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THE LONG AND SHORT OF IT

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Private Equity

Cyclical Openings to Secular Opportunities

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Private Equity: Cyclical Openings to Secular Opportunities

We believe that 2024 may be among the more interesting vintage years for new funds. Private equity (PE) remains in transition both cyclically and structurally, which will present both opportunities and obstacles for managers and investors. The cream always rises to the top, so we expect dispersion to become increasingly relevant.

SECONDARIES

Higher rates and the related turbulence in the macro landscape have created a new set of interesting investment opportunities. We believe private equity secondaries, in particular GP-led (general partner) single asset continuation funds, provide a prime example, with the potential to be a liquidity provider for quality assets. Mergers and acquisitions and initial public offerings (IPOs) activity faltered in 2022 and 2023 as capital markets slowly adapted to the new, more restrictive, financing environment. With the exit landscape still weak, the holding periods of U.S. private equity-backed companies are longer than ever, and distribution rates have fallen to levels on par with the Great Financial Crisis.

As a result, the private equity industry is running out of time for its finite-life funds to wind down portfolio holdings in an orderly fashion. Consequently, the impending maturity wall has pushed them to devise new liquidity solutions. As they prioritize liquidity over returns, GPs who have vested interests in maximizing the exit values of their trophy assets, have increasingly turned to continuation funds. Meanwhile, limited partners (LPs), such as pension funds and endowments, remain cautious.

Given such dynamics, investors with liquidity have the potential to enjoy both offensive and defensive strategies in this market. In practice, we see this opportunity as (1) entering at modest valuation, (2) taking a selective approach to high quality assets with well adapted core businesses, (3) and investing alongside GPs with a strong alignment of not only interests, but also skills in enhancing operational efficiency. In our view, this last piece is crucial to counterbalance the secular headwinds, such as the higher cost of leverage, as we expect a widening dispersion of performance in private equity.

GROWTH EQUITY & VENTURE CAPITAL

In the last couple of years, the growth equity and venture capital space has swung from one extreme to another, as reflected in fundraising, dealmaking, and valuations. While the major macroeconomic shifts that contributed to the slowdown in 2022 and 2023 have likely stabilized, we expect only a gradual recovery in 2024.

In terms of fundamentals, supply chain normalization and cooling inflation are conducive to incremental company improvements in production capacity, operational efficiency, and consequently, earnings growth.

Nevertheless, it is our view that a broad-based improvement in valuations for venture and growth, which have experienced significant rerating over the past two years, will take some time. A key rationale lies in the difficult exit environment. Despite the rally in public equities, the IPO market has yet to reopen significantly. As companies are forced to stay private for longer, the cumulating pressure to secure the next equity financing round from investors – or else flounder – has resulted in some aggressive valuation cuts.

In addition, the reported record level of dry power in the venture ecosystem is concentrated in the largest funds. Here, GPs have been more selective in providing capital to support their most promising portfolio companies, as the timing of a turnaround in the exit environment remains uncertain. Given such dynamics, we expect a continued widening of dispersion of performance across GPs for existing funds.

We believe 2024 is likely to be a great vintage year for new funds.

Since returns and distributions from existing funds are key factors in determining the amount of capital recycled into new funds, we expect fundraising activity to remain lackluster in the coming quarters. Such an ongoing financing drought presents a highly investor-friendly environment, contrasting sharply with 2021's extreme startup friendliness fueled by voracious LP appetite and crossover investors.

In addition, we expect the trend of up-in-quality to continue in 2024. GPs have generally switched to a more disciplined investment approach to dealmaking than afforded by the manic market a few years ago. Correspondingly, portfolio companies have shifted from a "growth at all costs" mentality to one of capital efficiency and profitability.

On a longer-term basis, growth equity and venture capital play an important role in portfolios by providing the most direct exposure to organic growth associated with potentially transformative trends in life sciences and technology.

LEVERAGED BUYOUT

Broadly, private equity sponsor-backed companies have thus far been able to weather rising debt costs better than many expected, partly through aggressive cost cutting, though valuations have undoubtedly taken a hit. Looking forward, these companies should benefit from an incrementally more benign financing environment as the Fed begins to lower policy rates (albeit, in our view, at a more muted pace than expected by markets).

Nevertheless, the key outstanding question for leveraged buyout is how it will adapt to the new funding environment. While structurally higher interest rates indicate a trickier path forward for most asset classes, arguably none is more intimately affected by such a regime shift than this segment of private equity. Already we are seeing some reaction as private equity investors and operators are placing a greater emphasis on generating revenue growth and enhancing operational efficiency, requiring more than financial engineering to generate returns. Intuitively, as skill becomes a more important determinant of performance, we expect greater dispersion among GPs of similar strategies.

Given this shift, we identify a relatively richer opportunity set for specialized operators in tech-focused industries such as software and enterprise technology.

2024 may be an opportune time for LPs to consider committing new capital. While valuations remain muted, the bid-ask spreads between buyers and sellers have recently narrowed in comparison to the past two years. Although the recovery of dealmaking activity may be gradual, the backlog of currently held PE companies presents a potentially fertile hunting ground for new funds. In addition, the growing inventory of non-sponsor backed, founder-owned companies are yet another increasingly relevant source of acquisition targets, given their lack of institutional financing baggage, greater potential for valuation creation, and relatively lower purchase price multiples.

BRINGING IT TOGETHER

As we look for opportunities to deploy capital, we would argue for commitments to traditional funds across buyout, growth, and venture in 2024 to take advantage of generally the attractive entry points as well as the heightened quality focus among sponsors and companies. In our view, while it may take some time for these drawdown funds to deploy committed capital, the private equity space also offers more tactical opportunities in secondaries. Here, particularly for GP-led strategies, the pressure building in the existing exit landscape may lead to higher potential for positive convexity, as well as faster distributions and shorter fund lives.

Finally, we believe evergreen funds can offer another potential complement to this blend of private equity strategies, though we would stress the importance of focusing on newer evergreen funds making direct investments. These funds are less likely to be burdened by more mature investments that face the dual headwinds of valuation pressure and exit timeline uncertainty, particularly with recent difficult vintage years. Across these styles and strategies, we believe a focus on quality sponsors will be paramount. Even as the cyclical environment improves, higher rates and the need to drive operational improvements in portfolio companies will continue to create more dispersion among managers.

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