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Key LP Investments Trends in 2024 and Beyond

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C.S. Lewis once wrote, "*Onwards and upwards! To Narnia and the North*," and this seems to have been echoed by the private equity market in 2024 thus far. Except this time, it appears the destination is not Narnia but rather the land of better returns and improved capital raising.

The past few years have been challenging for private equity, with rising interest rates, heightened regulatory scrutiny and geopolitical instability. General Partners (GPs) and Limited Partners (LPs) alike have struggled in a stalling market. A new dawn does seem to be around the corner with improving macroeconomic trends and a rebound in fundraising. GPs and LPs have also been innovative with the use of co-investment structures and GP stakes funds to find returns. However, there is scepticism from LPs around the increasing use of alternative metrics such as distributions to paid-in capital (DPI) and net asset value loans (NAV loans) to fund distribution, and whether these metrics are the result of financial engineering covering not-so-great returns.

There is a clear contrast in terms of how GPs and LPs are navigating the market. In light of this, we take a look at key investment trends in 2024 and beyond.

1. ***Release the Doves*** – Softening Interest Rates

The Chair of the Federal Reserve Jerome Powell may have warned market participants that the Federal Reserve's September 50-basis point rate cut should not be assumed to be "the new pace",[1] but there is no doubt central banks in developed economies are singing from the same hymn sheet with corresponding interest rate cuts from the Bank of England and the European Central Bank. The Governor of the Bank of England even went as far as to say that rate cuts could become "a bit more aggressive" provided inflation data remained on track.[2]

The market is anticipating a low-interest environment, which will likely accelerate capital raising and deal volume even further. Global private equity-backed M&A activity has already reached $378 billion in H1 2024, a 40 percent increase over the same period in 2023.[3] Interest rate cuts may also encourage an initial public offering (IPO) rebound, helping GPs return locked-up capital to LPs. According to data from PitchBook, the median holding period for private equity assets sold in H1 2024 saw a sharp reduction to 5.8 years from 7 years in earlier periods, indicating improved exit opportunities.[4]

Private equity fundraising also appears to be on the rebound, with funds collected at $408.6 billion in H1 2024 compared to $374.6 billion across the same period in 2023.[5] Despite not being at the record $506.4 billion levels we saw in 2021, the recent data still gives hope of an uptick in trend.[6]

The environment is improving to be ripe for deal-making and capital raising for H2 this year and beyond. The recalibration of monetary policy marks a positive turning point for private equity funds, perhaps even a time to release the doves (as in the birds, not the dovish central bankers).

2. *Moving the Goalposts* – Is "DPI" the New Buzzword?

Internal rate of return (IRR) has been the traditional indicator to measure fund performance, however, the market has recently seen the introduction of an alternative metric by GPs in the form of distribution to paid-in capital (DPI). Some GPs are highlighting DPI to demonstrate the amount of money they return to their LPs, particularly in a difficult exit environment over the past few years. However, LPs are sceptical of the GP's use of such new metrics as it is moving the goalposts on the traditional fund performance expressed as IRR.

LPs are concerned about whether the DPI metric is an accurate representation of performance as it relates to a fund's ability to generate liquidity and return capital back to LPs rather than the actual performance or returns of the fund itself. DPI calculations are also complicated and inconsistent, and the method of calculations can vary between funds. Industry bodies like the Institutional Limited Partners Association (ILPA) are looking to standardise performance metrics with its recent ILPA Quarterly Reporting Standards Initiative consultation (available here), which aims to help LPs compare metrics relevant to their circumstances.

So, whilst moving the goalposts in this manner may demonstrate how much money a fund hands back to investors in the wake of tied-up capital, LPs need to ensure they strike a balance in assessing actual return on investment versus cash distributions to avoid an own goal.

3. *Better Together* – A Growing Appetite for Coinvestments

Coinvestments allow LPs to bypass traditional fund structures, reducing fees and obtaining greater control over investment decisions. For an active LP, it is unsurprising that co-investment structures are becoming more popular. One private equity firm saw an increase of coinvestment opportunities by 38 percent in 2023 and expects a 47 percent increase for 2024 — it is clear the opportunities are available and growing.[7]

A rise in coinvestment structures will no doubt reshape the GP-LP dynamic, and GPs can leverage its growing demand by offering access to coinvestment opportunities for larger and more committed capital contributions. For LPs, a coinvestment structure may help satisfy an appetite for better returns and greater control. These new structures mark a shift in the GP-LP relationship, one that is more intertwined, perhaps it is better to be together.

4. *A New Hope* – Rising GP Stakes Funds

More LPs are joining the bandwagon by investing in GP stakes funds and taking minority noncontrolling stakes in GPs. This provides an alternative source of revenue for investors, including management fees, carried interests and balance sheet income.

The popularity of GP stakes funds is illustrated by the announcement of 26 deals in Q4 2023,[8] the highest quarterly total of the year. The Private Equity International LP Perspectives 2024 Study stated that 49 percent of LPs have invested in GP stakes funds or intend to do so, representing an increase of 36 percent compared to last year.[9] It shows a growing appetite in GP stake funds for generalist managers/investors, as opposed to being a strategy traditionally exclusive to specialists. A growing comfort for GP stake funds may present a new hope to investors looking for other forms of return.

5. *What's NAV Got to Do With It* – The NAV Loan Defence

The last few years have been challenging for private equity, with difficulties in fundraising, deal-making and exits caused by a difficult macro environment. Performance has also suffered as a result of funds holding struggling companies in their portfolio that they cannot offload.

GPs have been using NAV loans that are secured against fund assets as collateral mainly in two ways: first, to protect a fund's portfolio investments by using loan money to support non-performing companies within the fund, and second, to boost the fund's liquidity for distribution and to finance new funds.

NAV loans are not without risk. Borrowing requires consistent liquidity for interest payments, and loans may put the broader portfolio at risk as well as impact the fund's returns. Whilst the general outlook for the market is looking up and interest rates are softening, this is a slow ramp up and the recovery may not be quick enough to alleviate the debt pressures.

The risk associated with such loans is highlighted by the ILPA's recent publication on the use of NAV-based facilities in private equity strategies (the Guidance).[10] The Guidance highlights its LP members' concerns, including how LPs often have limited insight into when NAV loans are used and the struggle with the lack of governance around the GP's use of such facilities. The Guidance, therefore, recommends greater transparency and disclosure in the GP-LP relationship where NAV loans are involved. This is likely to increase LP queries on NAV loans relating to the fund's governing documents and regular reporting. For more information on the Guidance, please see our recent advisory (available here).

Tina Turner may have said, "*What's love but a sweet old-fashioned notion*," but NAV loans may not be the same sweet old-fashioned notion.

6. *Champions Keep Playing Until They Get It Right* – Continued Interest in Continuation Funds

As one of tennis's greatest players, Billie Jean King, once said, "*Champions keep playing until they get it right*." More GPs have taken a page out of Billie Jean King's book by using continuation funds to buy time to wait for a better environment or to continue to generate greater value. It also provides LPs with an opportunity to invest in pre-identified assets that are already high-performing, providing greater certainty in control and returns.

Continuation funds can also be used by GPs to create DPI and wipe the slate clean by taking their best portfolio company in an existing fund to establish a continuation fund; GPs give the impression that it is a high-performing fund when, in reality, the bad performers have been left behind in the previous fund. Whilst this is a justifiable concern for LPs, it can act as a way to leave behind previous holdings.

While GP-led transactions make up around 40 percent of the secondary market in the first half of 2024, it is worth noting that 86 percent of this GP-driven deal volume was in continuation vehicles[11] – a record high for H1. This continues to demonstrate how GP-led secondary transactions (along with NAV loans) are used to address liquidity concerns in light of a difficult exit environment.

Secondary market volume is hitting a record high this year, up 58 percent at $68 billion in H1 2024 compared to $43 billion in H1 2023,[12] and asset managers such as Vanguard and Jefferies expect annual transaction volume to remain elevated at around $130 to $150 billion for 2024, which is significant compared to $114 billion in 2023. These figures suggest a popular and rising secondary market and that LPs have shorter exposure and timelines. This is expected for GP volumes as well and we anticipate that the rest of the year will likely include a steady rise in continuation funds volume.

7. ***Road Trip?*** – A Slower Fundraising Market

Private equity fundraisers are spending more time on the road to close funds. According to *PitchBook* data, the median time for private equity funds to close in the United States was 18.1 months in H1 2024, up from 14.7 months in 2023 and 11.2 months in 2022.[13] Similarly, first-time European private equity fundraising is expected to hit a new low since 2019, with €2.4 billion raised so far, comparable to the lowest in recent times during 2020 with €2.9 billion.[14]

Fundraising timelines have soared due to rising interest rates and inflation, creating a difficult exit environment as well as below-expectation distributions to LPs. Subdued exit activity may have also contributed to overallocation into private equity by LPs, leading to dampened interest in the new deployment of capital into private equity. However, the reversal of key macroeconomic factors and an improving secondary market may alleviate some of the congestion within the private equity ecosystem and signal a shift in the fundraising environment.

8. ***Mixed Messages*** – A Divide on ESG

Actions speak louder than words. Following an exodus of American asset managers from Climate Action 100+,[15] an investor-led initiative to take appropriate action on climate change, it is clear that market participants have a lot to say about the highly politicised concept of environmental, social and governance (ESG) in the United States.

On the other side of the Atlantic, European private equity managers fare better with 87 percent securing an 'excellent' or 'good' ESG rating in its investment practices, according to LGT Capital Partners' 2024 ESG Report.[16] This is in stark contrast with US private equity players, with only 53 percent achieving equivalent ratings. Even the Asian private equity managers are performing at a higher standard at 76 percent at the same ratings. This suggests that private equity managers' views on ESG and its returns are not uniform, with some obtaining value and return elsewhere rather than ESG investments. It also shows LPs may not view ESG as important as part of their investment portfolios.

The difference in attitude may be unsurprising given Western Europe's aggressive regulatory stance with the European Union's Sustainable Finance Disclosure Regulation and Corporate Sustainability Reporting Directive. It shows a real divide and spectrum across the globe on ESG, it is clearly a polarising issue causing the private equity sector to send mixed messages.

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