CIO sees a range of attractive opportunities in private equity, especially managers skilled at transforming companies and identifying the next generation of disruptors. (UBS)

Can private equity overcome recent headwinds?

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Private equity funds faced several challenges going into 2024. But headwinds from high interest rates, lower transaction activity, and a record USD 2.6tr in dry powder may fade.

CIO sees opportunities in top private equity funds, an allocation to which can improve the long-term risk-return outlook for portfolios subject to managing certain risks. Investors should consider the risks inherent to private markets before investing, including illiquidity, long lockup periods, leverage, and overconcentration.

Private equity funds face several key challenges going into 2024.

- Elevated interest rates increase the cost of borrowing, which is an important component of private equity deal making.
- Weak transaction activity has made it harder to exit past deals, leaving the industry with a record USD 2.8tr in unsold investments, according to Bain & Co.
- Funds are sitting on a record USD 2.6tr in dry powder for deals, as of 15 December, according to S&P Global Market Intelligence.

But these headwinds look likely to fade in 2024, with plenty of opportunities for strong returns.

- The price of many acquisition targets has become more attractive due to recent headwinds. Opportunities have increased as companies seek to sell non-core operations.
- Rate cuts from the Fed, combined with a soft economic landing, should help restart dealmaking in 2024.
- While dry powder is at a record in dollar terms, relative to assets under management it is below the historical average. So, we don't see a glut of cash chasing too few deals.

So, investors should continue to allocate selectively to top funds.

- In the current environment, we favor funds with a strong record of boosting operational performance, along with funds exposed to strong secular trends.
- We have also seen sharper price declines in the valuations of middle-sized companies, creating greater opportunities. Investors should also consider adding exposure to secondaries.

Did you know ?

- A combination of slow global dealmaking and a weak public offering market meant that the number of private equity exit transactions last quarter was close to the lowest level in a decade, according to consultancy Bain & Co.
- Despite hitting record highs, current dry powder represents 27% of total assets under management, well below historical averages. Importantly, 50% of current dry powder was raised within the last two years and 70%within the last three. This suggests managers still have plenty of time to find opportunities.

Investment view

- The headwinds for private equity can be overcome, in our view. We do not expect returns to be undermined by a glut of capital chasing too few deals. But investors should be selective. We see the greatest potential in funds with strong track records in operational upgrades, identifying high growth companies, and picking up secondaries at a discount.
- We think adding private equity to traditional portfolios can both improve investors' long-term risk-return outlooks, while diversifying sources of return.

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