OUTLOOK

2023 Investment Outlook: Private Equity

December 20, 2022

Record Levels of Dry Powder and Earnings Propel Private Equity

KEY POINTS

1. Earnings serve as the engine of growth in private equity, accounting for nearly half of value creation.
2. Rising interest rates may lead to reduced leverage and lower multiple expansion.
3. Dry powder remains at record levels of $3.6 trillion and should fuel high transaction volume.

What We Are Seeing

Earnings growth is likely to be the principal driver of PE returns ahead, and manager selection will remain key, with experts in profitability-enhancing operational improvements and strategies that capture synergies best placed to generate alpha.

Leverage's contribution comprised roughly one-quarter of total Multiple on Invested Capital (MOIC), only slightly behind multiple expansion.

Higher borrowing costs and less buoyant IPO and strategic buyer demand are hindering multiples.

Monetary tightening, fiscal retrenchment and supply-side disruptions are shrinking global demand. The economic slowdown, coupled with higher inflation and rising interest rates, has pushed global equity markets into bear market territory. Rising interest rates may trigger reduced leverage and lower multiple expansion, limiting the contribution to performance from these key return levers.

What We Are Doing

We emphasize capturing value at entry in transactions because in an environment of rising interest rates, we don't expect multiple expansion to drive returns as much as it has over the past 20 years.

Buy-and-build strategies are key to unlocking stronger revenue growth and maximizing operational efficiencies, as they help to grow scale and capture synergies. This investment approach is repeatable and often enables add-on acquisitions at below headline valuation multiples.

We are staying the course as PE absorbs market dislocations and capitalizes on interesting entry points. PE is showing the most growth potential among private asset classes and is on track to account for nearly 70% of alternatives AUM by 2025, according to Preqin.[1] We continue to build on PE's exceptionally robust performance over the past decade.

We focus on profitability-enhancing operational improvements and strategies that capture synergies best placed to generate alpha.

What We Are Watching

General partners (GPs) must implement best-in-class operations and capture synergies and scale through strategies such as buy-and build.

Fundraising may slow, but dry powder remains at record levels of $3.6 trillion, which should sustain high transaction volumes. Amid continued competition for quality assets, deal origination at attractive value-at-entry levels is not a given, and GPs must remain selective and disciplined to create value.

Earnings become increasingly important as a source of value creation due to multiple compression and rising debt costs. Investors continue to increase their allocations to alternatives to meet their long-term investment objectives.

Partnering with founders in the midmarket — particularly those seeking support from financial investors for the first time — and reducing operational vulnerabilities may make businesses less sensitive to economic headwinds.

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[1] "The Future of Alternatives 2025," Preqin, August 2020.

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