A Regime Shift in Private Equity Returns

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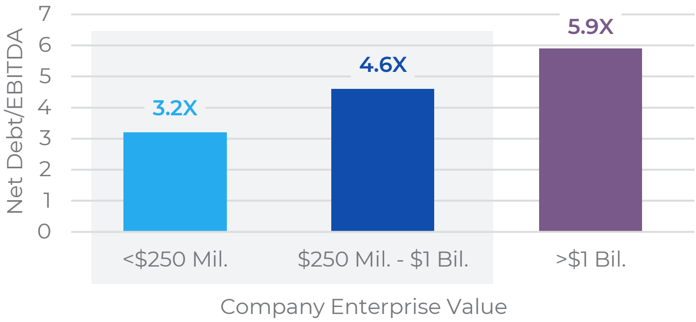
The world is undergoing a reordering of global markets that challenges most long-term capital allocation assumptions. Over the past three years[1], we have consistently posited that ongoing inflation pressures and uncertainty would set a new lower bound for U.S. rates that is much higher than during the previous decade. The long-term structural drivers of these trends remain in place, and the market consensus (reflected in long-term interest rates) supports the view that the current political economy is likely to reinforce if not accelerate those pressures. As the current geopolitical and macroeconomic environment is reordering expectations of winners and losers in public markets, this is also true for private markets. In our recent dive into the shifting political economy in Europe, we shared our bullish 5–10-year outlook for European private equity (buyout and growth) returns.

In this piece, we will look into key structural differences within segments of U.S. private equity strategies (with an emphasis on buyout funds) that are likely to become critical return drivers in the coming years in the evolving macroeconomic environment. These key differences stem principally from different levels of leverage and relative valuation multiples that are likely to widen the dispersion of realized distributions between large and mid/small funds for the foreseeable future.

Losing Leverage

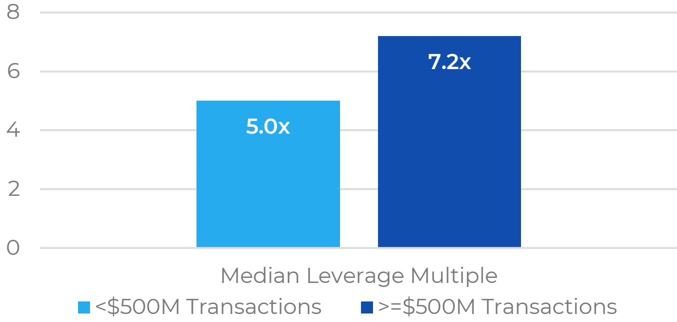
The classic playbook for buyout strategies, combining operating leverage through management improvements and/or additional scale with financial leverage through (comparatively) cheap debt to drive higher equity returns, is clearly under pressure amid higher rates. But this stress is especially acute for larger buyout funds given their historic reliance on greater levels of leverage for their underlying portfolio businesses. Long duration data from 2000-2020 (see **Chart 1**) shows that average leverage multiples have been 50-100% higher for larger buyout companies, which remained true in the post-GFC period data (see **Chart 2**).

Chart 1 | **Long-term Average Leverage Multiples 50-100% Higher for Larger Buyouts** 2000-2020



Source: Cambridge Associates

Chart 2 | **Post-GFC Saw Higher Leverage Levels Across the Board, but Larger Buyouts Used Nearly 50% More Leverage** (2010-2024)



Source: Cambridge Associates

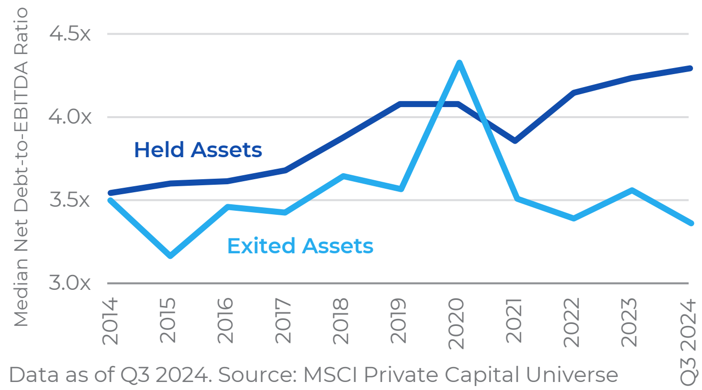
During the post-GFC period in particular, rates were not only consistently low, but the growth in private credit created an additional supply of debt to buyout GPs. But with policy rates now 400bps+ higher and private credit AUM growth slowing[2], the cost of leverage is taking its toll on private equity returns. Not only do higher levels of leverage generate additional costs for sponsor-backed enterprises, but in this environment of uncertainty and widening spreads, it also imposes substantial enterprise risk. This is why exits in highly levered companies have collapsed in recent years, impairing distributions and LP returns, especially from larger funds (see **Chart 3**).

Valuing Valuations

The costs and appetite for leverage are not the only factor that has changed in the past three years. For decades, median realized private equity valuations routinely exceeded those of unrealized valuations. Thus, LPs could count on the marks being used for most of their private investments to be realizable minimums in forthcoming exits. But the rate and market shocks of 2022 have led to a breakdown of this relationship as well. As **Chart 4** shows, the last several years of private equity exit valuations have fallen not only significantly short of unrealized valuations but saw two years of absolute valuation declines.

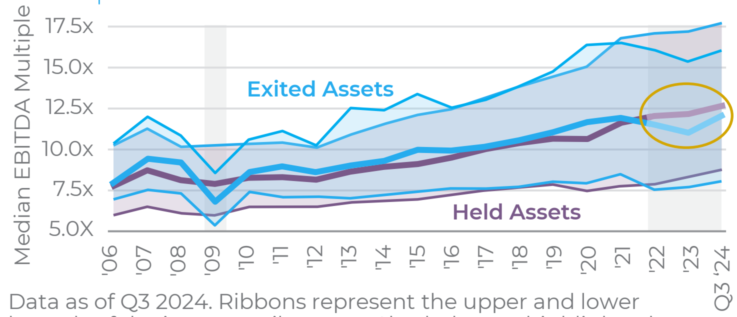
While this pressure on valuations is a market-wide phenomenon, it will be felt most acutely by the largest funds who (as a group) have traditionally paid much more for their assets. **Chart 5** shows that small buyouts (defined as sub $1bn companies) have consistently enjoyed a material discount in the market to their larger peers. Moreover, valuations are consistently more attractive for lower deal sizes, while valuations for the smallest GP's buyouts have already largely recovered relative to the 2021 peak (see **Table 1**). Historically, these higher valuations were partly justified by higher levels of profitability for larger firms that were on average 3-5 percentage points higher.[3]

Chart 3 | **Exits Favor Lower Levels of Leverage Much More than Pre-2022**



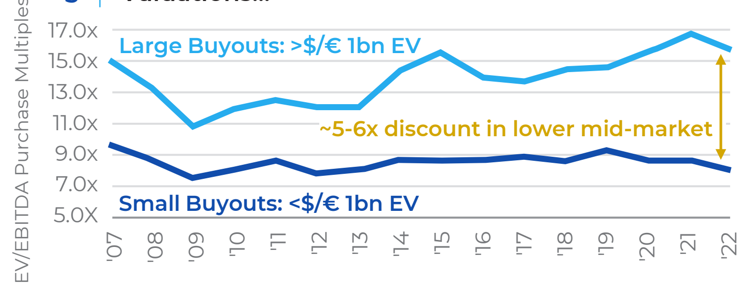
Data as of Q3 2024. Source: MSCI Private Capital Universe

Chart 4 | **LPs Beware! The Historical Relationships Between Realized and Unrealized Gains Have Broken Down**



Data as of Q3 2024. Ribbons represent the upper and lower bounds of the interquartile range. Shaded areas highlights the years when exited assets' median. EBITDA multiple was higher than that of held assets. EBITDA multiple = total enterprise value/EBITDA. Source: MSCI

Chart 5 | **Large Buyouts Have Consistently Higher Valuations...**



Source: Schroders Capital

Table 1 | **...And Even Smaller Deals (sub-$500m), Valuations Have Been Cheaper Still, and More Resilient.**

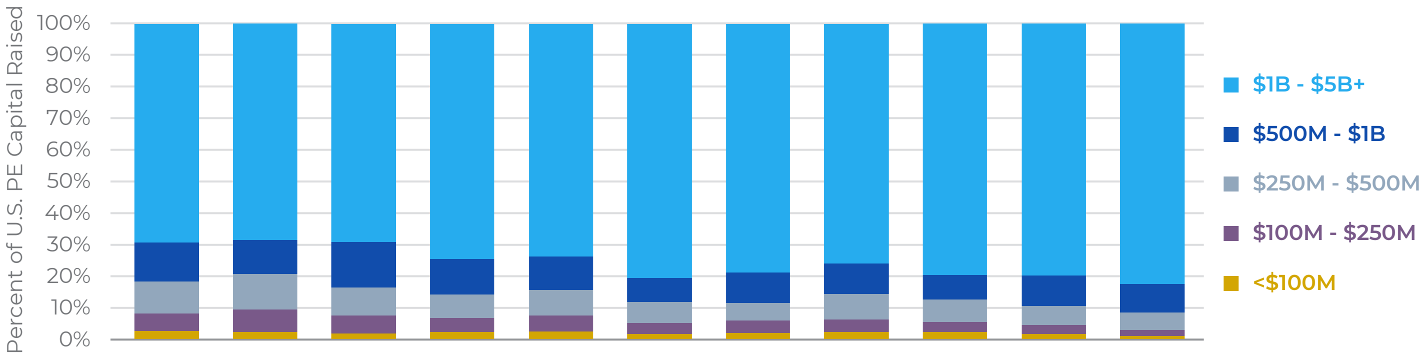
TEV	2003 – 2019	2020	2021	2022	2023	YTD 2024	Total
10-25	5.8	5.9	6.1	6.4	6.0	6.4	5.9
25-50	6.5	6.7	7.3	7.0	7.0	6.7	6.7
50-100	7.5	8.0	8.3	8.5	8.0	8.5	7.7
100-250	8.2	8.7	9.3	9.1	9.6	8.2	8.5
250-500	9.0	10.4	10.9	10.1	10.7	9.5	9.9
Total	6.6	7.0	7.5	7.5	7.2	7.1	6.9

Source: Apogem, GF Data, data available through November 2024 and accessed January 2025. Valuation ratio: total enterprise value (TEV) / EBITDA

But **Chart 4** suggests that this historical profitability advantage has either diminished over the past two years[4] or is now insufficient to compensate investors for higher valuations in the new rate environment.

Despite these challenges, the largest buyout funds have continued to dominate the fundraising landscape (see **Chart 6**).

Chart 6 | **Large Funds Continue to Dominate Allocators' Preferences at Their Peril**



Source: New York Life Investments

Passing Fad or Passing the Baton?

While it is difficult to predict if the heightened sensitivity to leverage and higher valuations will hold for the next decade, we think there is good reason to think it is the path of least resistance, at least as it applies to U.S. buyouts. As we have written about previously, we believe the outlook in America is for higher rates for longer given the abundance of inflationary pressures affecting the U.S. economy including reshoring, tariffs, AI-driven energy demand, policy-created labor market shortages, and fiscal largesse that increases the supply of U.S. government debt the market needs to absorb. Perhaps even more important is just the opportunity cost of capital. More than any time in the past 10 years, private equity faces new competition in securing limited space in allocators' portfolios from private credit, resurging macro and commodity/CTA strategies, as well as overseas assets (buoyed by a medium to long-term outlook for USD-weakness - whether structural or cyclical). Coming on the heels of a period of depressed exits and distributions from private equity, investors are likely to maintain their newfound selectivity within the asset class for years to come. With structurally higher interest rates, compressing valuations, and now a potential repricing of U.S. risk premia by foreign investors too, we feel that allocators may be better served by focusing their private equity investments much further down the size spectrum than they have before.

In our next discussion, we will look at the empirical evidence for whether smaller funds have delivered superior returns and distributions, and what the outlook for any historical trends in those return patterns may look like going forward in this new investment landscape.

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[2] Pitchbook US Private Credit Monitor. May 2025.

[3] https://www.cambridgeassociates.com/en-eu/insight/us-private-equity-looking-back-looking-forward-ten-years-of-ca-operating-metrics/

[4] Reliable data on margin levels for the past 2 years by company size could not be found.