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The Carlyle Compass

By Peter Cornelius
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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition features guest author Peter Cornelius, Chief Economist at AlpInvest.*

The global monetary cycle has come to a turning point. The European Central Bank (ECB), in concert with several other European central banks, cut its policy rates by 25bps in June. The Bank of Canada has done the same, and the probability of a first rate cut in the United States has increased as economic growth has slowed, unemployment has risen, and the Federal Reserve's preferred inflation gauge, the core Personal Consumption Expenditures Price Index, is getting closer to where the FOMC wants to see it. Now that central banks have begun to reverse some of their aggressive rate hikes over the past two years, it's time to review where we are in the private equity cycle.

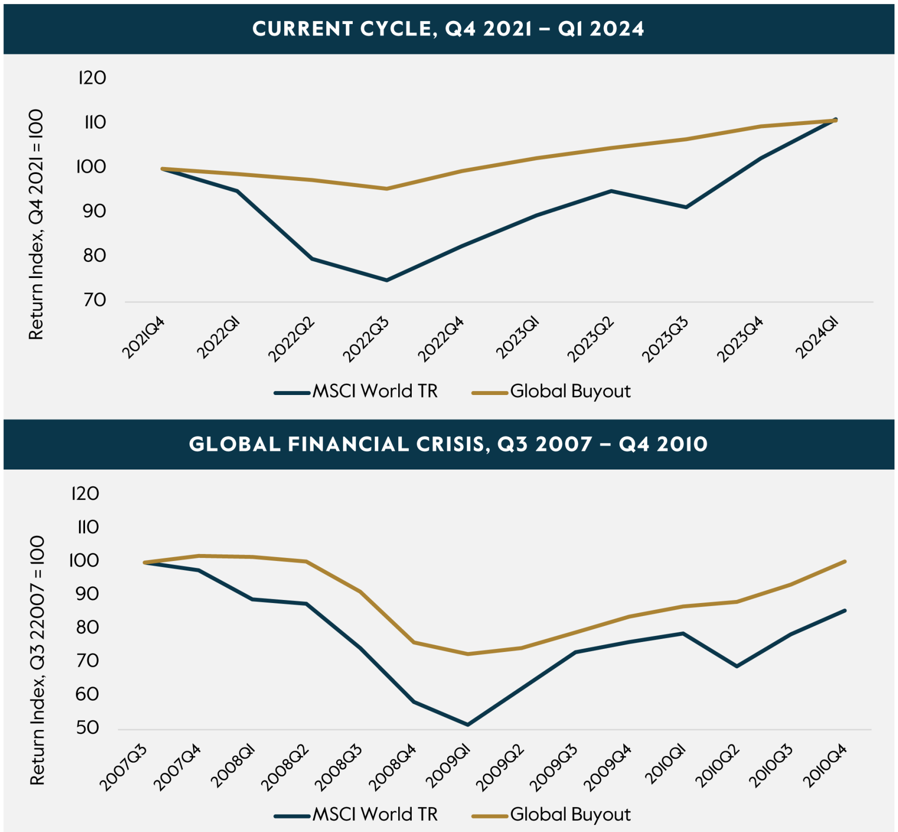
Differing Impact of Higher Financing Costs on Private Market Performance

There is no denying that sharply higher rates have had a profound impact on deal activity, fundraising, and returns. Let's start with the latter and focus on pooled trailing returns, which are reported by various data providers for fixed investment horizons, typically 1 year, 3 years, 10 years, and sometimes 20 years.

Venture capital (VC) has been most affected by sharply higher interest rates. Over the 3-year period that ended on March 31, 2024, the latest valuation date, net returns in the U.S. market were essentially flat. However, despite this steep decline, VC has still been the best performing asset class on a 10-year horizon. Buyouts have also suffered but to a much lesser extent. During the 3 years that ended in Q1 2024, net returns came in at 12.7% compared to long-term returns of 15.6%. Importantly, Infrastructure and Private Credit actually show higher returns over the tightening cycle when benchmarked against their long-term performance.

It is important to note that private and public markets have followed differing valuation dynamics. When central banks around the world embarked on aggressive monetary tightening in the first half of 2022, public equity markets fell into bear territory. Private valuations remained far more stable. As a result, many investors found themselves over-exposed to private equity. However, following a steep fall in valuations, global equities have recovered strongly, and by the end of QI the denominator effect has completely disappeared (Figure I).

Figure 1. Differing Valuation Dynamics in Public & Private Markets



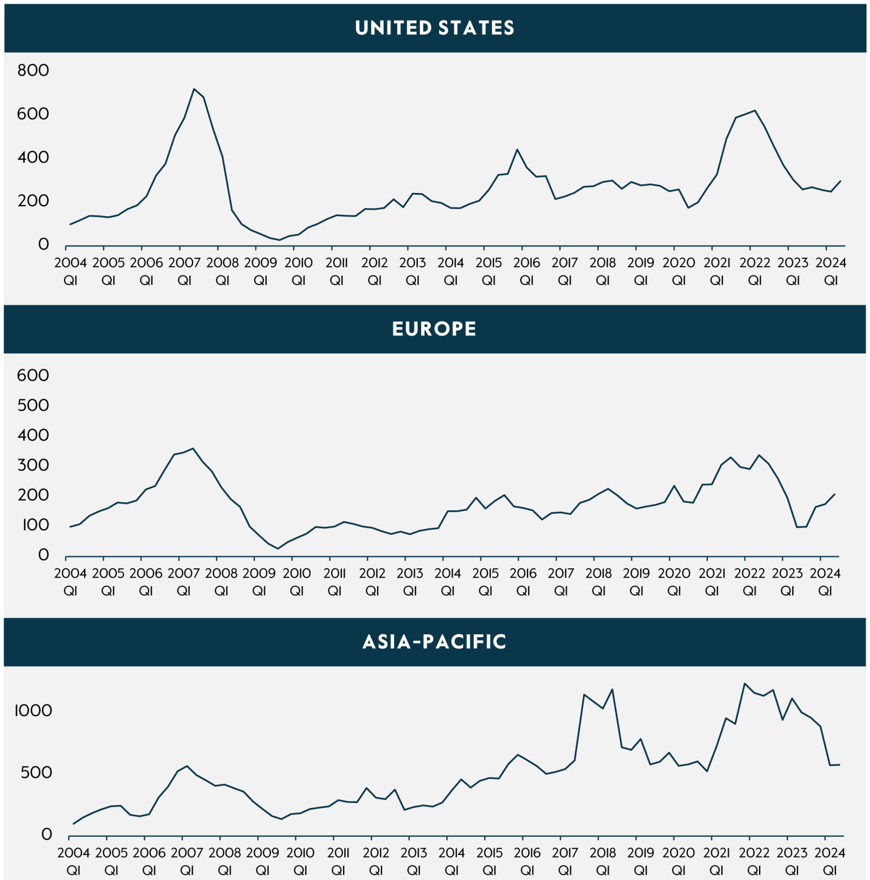
Source: Preqin, accessed 7/3/24. For illustrative purposes only. There is no assurance that any trends depicted or described will continue.

Buyouts and Exits Following Different Dynamics

While the denominator effect has lost its significance, the lack of liquidity remains a key issue on LPs' minds. With sharply higher interest rates having caused a log jam on the exit side, distributions slowed progressively. New sponsored transactions also declined but to a lesser degree. More recently, as policy rates have peaked and spreads have tightened, buyout activity has regained momentum (Figure 2).

Figure 2. Recovery in Buyout Activity Underway

4-Quarter Moving Average, Q1 2004 = 100



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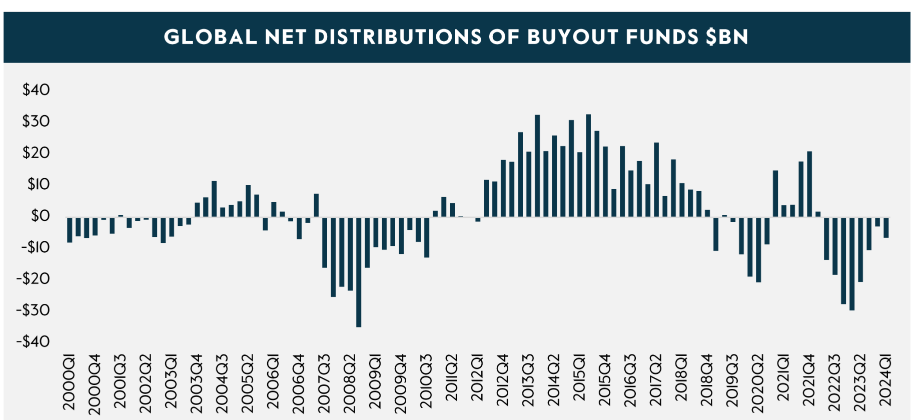
On the exit side, however, the impact of lower financing costs has been less visible thus far. Net distributions are still negative (Figure 3), and with a significant share of reported returns yet to be realized, it is unsurprising that Distributions to Paid-In Capital (DPI) has attracted increased attention as a performance measure.

Figure 3. Net Distributions Still Negative but Improving



Source: MSCI, accessed 7/7/24. For illustrative purposes only. There is no assurance that any trends depicted or described will continue.

Several LPs have responded to liquidity constraints by recalibrating their commitment pacing. While it has generally taken longer to raise capital, VC and growth capital funds have mainly borne the brunt of lower commitments as returns have fallen far short of investors' expectations.

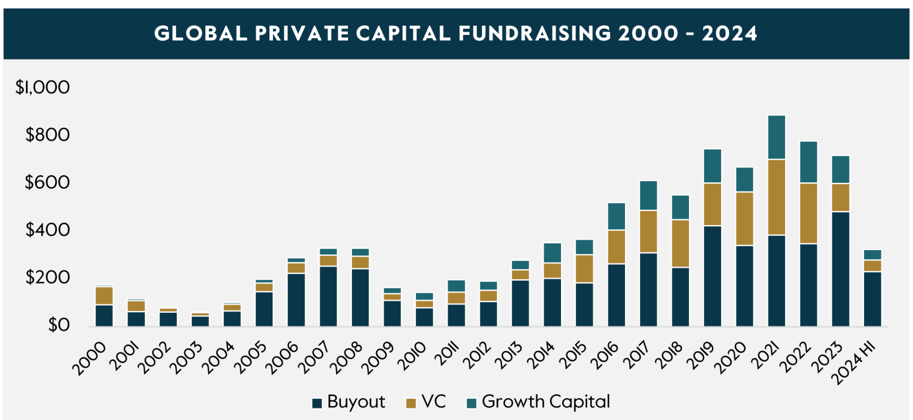
Resetting the Private Equity Cycle

To reset the private equity cycle, it is critical that the log jam on the exit side be cleared. Here, lower interest rates are likely to play an important role as they should help global M&A regain momentum. In fact, trade sales to strategic buyers represent the most important exit route for buyout-backed portfolio companies. Lower interest rates are also expected to support a recovery in IPOs. Encouragingly, we have already seen some green shoots in the U.S. IPO market, which essentially closed when interest rates skyrocketed.

However, with economic growth expected to be in line with potential output growth and inflation still higher than targeted, any rate cuts are likely to be gradual. Thus, the secondary market is likely to play a key role in rebalancing investors' portfolios. While the secondary market has evolved precisely for situations investors are currently confronted with, in recent years there have been numerous innovations. GP-centered transactions have gained substantial momentum, with continuation funds having emerged as an alternative exit route. Credit-based solutions are increasingly supplementing traditional tools, allowing LPs and GPs to find the most efficient strategy given their individual circumstances. From an investor's perspective, the strong demand in the secondary market may offer attractive investment opportunities.

Past downcycles have typically lasted for 2-3 years (Figure 4). If this pattern holds in the current market environment, one might expect a turnaround in private equity activity in the second half of this year, with increased traction in 2025 and beyond. In fact, deal activity has already picked up and net distributions, although still negative, have improved. To the extent that lower interest rates, supported by the secondary market, help unclog exit channels, cash flows should continue to become more balanced, setting the stage for a sustained recovery in fundraising.

Figure 4. Fundraising Cycles Typically Bottoming After 2–3 Years



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