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Cash flow gridlock: understanding the private equity distribution challenge

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Over the last three years, many investors have experienced a considerable decline in the distributions they had grown accustomed to receiving from their private market investments. The liquidity that fueled a robust cycle of exits and distributions slowed dramatically beginning in 2022, coinciding with the rise in interest rates. Many general partners (GPs) responded by extending hold periods and seeking alternative sources of liquidity, leading to a collective bottleneck in distribution activity in private equity.

Key takeaways

- → **Current distribution environment:** For much of the prior decade, limited partners with mature private equity portfolios have received distributions between 20% and 30% of asset value each year. However, since 2022, distributions for many private market asset classes have generally been highly constrained.
- → **Distribution rates decline:** Distribution rates have fallen to levels not seen in recent history. This drop-off in private equity distributions is largely due to overlapping factors that have reshaped the landscape for private equity.
- → **Light at the end of the tunnel?:** The current private equity distribution environment remains constrained by several interrelated challenges. These include higher interest rates, limited exit opportunities through IPOs or M&A, and a persistent valuation gap between buyers and sellers. However, potential catalysts such as anticipated Federal Reserve rate cuts, a robust public market recovery, and the potential deployment of dry powder may offer a path to recovery in the near- to mid-term.

Current distribution environment overview

For much of the prior decade, limited partners (LPs) with mature private equity portfolios have, on average, received distributions between 20% and 30% of asset value each year. However, since 2022, distributions for many private market asset classes have generally been highly constrained. As illustrated in Figure 1, distribution rates have fallen to levels not seen in recent history.

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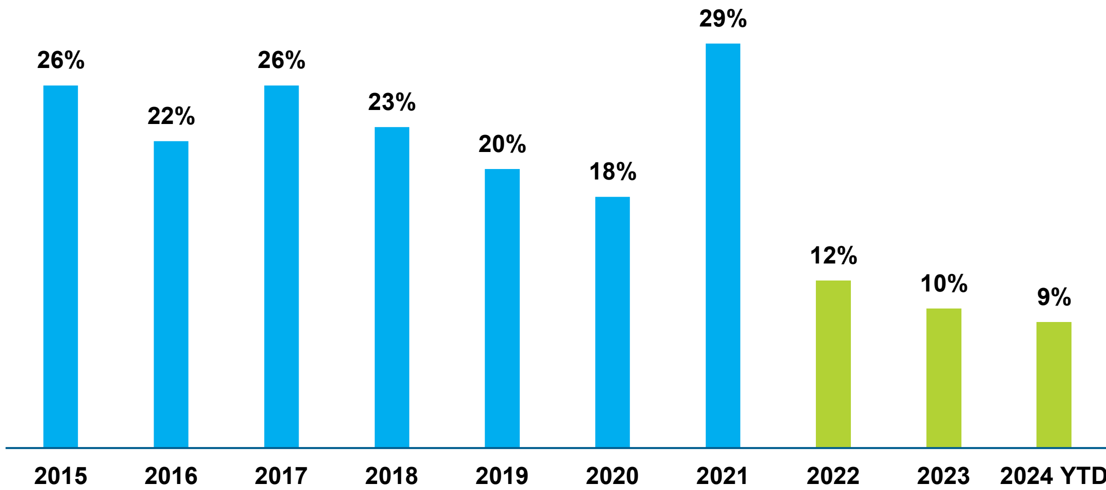

FIGURE 1
Private Equity Distribution Rates

Source: MSCI Global Private Capital Performance Report Q2 2024. 2024 YTD as of June 30, 2024. Distribution rates are calculated as distributions as a % of net asset value.

The drop-off in private equity distributions is primarily the result of overlapping factors that have reshaped the landscape for private equity (PE) and other alternative investments. We review some of these factors in the following sections.

Rising rates

After an extended period of subdued interest rates, rates started increasing in 2022, and by 2023 rates had moved above levels not seen in more than a decade. Such higher rates (see Figure 2) increase the borrowing costs, and most private equity transactions rely on borrowing. Higher borrowing costs imply that a lower purchase price is needed in order to hit return targets. Therefore, GPs may not be inclined to sell at these new, lower prices demanded by buyers. Hence it is likely that GPs are holding onto investments longer than originally anticipated and have extended the life of some of their funds in the hope/expectation that something (e.g., a reversal in interest rates) may change to bring prices back up.

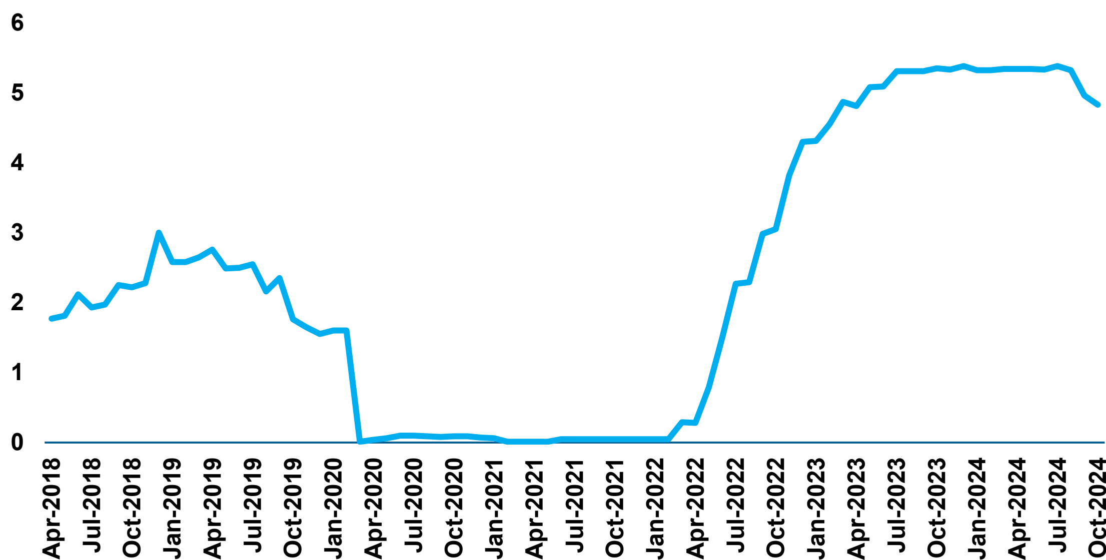

FIGURE 2
Secured Overnight Financing Rate % (SOFR)

Source: St. Louis Fed Economic Data. Last updated October 25, 2024.

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Secondary buyouts

A common exit avenue for PE funds over the last 10-15 years has been selling to other (often larger) PE funds. As borrowing costs have risen, financing conditions for leveraged buyouts (LBOs) executed by funds to acquire portfolio companies of other GPs have become less favorable, making it harder for these GPs to execute exits at valuations that meet investor expectations. Some GPs are avoiding portfolio company purchases from other GPs (who are highly price-sensitive sellers), with many waiting for more favorable market conditions to avoid overpaying for assets without compelling debt financing.

Partly as a result of rising rates, secondary buyout activity since 2022 has fallen significantly below the peak year of 2021 and is more tepid (at least in terms of deal count) than much of the prior decade (see Figure 3).

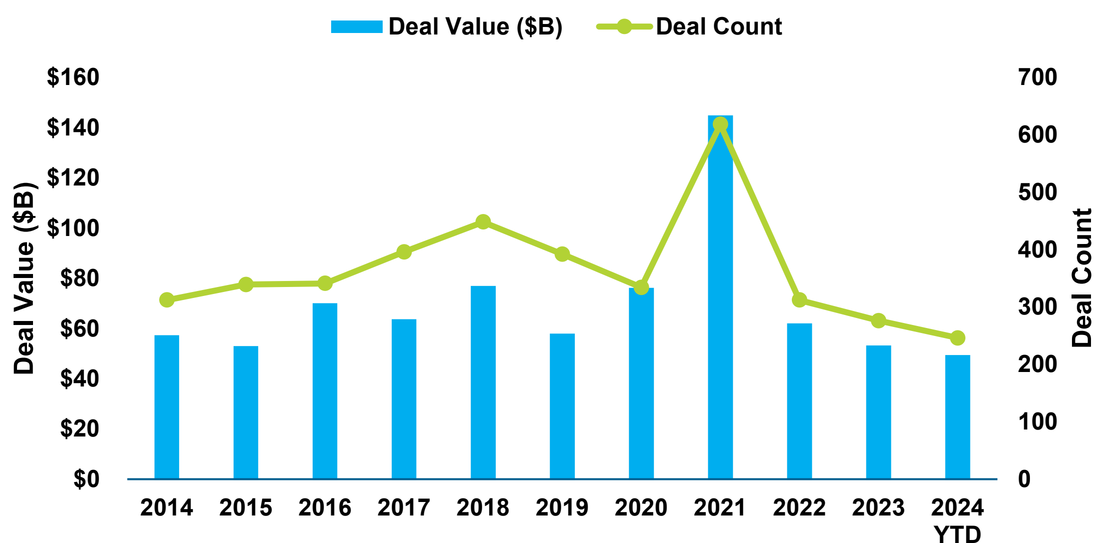

FIGURE 3
US Secondary Buyout Activity

Source: Preqin. 2024 YTD as of October 4, 2024.

Public offerings

Public markets experienced significant headwinds starting in 2022, with a virtual closure of the initial public offering (IPO) window. The IPO market can often serve as a robust avenue for private equity firms to exit investments and realize returns. However, IPO activity slowed to a crawl in the higher interest rate environment of the last several years (see Figure 4). At the same time, the SPAC (Special Purpose Acquisition Company) frenzy of 2020-2021, which provided a fast track to public listings, collapsed as many SPAC mergers underperformed, leading to a loss of investor confidence. The resulting decline in public exits cut off a major avenue for PE distributions, further contributing to the slowdown in capital return to investors.

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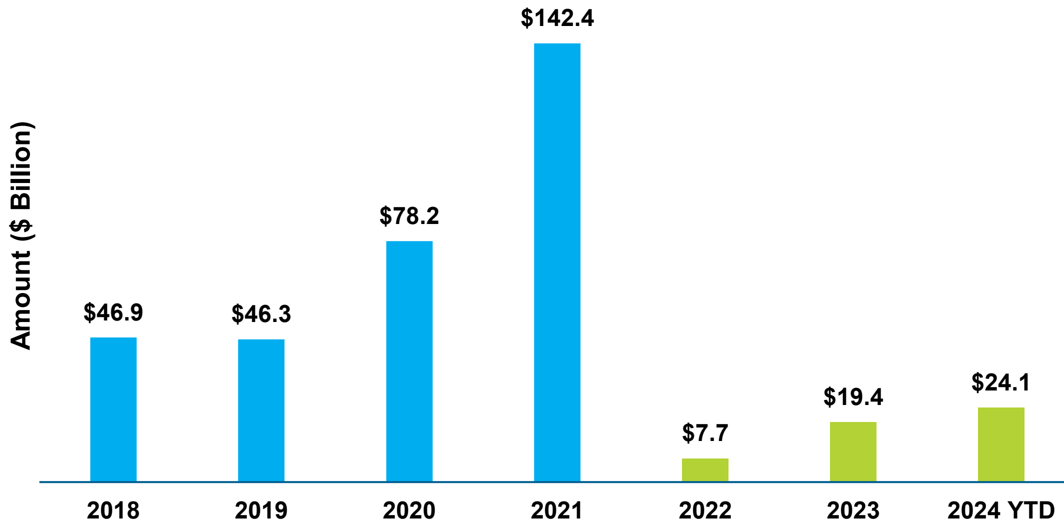

FIGURE 4
US IPO Proceeds

Source: Renaissance Capital. 2024 YTD as of September 23, 2024.

Corporate mergers & acquisitions

Corporate mergers and acquisitions (M&A) have historically served as another key driver of liquidity for private equity GPs by selling their portfolio companies to "strategic" buyers. However, M&A activity also saw a significant decline starting in 2022 with many acquisitive firms pulling back significantly on M&A spending (see Figure 5). Faced with higher borrowing costs, supply chain disruptions, and margin pressures in an inflationary environment, many corporations opted to scale back M&A activity. Instead of pursuing new acquisitions, many companies concentrated on conserving cash and correcting for previous overspending, leading to fewer strategic buyers for PE portfolio companies. This reduced corporate demand for acquisitions, slowed exits and, in turn, distributions to LPs.

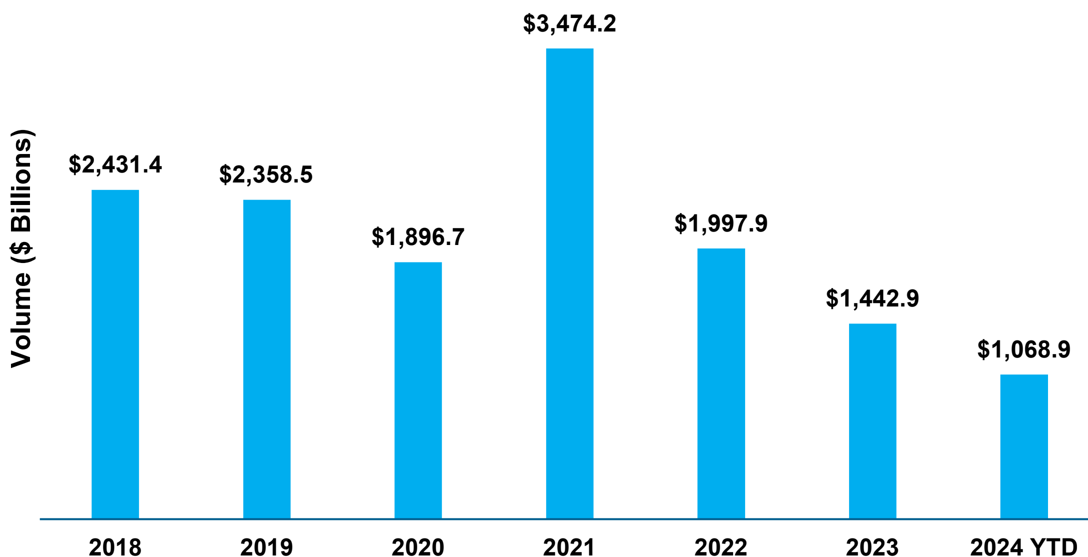

FIGURE 5
US M&A Volume

Source: Institute for Mergers, Acquisitions & Alliances. 2024 YTD as of August 31, 2024.

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Distribution environment outlook

Several contributing factors could drive a near- to mid-term recovery in private equity distributions, offering some optimism. These factors include a combination of macroeconomic changes, market rebounds, and sector-specific dynamics that may create favorable conditions for liquidity events in the private equity space.

Rate cuts

One of the potential catalysts for a recovery in PE distributions is the prospect of the Federal Reserve cutting interest rates. If interest rates move lower, it will reduce the cost of borrowing, improving the financing environment for PE firms. Lower interest rates make leveraged buyouts and other debt-driven deals more attractive, which in turn could lead to an increase in M&A activity, recapitalizations, and exits. More broadly, a lower rate environment may also spur broader economic growth, increasing corporate earnings and valuations, creating a more favorable backdrop for PE transactions. PE firms would be able to better access capital markets, refinance debt, and pursue more aggressive growth or acquisition strategies, all of which are key to generating distributions. As Figure 6 illustrates, the market is currently expecting short-term rates to move lower over the next year.

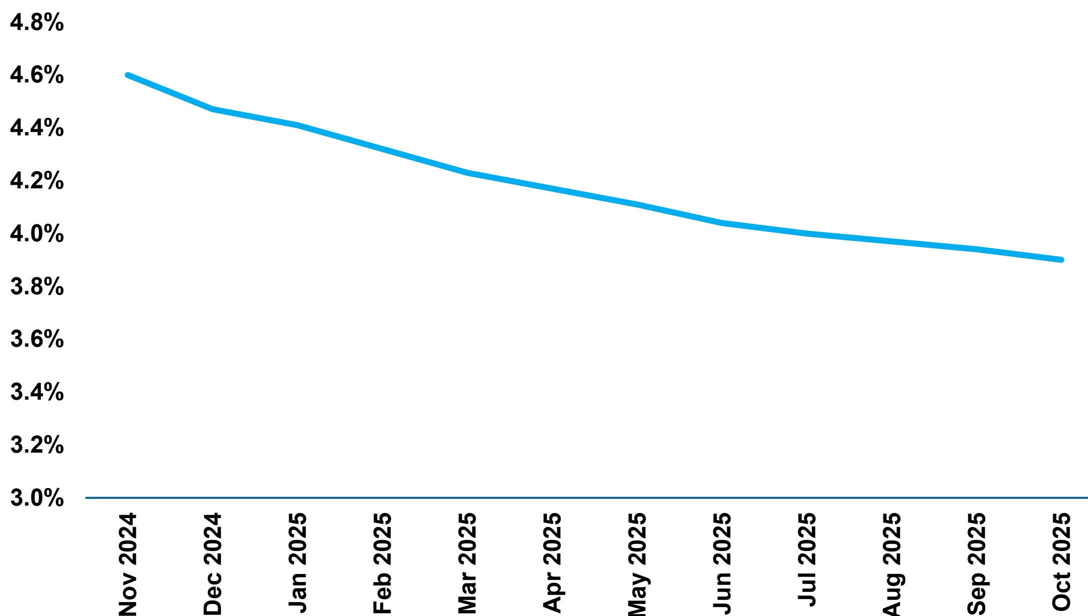

FIGURE 6
Market-Implied Short-Term Rate

Source: Bloomberg, CME. Market-implied one month term SOFR expectations as of November 11, 2024.

Public market recovery

Public equity markets experienced a robust recovery in 2023 and 2024, which may not yet be fully reflected in the valuations of many private equity portfolio companies (see Figure 7). Since private equity valuations tend to lag public market movements, the upward trajectory in public equities could lead to a corresponding, if delayed, uptick in private market valuations, creating opportunities for exits at more favorable prices. This could drive more initial public offerings and strategic sales, ultimately leading to an increase in distributions to limited partners.

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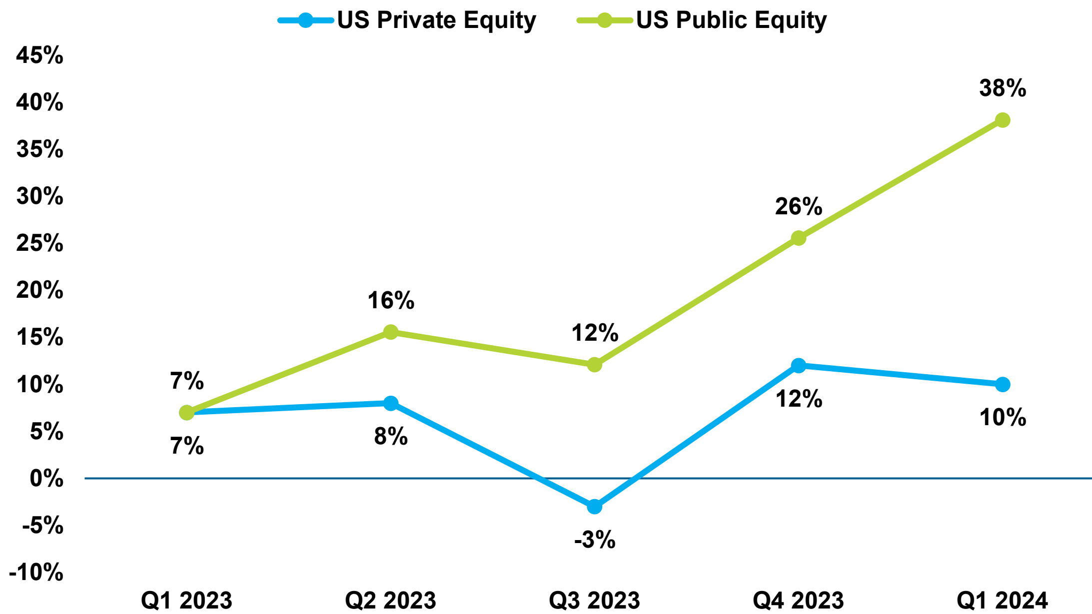

FIGURE 7
Relative Cumulative Performance Since Year-End 2022

Source: Cambridge Associates via IHS Markit, as of March 31, 2024. Reflects time-weighted returns for the Russell 3000 index and the Cambridge US Private Equity composite.

Dry powder

Private equity firms currently hold a large amount of "dry powder," or uninvested capital, which has accumulated in line with the growth of the overall private equity market (see Figure 8). This capital could play a pivotal role in driving a recovery in distributions as it gets deployed in recapitalizations, follow-on investments, or acquisitions of portfolio companies already held within PE portfolios. Recapitalizations, in particular, allow PE firms to return capital to investors without the need for an outright exit, providing liquidity while maintaining ownership of key assets. Furthermore, some of this dry powder will likely be used to make acquisitions, potentially resulting in a wave of transactions that drive increased liquidity and eventual distributions to LPs.

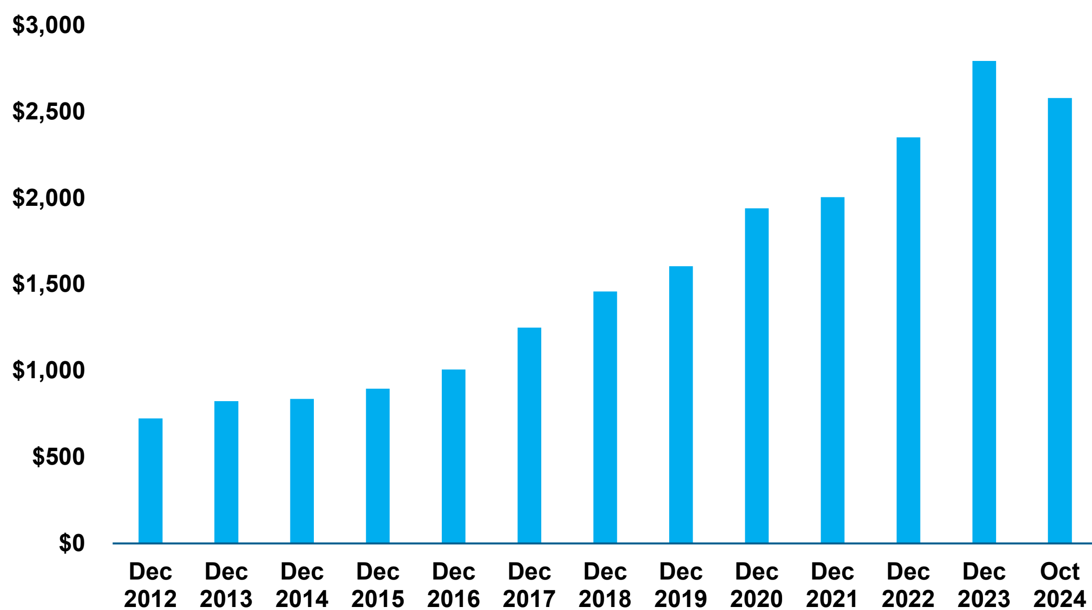

FIGURE 8
Private Equity Dry Powder ($B)

Source: Preqin, as of October 4, 2024.

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Conclusion

The current private equity distribution environment remains constrained by several interrelated challenges, including higher interest rates, limited exit opportunities through IPOs or M&A, and a persistent valuation gap between buyers and sellers. However, potential catalysts such as anticipated Federal Reserve rate cuts, a robust public market recovery, and the potential deployment of dry powder offer a path to recovery in the near- to mid-term.

In the meantime, many limited partners can adapt by recalibrating their expectations for near-term liquidity, adjusting commitment budgets while maintaining vintage year diversification, and actively engaging with their general partners for greater transparency on portfolio performance.

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