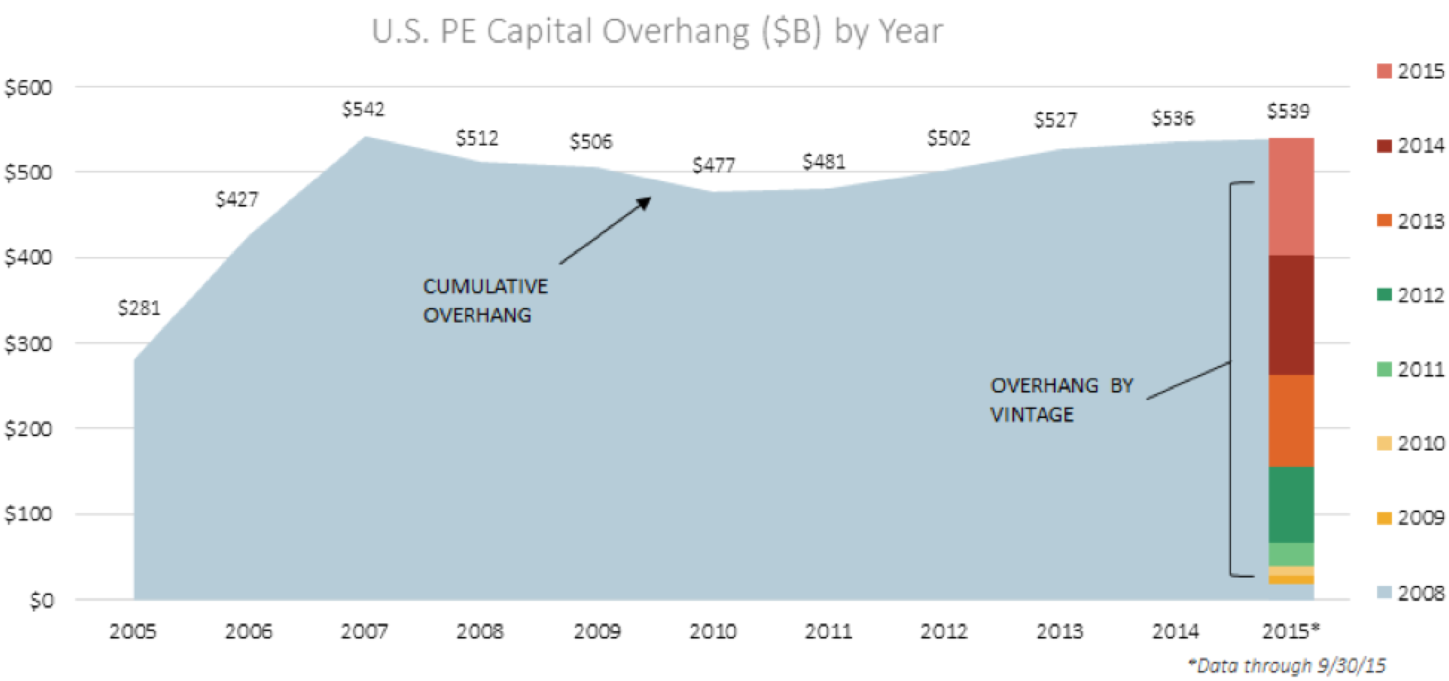
The Pulse of Private Equity – 11/9/2015

PitchBook | November 10, 2015

U.S. Private Equity's Overhang Remains Significant

At times nowadays, U.S. private equity firms look like they may well become victims of their own success. The top tier of investors has been able to outperform public markets to such an extent that they are still attracting plenty of capital commitments from numerous limited partners. Even if concerns as to whether they can maintain market-beating performance have surfaced, contributing to a slowdown in fundraising as of late, by now PE firms still have so much dry powder on hand that slackening is hardly a problem for overall capital supplies. But how that glut of capital affects dealmaking is another issue. High levels of dry powder have been a headache for PE investors for some time now, as they have to put it to work at some point—sooner rather than later for quite a few. This doubtless contributed to the surge in valuations observed over the past couple years, with sustained low interest rates also helping. But those same valuations, even as they are dampening slightly, are rarely a bargain for PE buyers. Averse to overpaying, they nevertheless have the means and motive to keep on making deals, which in turn only helps maintain deal multiples at elevated levels.



How this current state of affairs will play out is largely dependent on the other factors that have kept asset prices high for some time: competition for growth via acquisition from strategics and record-low interest rates, among others. The M&A boom has kept on for some time now—long enough, in fact, it seems more than likely activity will have to slow down soon, especially in light of growing unease regarding a slowdown in Chinese growth, which could produce less competition at the upper end from corporate bidders as well as an uptick in the number of companies experiencing distress. Monetary policy, on the other hand, should be less of a negative factor for PE firms in the short term, given how small the increase in base rates is expected to be and how long such a shift in policy has been anticipated. PE players have been very opportunistic and deliberate about dealmaking over the past couple years, in light of high valuations and memories of how riskier investments played out in the wake of the financial crisis. This caution could be somewhat of a delaying factor when it comes to working off the capital overhang, but it is necessary. Essentially, it seems likely the capital overhang could be reduced over the next few years, but the pace of diminution will be very gradual.

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