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Less debt today, lower returns tomorrow?

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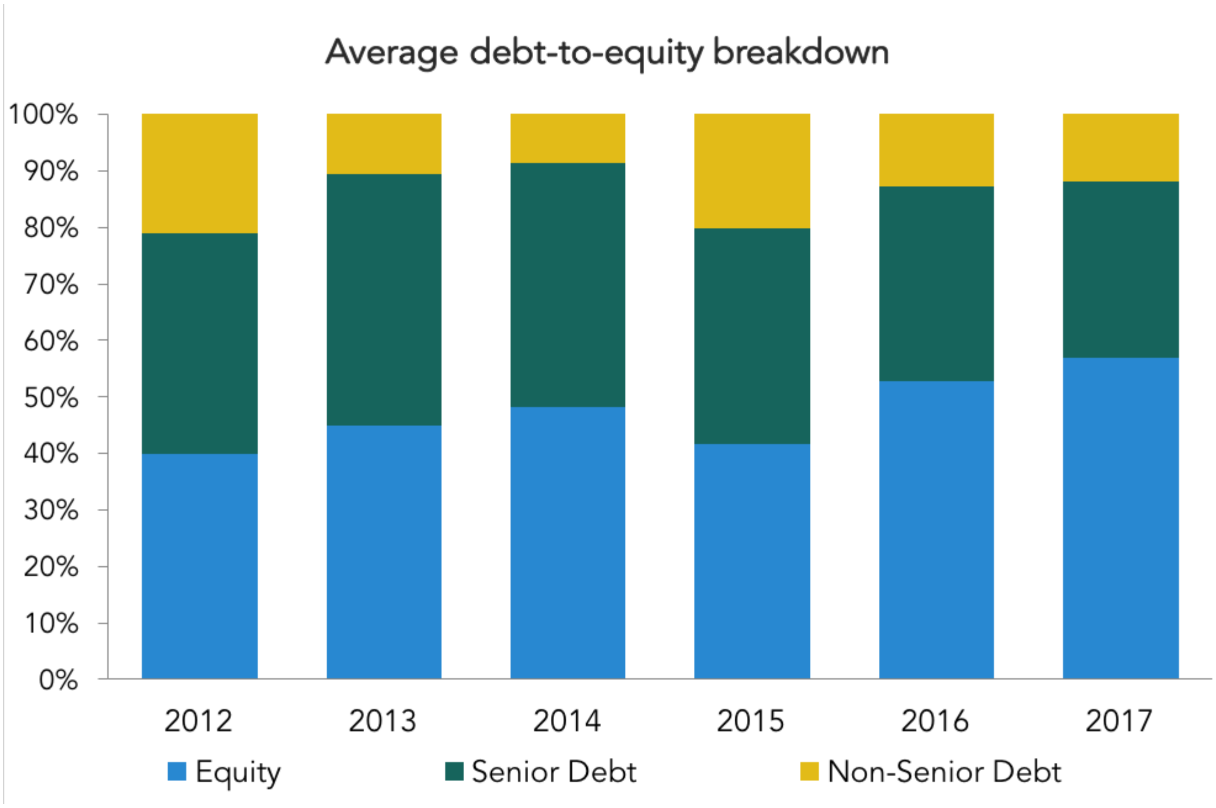

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According to our just-released 3Q Deal Terms Survey results, average equity contributions have climbed to 57% of EV year-to-date. That’s the highest percentage in our dataset, which includes survey results dating back to 2012. Whenever we release these datapoints, we caution taking them with a grain of salt, given the relatively small sample size. That said, we do think this data points to a reliable trend over the years—that PE sponsors have gradually incorporated more equity into their deals, as the accompanying graph shows. In 2012, which seems like a long time ago, equity contributions averaged around 40%, which almost matched senior debt contributions, even leaving aside non-senior debt. The seventeen-percentage-point shift in equity is significant, since higher equity portions will likely suppress future returns for those newer funds.

Given that the PE industry has historically relied on significant debt levels to maintain their rates of returns, this new shift poses a new question: Will PE be able to beat the markets going forward, especially with record dry powder levels and heightened valuations? Those three factors don’t suggest they will, if history is any guide. As we note in the report, many sponsors now stress their operational expertise, arguing that this lessens their dependence on financial engineering to generate returns. Many also stress multiples arbitrage via add-on acquisitions, which have been the new normal for some time. One wonders whether operational expertise and add-ons will be sufficient going forward, given the twin headwinds of valuations and dry powder levels. One thing is for certain, though—the importance of picking the right investments at the outset has never been higher.

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