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The Opportunities Across Private Equity's Current Liquidity Landscape

There are attractive opportunities for experienced liquidity providers in the current private equity market environment.

Higher capital costs, dampened exit activity and protracted fundraising cycles have presented private equity (PE) sponsors with a fundamental dilemma: How to balance investor demand for capital distributions with a reluctance to sell prized assets?

In this paper, we discuss three key solutions designed to address this dilemma, including mid-life equity co-investments, GP-led continuation funds and custom capital structures combining equity and debt. We believe these various structures have the potential to generate attractive risk-adjusted returns in a liquidity-constrained environment.

The Backdrop: Less Liquidity, Dampened Distributions

As the PE market has expanded and evolved in 2024, we find that sponsors continue to face an interwoven set of challenges. These include a difficult fundraising environment;[1] higher debt costs (rates on unitranche loans have surged roughly 300 bps, up 10%, since mid-2021);[2] and fewer exits (as economic growth has ebbed and geopolitical risk has simmered).

Over the life of a typical PE fund, general partners (GPs) return capital to their limited partners (LPs) through periodic distributions as they harvest their investments.

Costlier debt, fewer exits and longer holding periods have led to a notable drop in PE fund distributions, stooping to nearly half the long-term average and nearing levels last seen shortly after the 2008 Global Financial Crisis.[3]

Diminished distributions pose challenges for both sponsors and investors: Sponsors rely on that capital to invest in new deals, while institutional investors often use it to make commitments to new PE funds.

Key Opportunities for Liquidity Providers

We believe current market dynamics, including expensive debt, wider bid-ask spreads and lower distributions, continue to create attractive opportunities for those who can provide liquidity to address these challenges. Three key opportunities, in our view, are mid-life equity co-investments, GP-led continuation funds and custom capital structures that combine aspects of equity and debt.

Mid-Life Equity Co-Investments

Co-investments have long represented an attractive way to invest in PE, and we believe the current environment is playing to seasoned co-investors' strengths.

As debt has grown more expensive, GPs have generally needed more equity to complete new buyouts and, increasingly, to support their existing portfolios. In these scenarios, capital is often needed "mid-life" to support investment theses, complete strategic M&A, or recalibrate the amount of leverage in their portfolio companies. By taking on a mid-life co-investor, GPs are able to unlock liquidity without losing management control or fully exiting their positions.

These transactions can also facilitate distributions to current LPs. From the liquidity providers' perspective, the ability to provide mid-life co-investment capital opens up a number of interesting investment opportunities that average investors often aren't able to access. Generally, the liquidity provider is also better equipped to negotiate the valuation, terms and structure of these transactions. Due to the complex nature of coming into these investments "mid-life", we believe this approach not only requires a different skill set than co-underwriting new buyouts, but also deep relationships with established PE sponsors.

GP-Led Continuation Funds

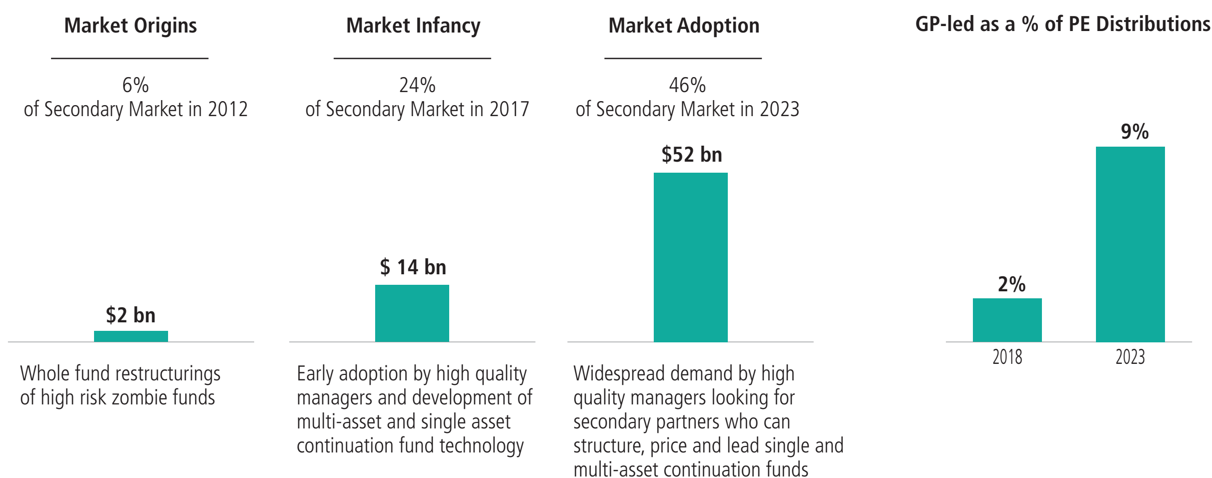
We have observed that demand for liquidity has led to the rise of a robust secondary market for PE assets. One popular manifestation is GP-led continuation funds. These vehicles can allow GPs to offer liquidity to their LPs while simultaneously retaining up to complete ownership of high-quality, prized assets that have proven management teams and relatively predictable growth trajectories.

In a typical continuation fund, a GP might sell a single or select group of assets from an existing fund to a new vehicle—the continuation fund—managed by the same GP and structured in negotiation with secondary investors. LPs in the primary fund can either generate liquidity by cashing out their stakes at the price negotiated with the secondary buyer or roll them into the new continuation fund; GPs get extra time and capital to create more value through operational enhancements and potential growth opportunities.

As shown on the left side of figure 1, the GP-led secondary market has grown significantly since 2012, with GP-led deals now representing approximately 46% of secondary transactions. GP-leds now account for approximately 9% of PE distributions, up from 2% in 2018, as shown on the right.

[1] NBAA Analysis as of August 2024.
[2] Lincoln International and NBAA analysis. These estimates are based on market observations and no party provides any guarantee or assurance that these projections are accurate.
[3] NBAA Analysis as of August 2024. Represents Pure PE primary investments, excluding venture as of Q2 2024.

FIGURE 1: LACK OF LIQUIDITY HAS FUELED A GROWING AND UNDERCAPITALIZED PE SECONDARY MARKET



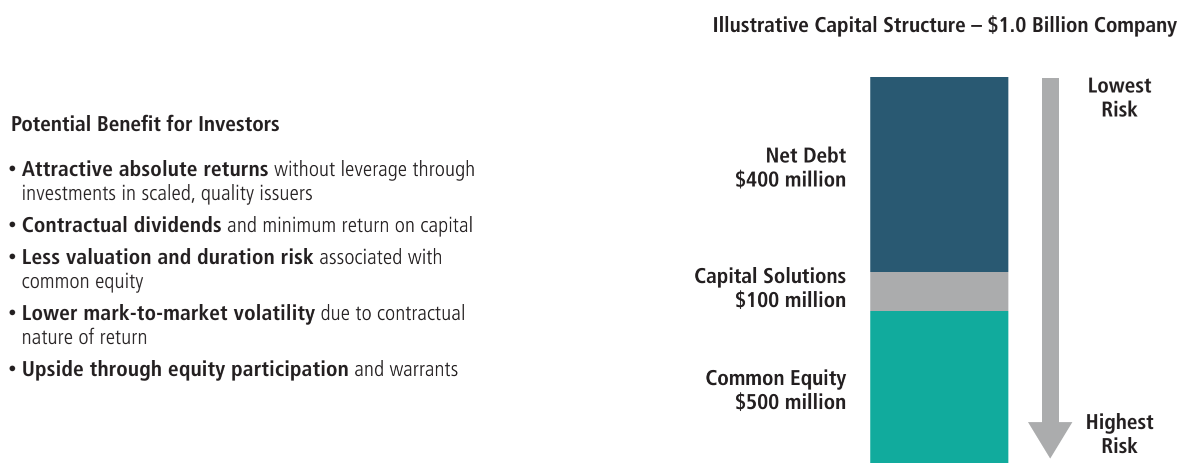
Source: Size of Secondary Market: Jefferies, data as of December 2023; NBAA analysis as of January 2024; GP-led as % of PE Distributions: Baird 2024, a leading secondary market advisor. (Note the 2% in 2018 is an estimate.)

Despite the potential opportunities in this sector, we observe that continuation funds have remained considerably undercapitalized, creating a supply-demand imbalance. In our view, this imbalance has the potential to benefit experienced investors willing to provide liquidity and negotiate terms in their favor.

Custom Capital Solutions

In addition to co-investments and secondaries, we think opportunities to provide liquidity can emerge throughout the capital stack, including highly customized capital solutions for larger companies held by premier private equity sponsors. In our view, these privately negotiated instruments, which tend to sit behind senior debt but still ahead of the common equity, have the potential to deliver attractive total returns on invested capital at relatively lower levels of risk (see figure 2).

FIGURE 2: CUSTOM CAPITAL SOLUTIONS CAN OFFER ATTRACTIVE YIELDS AND REASSURING SAFETY



Source: Neuberger Berman. Such views and opinions are subject to change and there is no guarantee that any will prove to be accurate or that industry experts would agree.

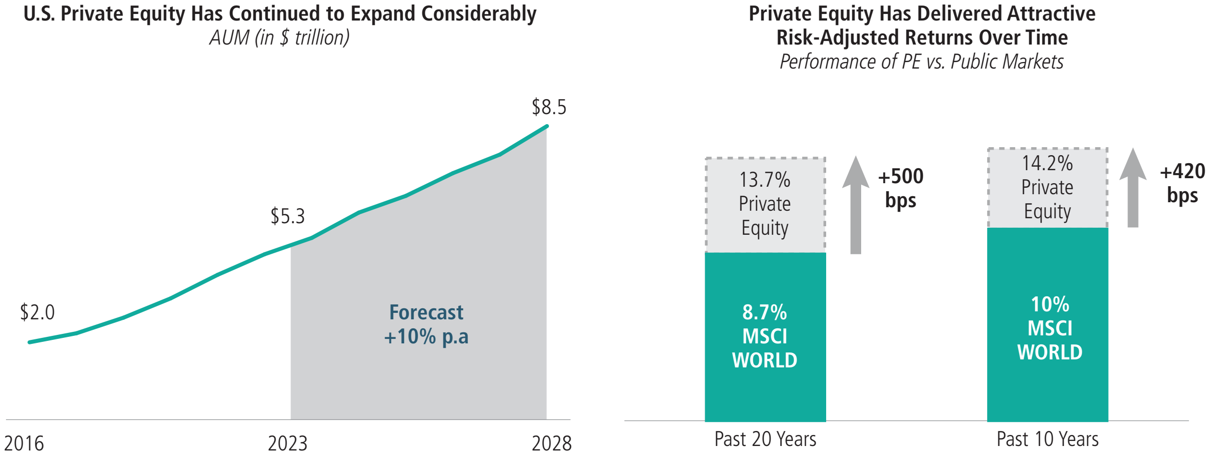
Custom capital solutions often have characteristics of both debt and equity. Instead of quarterly cash coupons (as in a typical private-debt arrangement), investors often receive a contractual coupon paid in kind, along with a discount to its original face value and even additional call protection. In some cases, investors can enhance overall returns through equity participation in the form of warrants or conversion rights. Given current market conditions, we anticipate these types of opportunities will increase over the next few years.

What's Next?

We believe PE remains an attractive complement to a well-diversified investment portfolio. We have observed that top-tier PE managers have significantly outperformed public markets over time, and we expect that the potential for attractive risk-adjusted returns will continue to attract capital for new PE funds.

According to Preqin, the PE industry is expected to reach $8.5 trillion in assets under management by 2028, up from $5.3 trillion at the end of 2023 (see figure 3). To put that figure in perspective, $5.3 trillion equals the combined market capitalizations of just two public companies: Amazon and Google. Compared to the public markets, we believe PE still has plenty of room to run.

FIGURE 3: PRIVATE EQUITY HAS OUTPACED PUBLIC MARKETS; MORE GROWTH APPEARS ON THE WAY



Source: Left chart: Preqin. AUM figures exclude funds denominated in Yuan Renminbi. And values are as of year-end. To avoid double-counting, the total excludes secondaries and funds of funds. Right chart: Private equity data from Burgiss. Represents pooled horizon IRR for Global Private Equity as of 2024 Q1, which is the latest data available. Public market data represent returns from the MSCI World Index, data of 2024 Q1. The benchmark performance is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of the benchmarks may be different than the investment objectives and strategies of a particular private fund, and may have different risk and reward profiles. A variety of factors may cause this comparison to be an inaccurate benchmark for any particular type of fund and the benchmarks do not necessarily represent the actual investment strategy of a fund. It should not be assumed that any correlations to the benchmark based on historical returns would persist in the future. **Past performance is no guarantee of future results.** Indexes are unmanaged and are not available for direct investment.

In the meantime, as PE exit markets continue to thaw and distributions ramp back up, we expect GPs will stay focused on enhancing value and compounding returns within their existing portfolios. These efforts, in our view, should continue to create potentially attractive opportunities for experienced liquidity providers spanning mid-life co-investments, GP-led continuation funds and custom capital solutions.

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