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2024 US Private Equity Outlook

Our analysts' outlook on the private equity market in 2024

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

2024 outlooks

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Outlook: Continuation funds will hit critical mass with more than 100 new formations and related exit transactions.

Rationale

PE exit activity has fallen to unprecedented lows relative to the industry's horde of capital under management. US PE AUM was just shy of $3 trillion entering 2023. PE firms have since parted with $227.2 billion in holdings based on deal value of exited companies, or 7.6% of beginning value. That is the lowest level by a long shot, worse even than the 11.3% registered at the depths of the Global Financial Crisis (GFC) in 2009 when seemingly nothing transacted that was not distressed.

As we've pointed out in previous reports—most notably in our analyst note, PE Exit Timelines and the Impending Maturity Wall—the industry is running out of time and options to wind down portfolio holdings in an orderly fashion for finite-life funds, which typically last 10 to 12 years. The traditional routes for exiting companies have been two-fold with four sub-components: (1) M&A sale to a corporate buyer; (2) M&A sale to a PE buyer; (3) public listing by way of an IPO, and (4) public listing by way of a reverse merger. Each was highly active for a solid decade, peaking in 2021 when a record 41.3% of AUM was turned over. Since then, however, each has faltered as interest rates rose and liquidity conditions turned negative.

It's long been our thinking that the industry needs to develop a third major option for exiting companies, and to do so quickly. True to form, the industry has been working ahead of these issues for many years now to devise new liquidity solutions for the funds, portfolio companies, and investors who need them. These run the gamut from other forms of lending including net asset value (NAV) financing, portability term loans, PIK loans, and structured debt and mezzanine solutions, to other forms of equity replacement such as LP-led, GP-led, and structured secondaries.

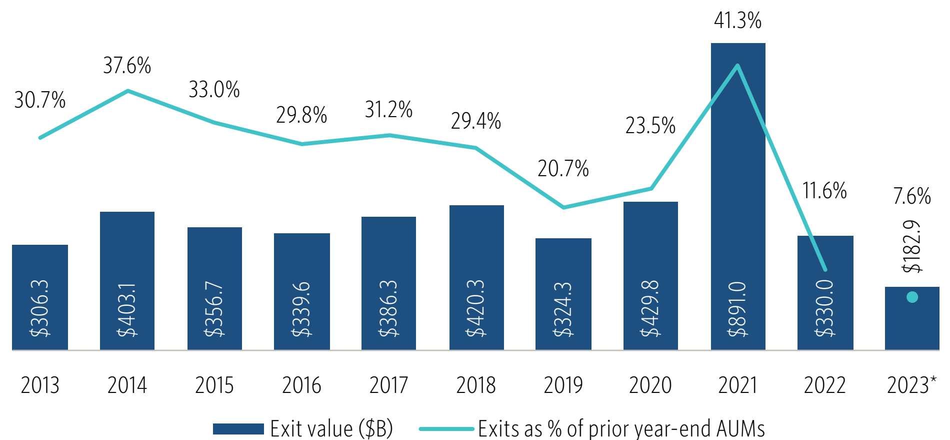
Of all these options, the odds-on-favorite to emerge as a new "third rail" is GP-led secondaries, otherwise known as continuation funds. Not only are these the simplest in terms of structure, providing liquidity to LPs and time for GPs simultaneously, but they are also scalable. The strategy is backed by $68.1 billion in fundraising through Q3 2023—more than the $57.6 billion raised for all of 2022—adding to the $202.7 billion in dry powder that had accumulated through Q1 2023. While some of this will go toward buying LP stakes directly, the vast majority will use GP-led continuation funds to speed deployment through large bulk transactions.

PitchBook has tracked 71 such exit transactions YTD in 2023, equaling last year's total with another month to go. While not a huge part of exit deal flow—total exit transactions will reach 1,160 this year—we expect that to change going forward. Continuation funds and the funds backing them have achieved critical mass, and with the pressure for liquidity building, we believe 2024 to be the breakout year with upwards of 100 exit transactions involving continuation funds as buyers.

Risks

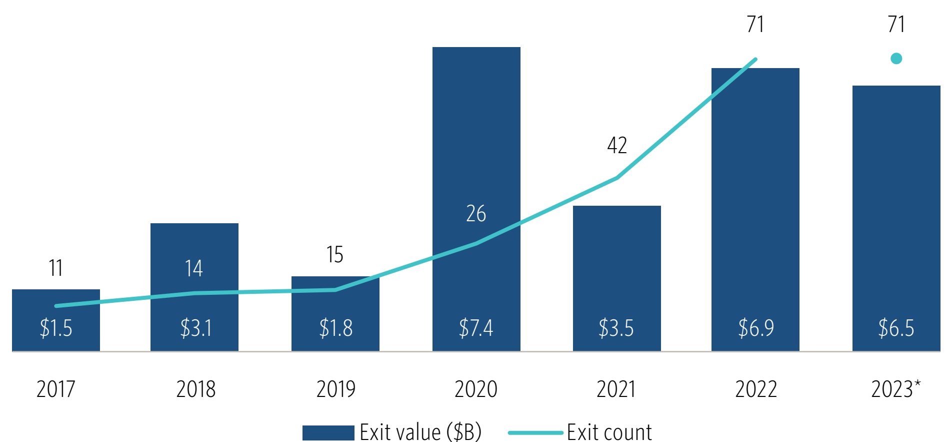
The continuation fund process can be highly controversial and is sometimes resisted by LPs as a result. Approximately one-third of these processes have reportedly failed in the last year, which is higher than the historical norm. Moreover, continuation funds must allow time for GPs to prepare fairness opinions and related exchange offer materials, and for LPs to review these materials and provide consent/non-consent. This limited bandwidth could restrict the number of continuation fund formations and related exit volumes.

PE exit value and share of AUM



Source: PitchBook • Geography: US • *As of September 30, 2023

Continuation fund exit activity



Source: PitchBook • Geography: US • *As of December 5, 2023

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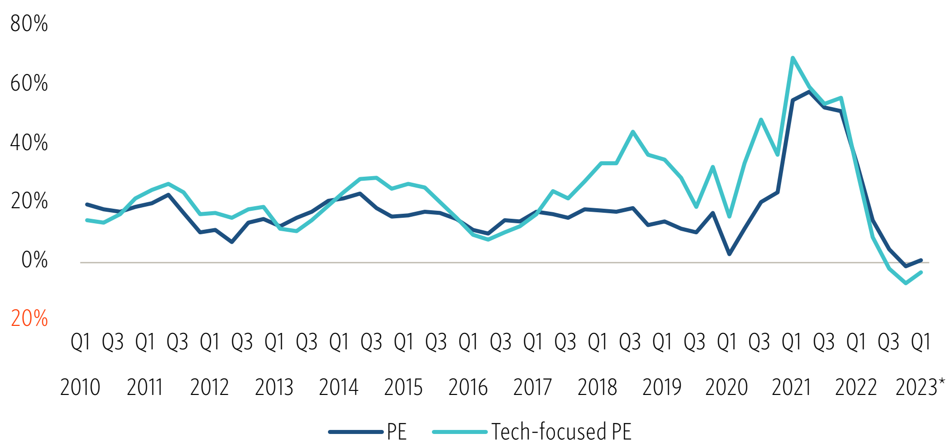
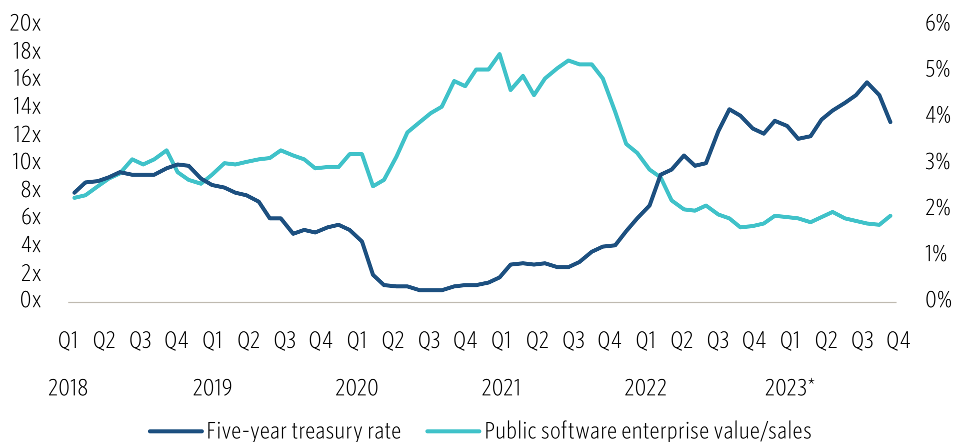
Outlook: Tech-focused PE funds will outperform more diversified PE funds.

Tech-focused PE and PE fund performance by quarter



Source: PitchBook • Geography: US • *As of March 31, 2023

Software EV/sales and US five-year treasury rates (RHS) by quarter



Sources: PitchBook • Geography: Global • *As of November 30, 2023

Rationale

Our data-driven insights for 2024 reveal a sizable opportunity for US-based tech-focused PE funds, which we expect will outshine their diversified PE fund counterparts in terms of investment performance. This prediction stems from an examination of historical trends starting from Q1 2010, revealing that tech-focused PE funds have not only outperformed but have done so with an average excess of 580 basis points and a median outperformance of 447 basis points, based on one-year rolling IRRs.

Our perspective is best explained by looking at quarterly performance data going back to 2010. Prior to 2014, tech PE funds experienced intermittent dips relative to more diversified PE funds. In 2014, the tide turned decisively with tech PE embarking on an eight-quarter trajectory of outperformance, averaging 629 basis points. This was followed by a five-quarter phase of slightly lagging performance starting in Q1 2016. But, in a historic pivot, Q1 2017 ushered in a remarkable 19-quarter cycle, with tech PE soaring to an average outperformance of 1,400 basis points, propelled by investor euphoria during the peak of the COVID-19 pandemic.

Despite this impressive history, the most recent six quarters have seen a reversal. Tech-focused funds have been faltering amid market corrections, surging interest rates, heightened recession risks, and uncertainty in IT expenditure. Yet, the interplay of market dynamics suggests a silver lining. The core business strengths of the tech and software sectors remain robust, and their valuations are more reasonable now. Delving into software, we analyzed 70 publicly traded software companies and found valuations are about a standard deviation below the five-year average on enterprise value (EV)/sales and P/E ratios; yet, fundamentals remain strong, as indicated by EBITDA margins reaching five-year heights in 2023. We highlight software companies because they comprise the majority of activity in the tech PE space with over 57% of all deals.

Combining these factors with a stabilized valuation landscape, anticipated pauses in interest rate hikes, and softening inflation expectations, we foresee a fertile ground for PE managers skilled at enhancing the operational efficiency of tech companies. Moreover, considering the downward trend in Treasury rates from recent highs, there's a window for potential valuation expansion in the software sector—particularly if interest rates decline further—echoing historical patterns where software valuations have materially benefited from falling risk-free rates, as seen in the chart above.

The stage is set for a potentially lucrative 2024 for tech-focused PE funds, underpinned by robust sector fundamentals, favorable economic conditions, and the historical inverse correlation of software valuations relative to interest rates.

Risks

A recession could result in downward pressure on technology-sector valuations, elevated concerns about IT spending, and a reduction in EBITDA margins. This could hinder tech-focused PE funds' ability to deliver better investment performance relative to diversified PE funds.

Andrew Akers, CFA
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Outlook: Disappointing fund distributions will push buyout capital raised below trend.

Trailing 12-month buyout fund distributions as a percentage of beginning NAV

Source: PitchBook • Geography: US • *As of September 30, 2023
Note: Data for the two most recent quarters was estimated using total PE-backed exit volume.

Quarterly PE buyout capital raised ($B) with trailing four-quarter average and one-year forecast

Source: PitchBook • Geography: US • *As of September 30, 2023

Rationale

While it remains to be seen whether exit activity will rebound in 2024, the dearth of PE-backed exits over the last 18 months is going to have an adverse impact on fundraising efforts. Exit activity plays an important role in the closed-end fund flywheel, as exits lead to distributions going back to LPs who often recycle that capital into commitments to new funds. There is currently a wrench in that flywheel. Despite GPs' best efforts to keep capital flowing through secondaries, continuation funds, and NAV loans, trailing 12-month buyout fund distributions through Q1 2023 have hit their lowest level since

the GFC. Buyout fund distributions were just 14.6% of beginning NAV, well below the long-term average of 26.5%. When we imputed the distribution data using exit volumes through Q3, the picture looks even worse, with the distribution yield falling to 11.1%.

The lack of distributions does not bode well for buyout fundraising forecasts in 2024. We employed a quantitative time series model to estimate the impact of the trailing 12-month distribution yield on total capital raised over the next year.[1] The model's forecast indicates that buyout fundraising is expected to be approximately 30% below its current linear trend. This would put one-year-ahead fundraising totals at the slowest pace since 2019 on a nominal basis. After considering the upward trend in fundraising over time, this would be the slowest pace since 2010.

Risks

While trailing fund distributions play an important role in GPs' ability to raise new capital, they are just one of many influential factors. While it is difficult to predict reliably, the macro environment will likely be the single most important factor. If the Federal Reserve (the Fed) can achieve a soft-landing, as many are now expecting, this should give a boost to exit prospects and LP sentiment toward PE in the first half of 2024. If the exit floodgates open quickly in this scenario, fund distributions should recover quickly as well and provide a support for fundraising activity in the second half of the year.

1: The forecast period is for the 12 months ending September 30, 2024.

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Outlook: Holding periods of US PE-backed companies will hit new records as the exit environment remains weak.

Rationale

Exit activity has plummeted since early 2022, as sponsors struggled against prolonged inflation and unfavorable valuation adjustments. PE firms tend not to be forced sellers, choosing instead to hold promising assets for longer until market conditions improve. In Q3 2023, exit value hit its lowest quarterly level since the GFC—outside of one quarter during the height of the pandemic—and is now down 83.7% from its peak in Q2 2021. Exits slowed down on all fronts, with the IPO market effectively closed and the M&A market choked off by higher borrowing costs.

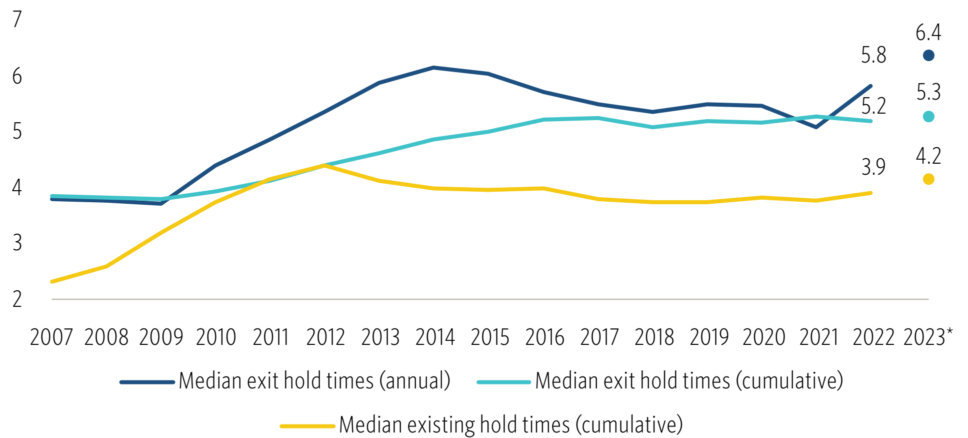
With interest rates expected to stay elevated for the foreseeable future, we expect PE firms to continue to postpone selling and extend portfolio company holding periods in the process. Currently, the median holding period of US PE investments exited in 2023 reached 6.4 years, crossing the six-year mark for the first time since 2015. This shows that even the winning assets in PE funds are being sold more slowly in the current environment. With industry participants not expecting a rebound in exit activity until halfway through 2024 and new companies likely to be added between now and then, the question remains, how much longer can the industry wait and how much older will its portfolios get?

We also expect the holding period of existing PE-backed funds that have yet to be exited to hit new records. It is likely that portfolio companies will remain in their funds for longer to allow for valuations to recover to the PE investors' liking or for revenues and EBITDA to grow to compensate for lower multiples. Companies currently in our US PE inventory have been held by their respective firms for a median of 4.2 years, which is the highest level seen since 2012. The median holding period of existing PE companies is on an upward trend, and we expect that to continue as exits get postponed. The PE inventory is the largest it has ever been as deal activity outpaced exits. The exit-to-investment ratio has also hit a historically low mark, standing at 0.37x by the end of Q3 2023, compared with 0.48x in 2021 and 0.41x in 2022. The mismatch between the explosion of deals made in the last few years and a fatigued exit market in parallel will cause the backlog of investments to swell and increase the "age" of currently held PE companies. Although the rush of new investments put downward pressure on median existing hold times, we expect it to creep upward for a sixth consecutive year and reach an all-time high median of 4.4 years by the end of 2024. Holding periods are universally stretching out, both for currently held PE companies and those that have successfully exited.

Risks

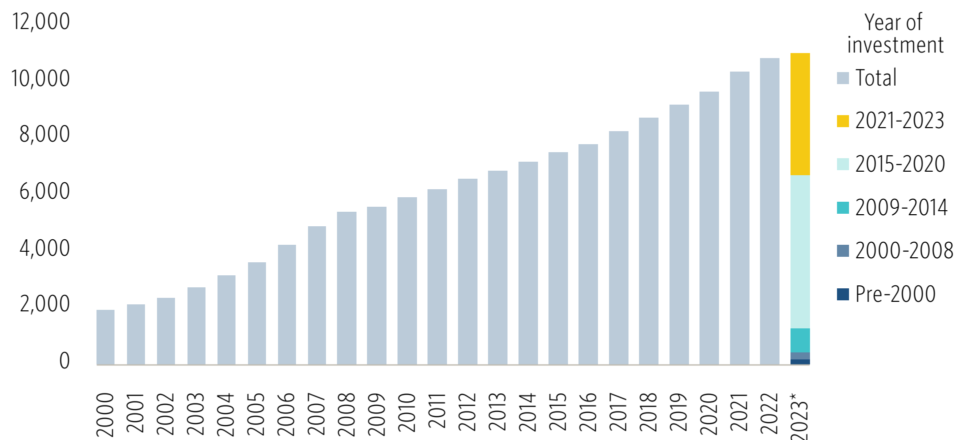
There is always the chance that exit activity can recover more quickly than thought if interest rates and the macroeconomic environment improve or if sponsors choose to force-sell assets when they can no longer push off giving back liquidity to LPs or come up against fund life terms. Holding periods can also come back down if GPs meaningfully turn toward continuation funds or secondary sales to create exits for their funds.

Median PE buyout hold time (years/months) by age



Source: PitchBook • Geography: US • *As of November 11, 2023

PE company inventory count by year of investment



Source: PitchBook • Geography: US • *As of September 30, 2023

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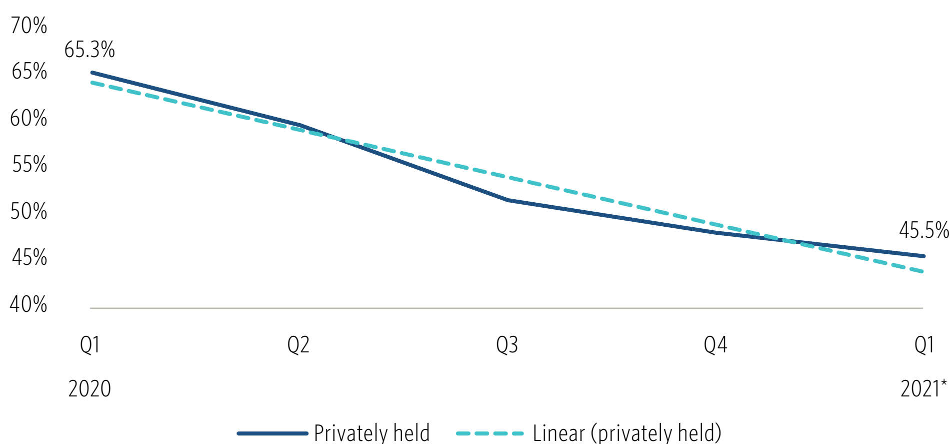
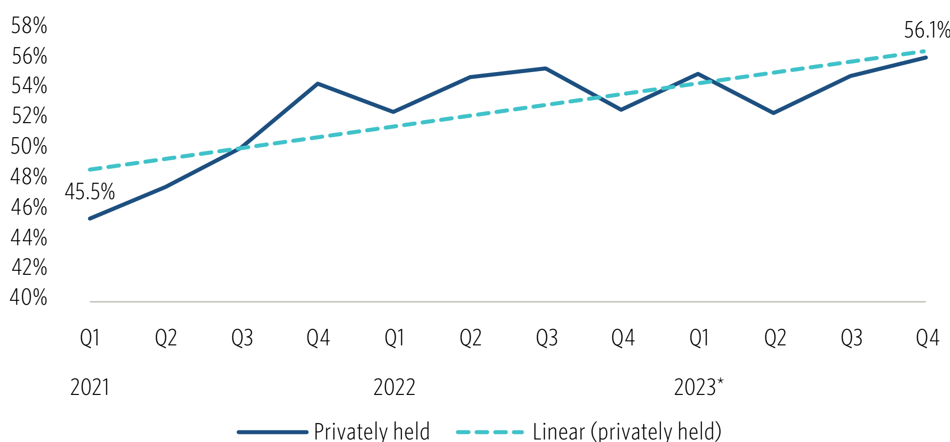
Outlook: The mix of founder-owned company deals, now 56% of all US PE buyouts, will push even higher next year.

Deals with nonbacked companies as targets as a share of all PE buyouts



Source: PitchBook • Geography: US • *As of November 28, 2023

Deals with nonbacked companies as targets as a share of all PE buyouts by quarter



Source: PitchBook • Geography: US • *As of November 28, 2023

Rationale

Nonbacked companies—meaning companies that have yet to accept institutional money—have historically represented the largest portion of US PE deal activity, accounting for an average of 55.6% of the total number of deals over the past decade. For the most part, these represent businesses that are still in the hands of the employees or families that founded them. Since the beginning of 2021, there has been an upswing in the share of all PE deals represented by these nonbacked

companies. From a starting point of 45.5% in Q1 2021, this percentage has now risen to 56.1% of deals as of November 2023. However, this falls short of the Q1 2020 peak when nonbacked companies reached 65.3% of all private equity buyouts, capping a nine-year upward trend. The COVID-19 pandemic caused PE interest in nonbacked companies to nosedive during that span, as they were less equipped to absorb the financial shock. So, in many respects, the recent rise in nonbacked companies is about regaining lost ground, but it also reflects the reluctance of other seller types. Those who can afford to wait out the current adverse interest-rate cycle are doing so, and that includes many financial sponsors and would-be PE sellers.

PE investors are currently placing a greater emphasis on operational improvements rather than relying solely on financial leverage to generate returns. When acquiring a founder-owned business, there has been no outside capital previously injected, so PE owners can start with a clean slate, free from any baggage or conflicting cultures from prior owners. Acquirers of founder-owned businesses are entering these companies on the ground floor in terms of value creation opportunities, such as scaling the business and improving cost efficiency. We anticipate that GPs will continue to turn toward nonbacked companies to operate their value-add strategies in this manner. Founder-owned businesses also tend to offer cheaper purchase price multiples—a welcome offset to higher borrowing costs. Furthermore, with US PE firms sitting on $955.7 billion of dry powder that needs to be put to work and a limited universe of sellers, private equity buyers will be incentivized to actively seek nonbacked targets.

Risks

If price dislocation subsides and widens the buying pool to deals of various backing types, the proportion of nonbacked companies as a share of total deal count would inevitably decrease, thus reversing this nearly three-year upward trend. Likewise, reduced interest rates and improved access to leverage could facilitate a market shift back toward larger deals, encompassing companies with various backing statuses. On the other hand, in the event of economic uncertainty turning into a recession in 2024, there could be forced selling from various backing types. Consequently, the proportion of deals from nonbacked companies would diminish.

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Outlook: PE healthcare services platform trades will not resume until the Fed begins cutting rates in earnest.

Rationale

PE healthcare services deal activity in the US and Canada is on track to reach 767 deals closed in 2023, down 18.9% year over year. But this does not tell the whole story. Platform deals—defined as buyouts that are not add-ons—are projected to total just 48 for 2023, compared with 98 in 2022, 135 in 2021, and 111 per year on average in 2017 to 2019. What's more, the vast majority of platform deals in 2023 have been acquisitions of small providers without existing institutional backing. Very few platforms have been sold from one sponsor to another, the traditional exit route in healthcare services. This means that sponsors are returning very little capital to their LPs, and some platforms are in dire need of recapitalization.

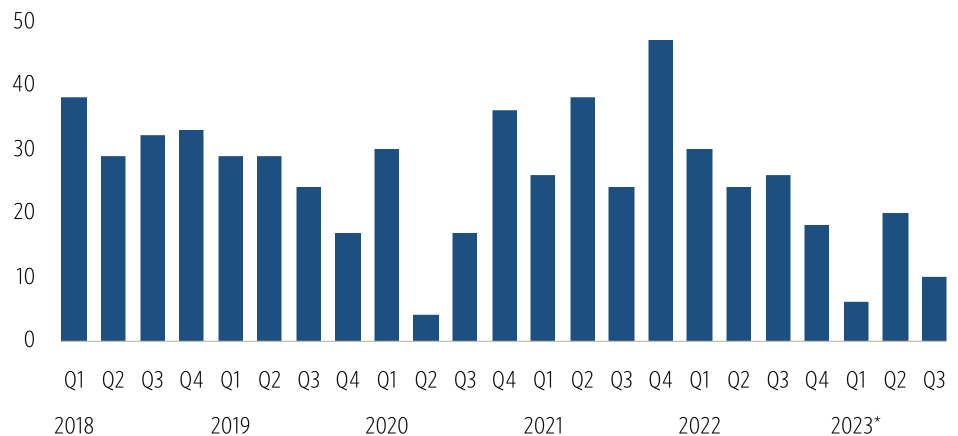
The key question, then, is when platform trades will resume. Anecdotally, bankers are sitting on growing pipelines of potential sales, but almost no one is willing to pull the trigger. Buyers, too, have capital to deploy, as evidenced by the fundraising trends discussed above. We believe that a substantial rate-cutting cycle will be the key impetus for the resumption of platform trades. Valuations have already come down a few turns (if not more) in most healthcare services categories, and sellers need to believe that they are exiting into the best market they can reasonably hope for. This is especially true for platforms that last traded at high prices in 2019 to 2021. Valuation, in turn, is dependent on the buyer's deal math. In a high-rate environment, deal math for a traditional PPM roll-up has become far less attractive, with more cash required up front, less headway available to finance add-ons with debt, and the real prospect of further multiple compression. Ironically, the tantalizing prospect of a soft landing—and concordant rate cuts—on the horizon makes sponsors less likely to exit now.

Put another way, we believe most sponsors will prefer at this point to elongate their holding periods rather than accept subpar returns, at least in 2024. A substantial portion of the older platform backlog was cleared between 2020 and early 2022, which should ease some of the near-term pressure to exit, and managers eyeing their next fundraise will be reticent to post less-than-stellar deal IRRs. When the floodgates do begin to crack open, the most conservatively leveraged platforms will likely lead the way.

Risks

There are two ways this prediction could be proven untrue: if the Fed significantly cuts rates and platform trades still do not resume, or if platform trades resume before the Fed cuts rates. The former scenario could happen if rate cutting occurs in response to a recession. The latter could happen—gradually—if the "higher for longer" refrain continues well into 2024 and sellers resign themselves to less competitive auctions and lower valuations than they are currently hoping for.

Healthcare services PE platform buyout count by quarter



Source: PitchBook • Geography: US and Canada • *As of September 30, 2023

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