Cover story

Navigating the

Will a drab 2024 market turn into a more fruitful 2025? Five market insiders share their insights.

By Kirk Falconer and Chris Witkowsky

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'bottom of the iceberg'

After two years of slowdown, private equity's deal market in 2024 showed a few green shoots.

A stronger economy, together with interest rate cuts, provided a better macro backdrop for dealmaking. But a lingering valuations gap kept many assets from selling, while some exit channels remained hard to access. Fundraising, impaired by weak LP supply, continued to decline.

Will 2025 bring recovery, giving cautious investors reason for optimism? Or will challenges persist? Will more robust deal and exit volumes help unlock fundraising? Or will problems take longer to solve?

To help answer these questions, *Buyouts* spoke to five top private equity leaders: Azra Kanji, Astira Capital Partners; Jim Pittman, BCI; Martin Brand, Blackstone; Scott Ramsower, Teacher Retirement System of Texas; and Nehal Raj, TPG.

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"It's a bit of a tale of two cities on LPs culling versus growing their number of relationships fundraising"

SCOTT RAMSOWER
Head of private equity funds, Teacher Retirement System of Texas

Q Will the deal market fully rebound in 2025?

Nehal Raj: This year has been more in-balance industry-wide, meaning volumes are up a little – and much of that growth has come from private equity firms increasingly willing to sell assets. But we only read about the deals that get done, which in 2024 was just the tip of the iceberg.

There's been a big bifurcation between the highest-quality assets, which have sold at premium prices, and everything else, where there was largely no trade. As we look ahead to 2025, one of the key dynamics is going to be what happens to the rest of the iceberg that didn't sell in 2024.

The economy is getting better, inflation is less of a worry, interest rates are becoming more affordable, but not going to zero. Overall, a reasonable amount of equilibrium, which is good for dealmaking.

There's greater chance for divergence in expectations when there's more variance around economic outcomes. The variance has shrunk recently and that helps lead to more meeting of the minds between buyers and sellers.

Jim Pittman: M&A is increasing, albeit at a slower pace than many would like. The private equity share of M&A last year was down to about 30 percent, and this year it's up to around 41 percent. I think that bodes well.

Companies are still being impacted by inflation. Rates are coming down but it's still fairly high on a long-term basis. That has an impact on the valuations at which GPs expect to sell. I believe the issue is partly valuation, partly IRR expectations, and partly being very selective as to what to sell – to try to show that what you sell is above the NAV mark on your books.

Martin Brand: We now have more normal yields – all-in yields are currently around 20-year averages. That more normal level, down 250 basis points from 2022 peaks, should support more normal deal volume.

I don't subscribe to the narrative that interest rates have been the sole reason for lower deal activity. The difference has been more about seller price expectations.

Auction failure rate is still elevated, but the bid-ask spread has narrowed materially this year from its 2023 trough. I expect a further narrowing for multiple reasons: assets growing into their valuation, more DPI pressure on sellers, and rising internal motivation for sponsors to deploy capital among those who have been relatively inactive the last two years.

A second reason for the softer deal environment in 2024 is difficult fundraising. People are more cautious spending money when they experience how difficult it can be to raise money for a private equity fund.

Azra Kanji: It feels like people are finally coming to terms with where things might transact – or at least the market will dictate a clearing price that sellers are willing to accept.

Recently, it has been about price expectations versus the reality of what the market was willing to pay. I'm not sure if the gap has narrowed or sellers have decided they're only taking the assets to market for which they will accept market pricing.

I believe deals beget deals. There was a lot of hesitancy to be the first person to print a deal. I think the more things that are getting done recently has led to others following suit, not waiting for the election to be done, not waiting for the new year.

Q Will exit markets turn around?

Azra Kanji: A prompt for sellers that everyone talks about is the LP pressure for liquidity – and that's real. While you

"A prompt for sellers that everyone talks about is the LP pressure for liquidity"

AZRA KANJI
Founding partner,
Astira Capital Partners

"Even if M&A increases quite a bit, it's not going to solve the lack of sales"

JIM PITTMAN
Executive vice-president and global head, private equity, BCI

can avoid it for a little bit, when you're fundraising again and LPs are demanding dollars back in order to put dollars in, people feel it. There's also obviously self-interest, as people wanting to get paid carry dollars after a lull following years of great returns.

Martin Brand: Sponsor-to-sponsor trades may be up modestly due to the narrowing of the bid-ask spread and increasing pressure to sell performing assets. That said, the bigger changes will be in IPOs and strategic exits. I think the IPO market is going to be stronger after a few weak years. Corporates will also become more aggressive, as a soft landing seems likely now and fears of a recession recede.

Nehal Raj: Traditional exit routes will be open. That said, one of the issues is size. Many of the deals done in the 2018-21 vintage block were large-scale. To exit those deals, transaction values will need to be \$5 billion-\$10 billion, and in some cases, \$10 billion-\$15 billion. This will likely require creative thinking on the part of sponsors.

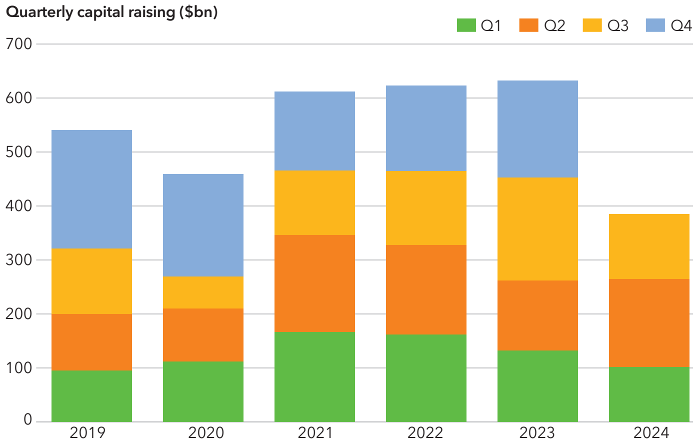
There was more sponsor-to-sponsor activity in 2024 but mostly concentrated around the A-plus assets. For the bottom of the iceberg, where there is a two-or-three-turn multiple difference between buyers and sellers, the question is who is going to blink.

There is so much activity that needs to happen and not all of it will occur through direct sales. More than ever before, the market is demanding solutions capital. For example, this has the potential to be a golden era for GP-led secondaries. LPs are increasingly aware of the opportunity because they're seeing it in their sponsor portfolios.

Jim Pittman: Even if M&A increases quite a bit, it's not going to solve the lack of sales over the past two to four years. But there is such pent-up demand and backlog of assets that were bought when prices were a lot higher than they are now.

So, even if M&A goes up by 25 percent next year, I don't see that significantly improving the fact that many LPs are overallocated. However, I think the secondary market is the right way to go for many LPs.

Quarterly capital raising ($bn)



Source for all data: Q3 2024 Fundraising Report - Buyouts

Q Will the pace of fundraising remain slow in 2025?

Scott Ramsower: I think it'll be several more years until we get back to peak fundraising levels. I say this for two reasons: first, if you look over the past two cycles, first the dot-com crash, it took six years to get back above the 2000 peak levels. The same thing with the global financial crisis – it took eight years to reset fundraising records.

If you think about where we are now, fundraising peaked in 2021-22, so we're kind of plus-or-minus three years into this one so far. If history repeats itself, it's going to be several more years until we get back to those peak levels.

That said, it feels as though we're out of the trough, especially in the US buyout fundraising market. It feels like we're growing year over year, so my prediction is 2025 will be a better fundraising environment than 2024.

Jim Pittman: I think there's a mathematical equation: if you think that the average pension plan in North America is 2 percent over its allocation and, if the average pension is $50 billion in AUM, that's a billion dollars over your marks. It's going to take two to four years to rebalance.

If you're more weighted towards the mega-market, and you've continued to allocate money to those funds, there is now pressure for them to deploy because they raised a lot and at the same time pressure for them to sell. It'll probably take three or four years to rebalance.

Q How are LPs handling weak distribution flows?

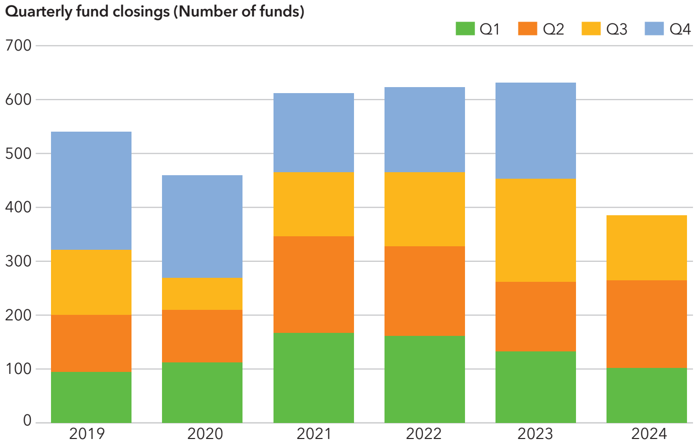
Scott Ramsower: I think this is an extremely important issue for the industry. Distributions are very important to us and we evaluate real DPI and capital velocity more today than ever before. We pay a lot of attention to this at the manager-selection level.

There's no immediate liquidity solutions required for our portfolio. We're not forced sellers in the secondary market, we don't need to completely sit out the asset class to allow the NAV to work through the system – none of that. We're just slowing down and tapping the brakes in terms of deployment, instead of slamming on the brakes.

Jim Pittman: On a go-forward basis, I think some pension funds will start to say, "Okay, we're still way overallocated. You need to do something about it. Let's go back to our advisers and figure out what's the best solution in the next 12 months." We should see 20 percent-25 percent more utilization of LP secondaries – and possibly more than 50 percent.

We've done secondaries successfully several times. However, many LPs are not incentivized to do that. Many are trained in how to allocate money and how to co-invest but are not as focused on actively selling their own interests.

Quarterly fund closings (Number of funds)



Q How is slow fundraising impacting relationships?

Jim Pittman: GPs obviously need a certain level of return. Many use DPI as another metric for rationalizing why they are good fund partners to continue to give capital to.

I think an issue here is that many very good mid-market firms simply don't have large investor relations teams. So, despite the returns or modest DPI, they'll struggle to raise money, just because many LPs are able to allocate only 30 percent of what they normally would allocate in any one year. Many LPs will probably be doing that for the next two or three years.

Scott Ramsower: One might think a slower LP deployment pace would indicate a broad-swell culling of relationships. I would say it really depends on what segment of the market you're looking at as to whether or not that statement is true.

I'm definitely seeing large, longstanding LPs that are comparable to us: culling relationships at the larger end and growing relationships at the smaller end. So, it's a bit of a tale of two cities on LPs culling versus growing their number of relationships fundraising.

$633m

Size of the average private equity fund closed in the first three quarters, edging out the average in the whole of 2023

56%

Buyout was the market's most popular strategy in the first three quarters, accounting for that portion of total capital raised

$385bn

Amount raised for buyout, growth equity, venture capital, secondaries and other funds raised as of the end of Q3

Source: Buyouts

Q What types of challenges will GPs face next year?

Nehal Raj: The industry leaned into deals in the second half of 2020 through the first half of 2022. Those will be pretty troubled vintages because multiples were high and leverage was readily available but premised on low rates. Is there a debt problem?

In some ways, yes, because many of these companies were over-levered to start. But in some ways, no, because spreads are attractive right now and there is a tremendous amount of private credit and bank demand to deploy new capital.

It's not a bad time to refinance capital structures that were put in place during those years. Next year, we'll see a lot of refinancings. There will likely be some pain for sponsors because not all the debt can be refinanced with debt. This, however, creates an interesting opportunity for hybrid-structured capital, which is among the best risk-returns that we're seeing today.

Jim Pittman: I break down the market into the haves and have-nots. There are those who can raise money and have plenty of capital to deploy. Then there are those mostly mid-market firms who have had a more difficult time raising money and are also hindered – in the short-term by portfolio company-level cashflows.

For example, let's say you bought a company and intended to pay 550 basis points in interest and you're now sitting on maybe 900 basis points. That's an incremental consumption of 35 percent-45 percent of money you didn't expect.

This additional interest expense

wasn't factored into their underwriting. And there are significant implications on a GP's ability to execute the value creation they thought they'd do, whether it was paying down some debt, creating cash or actively doing M&A.

Martin Brand: The pressure to generate IRR, if you have a significant allocation to high-priced deals, will continue to build with each year those assets are on the books.

Many GPs with this problem will continue to actively work portfolio operations, try to accelerate growth, drive cost efficiencies, do M&A, etc, to put assets in a position to exit sooner rather than later – because holding them forever is going to be quite difficult for your IRR. For the subset of firms with a 2021-vintage problem, it also slows down the ability to deploy capital in 2025.

There was a period of time when the private equity industry enjoyed the benefit of multiple expansion and more money flowing in, which allowed secondary and tertiary exits. That period is over.

The way to generate great returns is through operating intervention and making companies better. Making them aspirational, making them grow faster, making them what the next buyer would want to pay a higher multiple for. Not because the market multiple is up, but because we created our own multiple expansion by improving operations.

Azra Kanji: In the case of private equity firms with large portfolios, it is hard to manage that many companies at a time. The days of financial engineering are over, there's a real focus on value creation, and if you're not selling something today, you're almost surely resetting the clock.

If a seller took an asset to market and then didn't transact, they can't go again next year. They're waiting another two or three years before coming back to market. In addition, they have to deliver on that plan they marketed, to which

"I don't subscribe to the narrative interest rates have been the sole reason for lower deal activity"

MARTIN BRAND
Head of North America, private equity, Blackstone

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people can hold them accountable. Doing that for 10, 20, 30, 100 portfolio companies is hard on firms. At some point, you have to focus on what will be your best assets, fix what might be your worst assets, and you have to pull some of that out of the system just to create more bandwidth.

Q When will the backlog of unrealized assets exit?

Martin Brand: Of the volume surge around the 2021-vintage, a subset of companies will see an exit window in 2025 because they'll be four years old. If people didn't overpay and the companies performed, they'll be taking these unrealized assets to exit.

What will not come are the businesses that sponsors overpaid for

'Early days'

Nehal Raj, of TPG Capital, stresses the importance of growth-oriented operating capabilities

Q How key is value creation in today's market?

It's critical. But it's important to define the type of operating improvement we're talking about. Often, operating improvement is assumed to be about the margin opportunity – how can I take a 20 percent margin business and make it a 40 percent margin business – looking to cost management as the primary lever.

That has been an important skill set, but it's commoditized. It is priced into most assets, meaning it's assumed private equity firms will look for efficiencies when they buy a company.

That capability is not enough to differentiate or, more importantly, create, lasting, healthy businesses.

Growth is hard and is increasingly scarce in today's environment. In 2021, everyone was assuming things were going well and there was plenty of growth in the economy. Now, with higher-for-longer interest rates, growth is harder to obtain.

Private equity firms with operating capabilities that accelerate the growth of a portfolio company are going to create the most value. This growth-oriented operational skill set is going to be the most differentiating factor for value creation going forward.

Q Are private equity firms typically able to do this?

It's not as easy as looking around a table and saying, "Let's make growth happen." If you want to drive growth, you need to resource around it and ensure that you have a structure where your operating team is set up to succeed.

Historically, private equity operating teams functioned as separate units run by former consultants who were generalists. The deal team would do a deal, something would go wrong, and they would call ops.

The old model of "call the internal consultant" no longer works. In order to drive growth, we believe operating team members need to be integrated with sector-based investment teams and come from these respective sectors.

TPG's operating approach is an extension of our investment strategy, which focuses on driving transformational growth in specific sectors. For example, we hire healthcare operators from the healthcare sector who are fully integrated with our healthcare deal team.

These executives have highly specialized experience across market leaders like Abbott, Amazon, Activision. As a result, when they engage with portfolio company executives, they've lived in their shoes and can be real partners to management in making the business better.

If you think about the evolution of the deal team in private equity, most firms have migrated from a pure generalist model to one which is sector-oriented. It's the same change that we expect to happen on the operating side – it's just happening with a lag. Over the next five or 10 years, I expect operating teams are going to be just as specialized as deal teams have become. We're still in the early days of that shift.

during the boom – particularly in technology.

For those assets, even if the operating performance is good, it will take longer to amortize the purchase price. So, you're going to start to see a meaningful slice of the 2021-vintage come, but still not yet the bulk.

Jim Pittman: Some very high prices were paid for the large assets that changed hands from the second half of 2020 to the first half of 2022. I don't see them coming down for another year or two. It's going to take GPs four to six years to actually create value in them as they balance inflation and make sure margins are not eroding.

Nehal Raj: I expect we will see a fair number of sponsor sell-side attempts, mainly from companies that were backed in the 2018-21 period. I don't know exactly how it will go, but there will probably be some amount of capitulation on the part of sponsors because LPs want liquidity back. This could create an interesting buyers' market, as the supply of companies to be sold is going to be immense.

Q Does debt financing remain an issue?

Martin Brand: Only 10 percent of the syndicated market this year has been for M&A and LBOs. Normal levels are 30 percent and peak levels are 60 percent-plus. I predict LBO lending may be stronger in 2025. In particular, the flows into credit funds, public and private, have been significant.

Sponsors now have a large private and direct lending market to finance deals. That simply didn't exit five years ago at this scale. It helps, especially for technology deals that may be high-growth but lower-cashflow.

Nehal Raj: For part of 2023, the only market that was open for new financing was private credit. Now we have banks willing to lean back in, which has created a more favorable backdrop.

Q Where do some of the best opportunities lie?

Nehal Raj: There's going to be two gears for the deal market in 2025. One is going to be a run-of-the-mill flow gear: good companies selling for reasonably good prices from one sponsor to another. That was largely missing in 2023, started to come back in 2024, and will be in fuller force in 2025.

There's another gear happening in parallel, which involves more creative off-the-run situations. These situations accounted for the majority of our dealflow in 2023 – in the form of carve-outs, corporate partnerships and structured deals. We have seen that continue in 2024 and expect it will remain. Sponsors can choose their own adventure next year.

Martin Brand: Sponsors that have remained disciplined over the past few years and have significant dry powder can play offense now. In particular, corporate carve-outs have presented a greater opportunity. We've done a lot of them, and I believe there'll be an ongoing opportunity in 2025 to generate attractive returns with carve-outs, often as a result of a change in the strategic focus of the corporate parent.

Jim Pittman: The reason why take-privates and public company carve-outs are predominant today is because there are less private equity firms willing to put assets on the market since they fear the short-term price is too low. Accordingly, those firms looking to deploy capital must focus somewhere else.

Another area is preferred shares. As companies consume more cash just to pay their interest bill, they may need to get some preferred shares to pay down debt. While it's more expensive in interest, it's less expensive in cash and provides flexibility. I see it as an avenue that's going to pick up steam.

Lastly, the mid-market will have its time to shine in the next two years. There'll be more selling happening in this segment versus the mega-market because the mid-market tends to have smaller, more nimble companies that continue to do M&A and – once they reach a certain scale – become more interesting for a large-cap firm.

Q Will access to co-investments continue to grow?

Jim Pittman: It has always been a market where GPs will entice you if you have an ability to commit capital, especially if you use an SMA. In the past, you could put 75 percent of your money in fee-related and 25 percent in co-invest at very low fees.

Some GPs will consider a 60:40 split. But for some of the bigger funds that flexibility may start to go in the opposite direction as they've cornered the larger end of the market they're looking for and want to improve their fee base. I think there's more flexibility in the next 12 months, but that starts to turn to more rigidity of fees particularly for the bigger funds in the future.

Scott Ramsower: Despite volumes in PE being down, the co-invest pipeline is up for many LPs. How is that possible? A lot of LPs say they'll do co-invest but they've slowed down or pulled out. This is happening for two reasons.

First, LPs are reducing their overall deployment to the asset class. While a ton are theoretically structured to do co-invest, quite a few are sitting on their hands, because one way to get money out of the system is to not put money immediately in the system via co-invest.

Co-invest can also be pro-cyclical. Large amounts of co-invest go in at the peak and then those companies start to hit some bumps in the road. Co-invests are by definition more concentrated positions, so when less positive marks start to come through, they have more of an impact. LPs are now saying, "Whoa, this co-invest is not always just positive returns." ■

Quotes have been edited for length and clarity