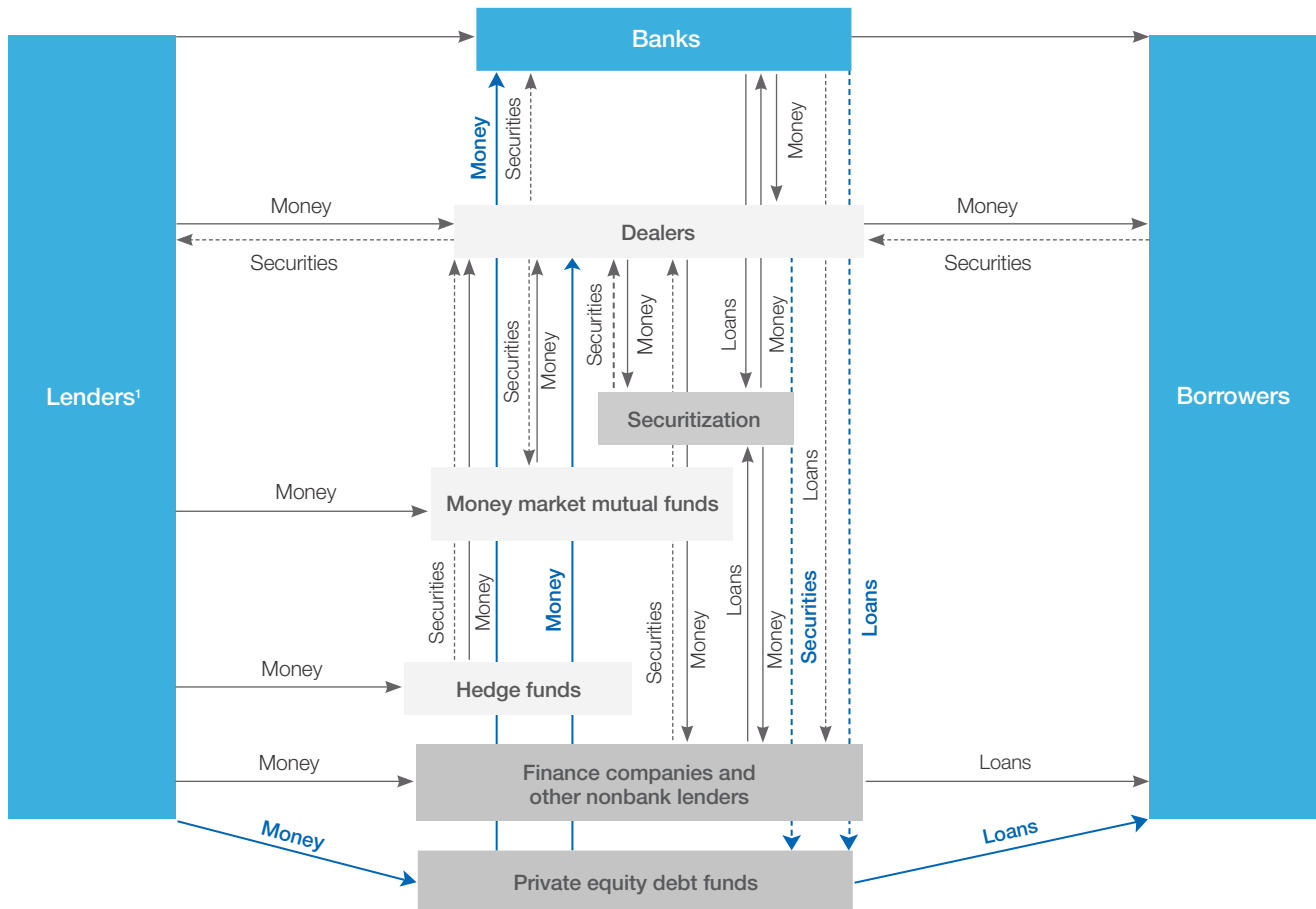
Number of private debt funds raised and total AUM, \$ billions



* Assets under management are through June 2014

Source: Preqin

Figure 23: Traditional versus shadow banking intermediation¹⁰⁹



Source: IMF staff illustration, World Economic Forum Investors Industries

Note: This simplified representation of the financial sector shows the flow of funds from lenders to borrowers. It does not show the reverse flows, such as bank deposit withdrawals and money market mutual fund redemptions. The blue boxes represent the components of a bank-based economy, with the rest representing the shadow banking sector. The boxes on the outside characterize a simple shadow banking system as might be found in a less developed economy. The lighter colored boxes in the middle reflect the kinds of shadow banking activities and entities usually associated with more advanced economies, with dealers as the hub of most activity. This activity comprises issuing securities on behalf of borrowers (including securitization vehicles, finance companies, and other nonbank lenders), providing prime broker services to hedge funds, and conducting repurchase agreements and securities lending. Securitization vehicles do not generally involve borrowers directly. Securitized assets generally come from banks and nonbank lenders, and securities from dealers. See Annex 2.2 for details on the role of securitization.

4.2. What you need to know

Three developments in private debt markets stand out:

1) traditional banks are retreating; 2) there is a noticeable shift into alternatives; and 3) the regulatory window may soon be closing.

4.2.1. Traditional banks are retreating

The fundamental driver is a decline in bank lending to smaller and mid-market firms, triggered by the global financial crisis and the ensuing wave of bank capital reforms. This led to a rapid fall in the lending capacity and risk appetite of traditional lenders in the post-crisis years.

In the same period, the demand from institutional investors for assets with relatively high yields has increased, for fundamental reasons already covered in this report series. The result has been

a sharp rise in the number of alternative investment firms and funds in the credit area, with many of the largest firms expanding their product offerings to include private debt funds.

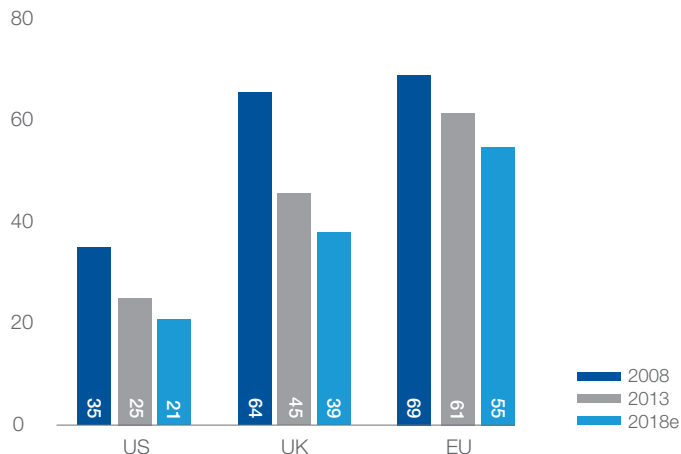
The scale of the withdrawal by banks from certain lending markets has proved immense, with S&P estimating that the shortfall in credit over the 2013 to 2018 period will amount to some \$700 billion in the European Union and United Kingdom, with an additional \$500 billion in the United States.¹¹⁰

Bennett Goodman, one of the three founders of GSO, a large credit fund, sums up the dynamic: “Regulatory pressures are driving the banks to reduce their leverage and adopt more of a ‘capital lite’ business model... accordingly, they’re trying to syndicate capital risk and we’re trying to own it.”¹¹¹

The result has been a significant reduction in the share of corporate loans provided by traditional banks (Figure 24).

Figure 24: The share of bank loans as a share of all corporate debt is expected to continue falling¹¹²

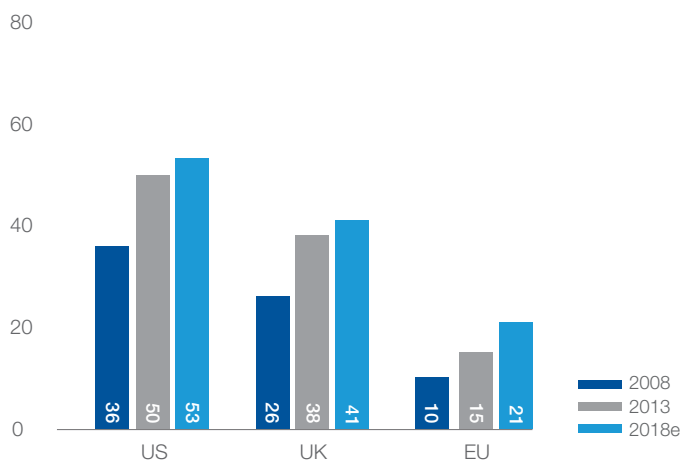
Bank and other loans/Total corporate debt, %



Source: S&P

Figure 25: The share of corporate bonds and debt securities as a share of all corporate debt is expected to continue rising¹¹³

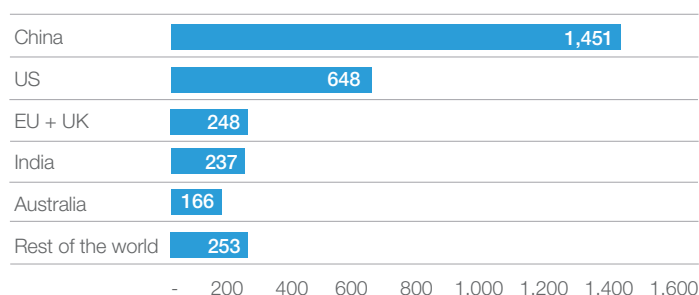
Bonds and debt securities/Total corporate debt, %



Source: S&P

Figure 26: China will account for half of the projected value of bank disintermediation by 2018¹¹⁴

Projected value of bank disintermediation by 2018, \$ billion



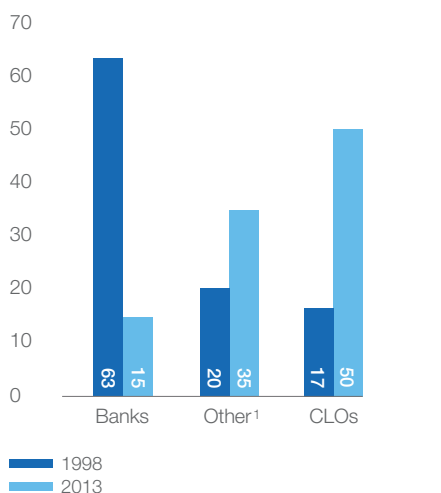
Source: S&P

4.2.2. There is a shift into alternatives

There is strong growth in the proportion of total corporate debt taking the form of bonds and other debt securities (Figure 25).¹¹⁵ Overall, S&P forecasts the scale of net bank disintermediation will amount to ~\$1 trillion by 2018 in Western economies and another \$2 trillion in China and other countries (Figure 26), which creates a sizable opportunity for alternative investment funds seeking to expand into the credit space.

The move from owning risk to syndicating risk can be seen clearly in the leveraged loan market. Banks used to be the primary investor in such loans, but non-bank sources such as alternative investors, CLOs, and prime rate funds now dominate the market (Figure 27), as underlying demand by institutional investors has remained robust.

Figure 27: Non-banks have replaced banks as the primary source of capital for leveraged loans¹¹⁶



¹ Other includes BDCs, hedge funds, private debt funds, insurance companies, and prime rate funds

Source: S&P LCD

The growth in illiquid private equity style funds, with their fixed life spans and formal fund raising cycles, has proven easier to track than the growth of hedge fund activity in the sector.

Since 2009, nearly \$300 billion has been raised by private equity style funds (excludes hedge fund managed credit funds).¹¹⁷ Within this set of funds, the strongest demand has been for direct lending and mezzanine-focused funds, with 76% of all private debt managers focusing on these two strategies (the remainder focused on distressed debt).¹¹⁸ Some 66% of private debt fund managers are based in the United States and 24% in Europe.

Hedge funds are also active in the space. A recent survey on direct lending by the Alternative Investment Management Association (AIMA), which represents the hedge fund industry, found that at least \$85 billion is allocated to private debt investments and they estimate that hedge funds are currently seeking to raise an additional ~\$77 billion.¹¹⁹

Leading private equity buyout firms and hedge funds, such as Blackstone, Apollo, Carlyle, KKR, TPG, and Bridgewater have all expanded their product offerings to include private debt funds, with some scaling up very quickly.¹²⁰ In just seven years, debt and credit funds have grown to become 25% of KKR and Blackstone's portfolios and ~60% of Apollo's total AUM,¹²¹ with the trio now managing more than \$250 billion in debt and credit assets. While the existing mega firms scaled up rapidly, this has not prevented new firms from entering the space, with nearly 700 private equity style funds raised from 2009 through Q3 2015.¹²²

4.2.3. LPs are increasingly investing in the asset class

In contrast to the minimal yields on government bonds, institutional investors often hope for returns of 8-14% from private debt funds.¹²³ The higher yield is a direct result of the additional risk associated with the underlying business, since most such loans are made to businesses that were unable to obtain lower cost loans from traditional banks.

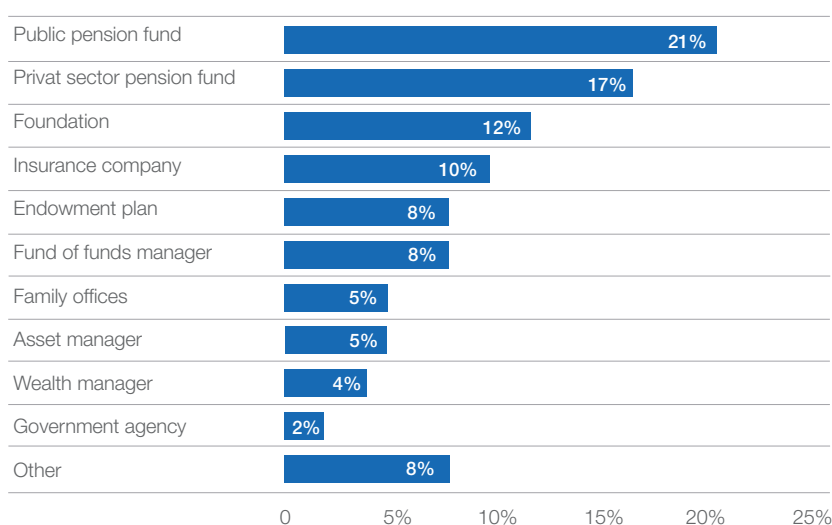
So far, institutions have been reasonably pleased with the results of their debt fund strategies, as Tim Walsh, CIO for the State of New Jersey's pension fund, confirms, "Their performance has been very respectable in a world of 2 percent Treasuries."¹²⁴

The reduced volatility relative to equity investments has also proven attractive to institutional investors. Margot Wirth, head of private equity for CalSTRS, the California pension fund giant, notes that, "There is a lot less certainty with buyout funds than with GSO [a large credit fund] about when the pay-off will come, how much the returns will be and how much of the returns will be eaten in fees."¹²⁵

Acceptance has been strongest by institutions in the United States and Europe, who account for 59% and 32% of all investors in the sector. Globally, 54%¹²⁶ of institutional investors of every type (Figure 28) now invest in private debt and another 13%¹²⁷ are considering doing so. Collectively, they maintain an average allocation of 6.8% to private debt, and prefer investing in North America (74%) and Europe (59%).¹²⁸

Figure 28: A wide variety of institutional investors presently invest in private debt funds¹²⁹

Breakdown of institutional investors in private debt funds by type



Source: Preqin

Box 2: Business development companies (BDCs)

Business development companies (BDCs) are another vehicle for providing small and medium sized businesses in the US with capital. They were created by an act of Congress in 1980 that sought to provide a new source of credit and are governed as mutual funds under the 1940 Act. BDCs pay limited taxes, but must pay out 90% of income to shareholders.

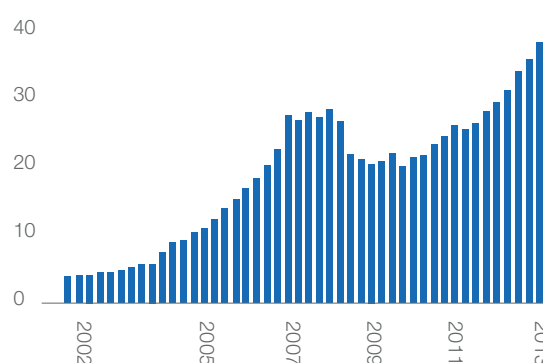
BDCs benefit from being able to lend like banks, only without having to adhere to the same complex set of regulations. They provide mostly floating rate loans, funded by fixed rate debt. Loans are typically issued at ~10% and target, by law, companies valued at less than \$250 million. Besides a focus on increased exposure to floating-rate investments, some BDCs have also chosen to hedge against the risk of rising funding costs through the use of interest rate caps for their revolvers and term loans. Leverage for BDCs is capped at a ratio of 1-1 with equity, though Congress is presently considering legislation that would relax this ratio to 2-1 debt/equity.¹³⁰

BDC fees can be high (similar to private equity, managers often receive 2% in annual management fees and 20% of profits) and corporate governance is typically limited,¹³¹ but yields are relatively high (average better than 9%) and come primarily through regular dividend payments (Figure 1).¹³²

BDCs have grown rapidly over the past decade, with total assets growing 8x since 2002 and doubling since the financial crisis to more than \$40 billion (Figure 2). Overall, BDCs represent a quarter of mid-market debt.¹³⁴ In recent years the vehicle has attracted the interest of many banks and PE firms, with Goldman Sachs, TPG, KKR, and Credit Suisse all raising BDCs.¹³⁵ Collectively, the segment is highly concentrated, as the 10 largest BDCs represent 3/4 of the capital.¹³⁶ Prospects for growth remain, but the ability of BDCs to scale rapidly, as private debt funds have, is limited by the governance structure and limits on the size of companies that it can provide capital to.

Figure 2: BDCs have grown rapidly over the past decade¹³⁷

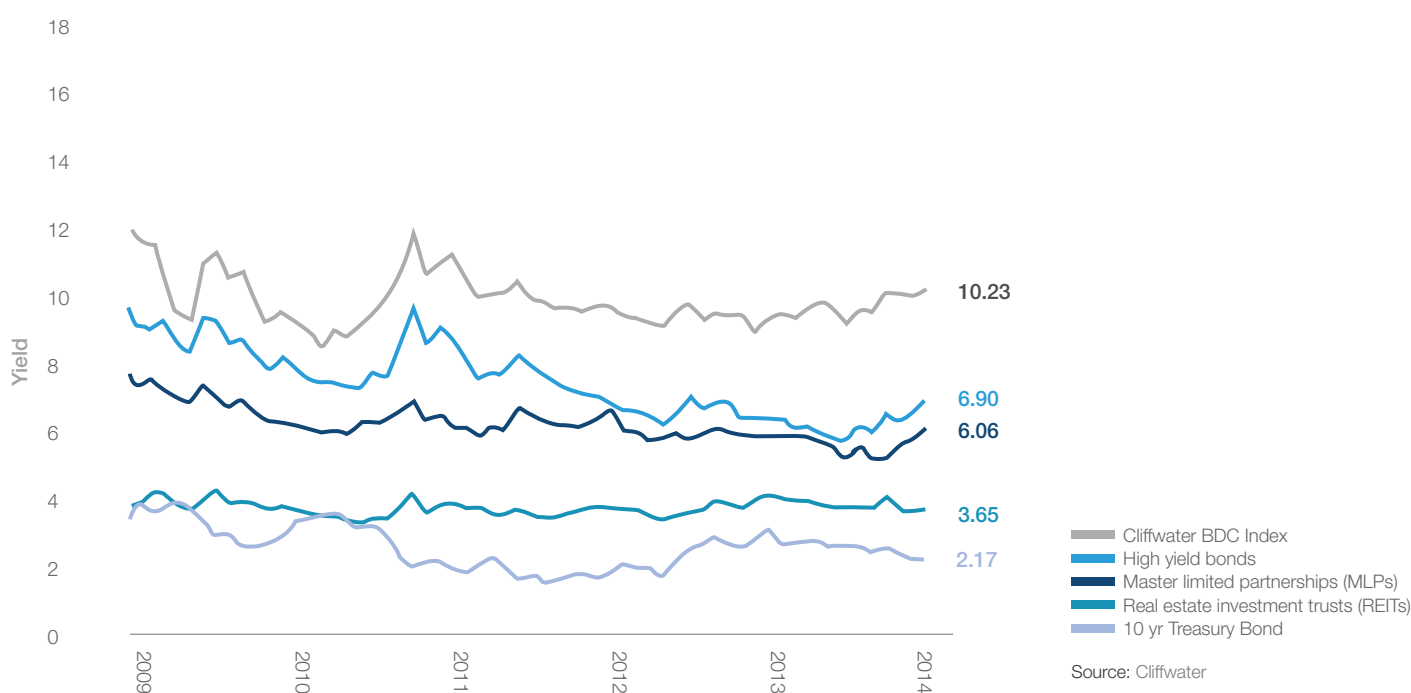
Publicly traded BDC assets, \$ billions



Source: SNL, Wells Fargo Securities

Figure 1: BDCs have outperformed other assets since the crisis¹³³

Yields for selected assets, %



Source: Cliffwater

4.3. What to look out for

The retreat of traditional banks will continue – and with it, the opportunity for alternative players to fill the gap. In this scenario, private debt will become an increasingly important part of not only the alternative investment landscape, but also in the real economy, where increasingly large proportions of companies will seek out private debt products.

4.3.1 Crowdfunding will continue to grow rapidly

Many of the drivers underlying the growth of private debt seem likely to endure, with banks facing continuing structural constraints on their risk taking, businesses remaining keen to raise capital, and investors just as hungry for high expected returns in a continuing low-interest rate environment.

4.3.2. The growth potential will be greatest in Europe and China

Europe and China offer the most growth potential for private debt markets. Post-crisis regulatory changes have led banks, historically the primary source of lending to SMEs, to structurally reduce their lending to SMEs. In China, large state owned banks have typically focused on lending to government related or supported projects, leaving private SMEs with limited access to capital. The demand in both markets is immense and private debt providers are poised to play a much bigger role in coming years.

4.3.3. The segment will face greater regulatory scrutiny

Private debt faces little regulatory scrutiny relative to of lending. Regulators have been keen to understand whether the growth in the sector is creating hidden systemic risks, but thus far they have largely given the industry a pass. GSO's Bennett Goodman has commented that, "We are not a domino. We have long-term capital. We are not vulnerable to forced selling by others. We can't have a run on the bank."¹³⁸

4.4. Take-away

Private debt is growing rapidly, driven in large part by restrictions placed on traditional banks through regulation. The role of private debt in providing capital to businesses will increase, particularly in Europe. The emergence of shadow lending as a critical source of capital will likely result in increased scrutiny by regulators and the introduction of new guidelines aimed at preventing material levels of risk being built-up without the knowledge of regulators.

Conclusion

In this report, we examined three possibly disruptive new sources of capital emerging in the alternative investments landscape. Each is growing within the broader tectonic shifts of the industry, including regulatory issues and macro- and technology trends, but all have their own complex combination of supply-side and demand-side drivers.

Through this exercise we have identified three drivers for new sources of capital:

1. Regulations

For all three new sources of capital we examined in this report, regulation was or is the major factor in the creation of growth of the capital flow. In the case of startup capital, regulation of public markets keeps startups out of them longer and pushes investors into private markets. And in the case of crowd platforms and private debt, incentivizing less risk for traditional banks has spawned new players with more risk appetite.

Insight: Where regulation constrains a capital flow for which there is demand, a new source of capital will emerge to fulfil that demand.

2. Changing demand for capital

As the macro environment evolves, demand for capital evolves. Start-ups are a case in point: as starting a business becomes ever cheaper and the need for funding is reduced, smaller checks are required for funding, which opens the door for investors with smaller pockets. This has attracted high-net worth individuals to create a whole industry of angel investors fueling seed and early stage venture funding to meet this new type of demand for smaller rounds.

Insight: Where capital destinations develop demand for new forms of funding, investors will innovate to meet that demand.

3. Technology

Technology provides players on the demand, the supply side and intermediaries between them with new capabilities. This is most obvious in the case of crowdfunding platforms, which have produced emergent behaviors on both sides. As result, new products and services emerge that would not be possible without new underlying technology.

Insight: Where technology enables new types of origination, investors will take advantage of those opportunities.

Acknowledgements

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