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The year ahead: top 5 private capital trends



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Private capital stands primed to capitalize on what looks set to be a favorable environment for generating returns and income as the macroeconomic fog clears, financing costs ease and improved liquidity sets the market moving in a virtuous cycle.

FIVE THEMES FOR 2025

1. **Somewhat higher for longer:** What slower rate cuts mean for private capital investors
2. **A busier market:** What it will take to source and secure high-quality opportunities as deal activity increases
3. **Default position:** Discipline and careful portfolio construction will keep portfolios clean
4. **Platform excellence:** What today's highly selective LPs will look for in a manager
5. **A breath of fresh air:** How exits, fundraising and new deals will develop through 2025

A year ago, we identified four themes for 2024 that would lay the foundations for a Goldilocks era for private debt and private equity (or private capital). (1) As the market was recalibrating to accommodate the new normal for interest rates, (2) we set out why dispersion between winners and losers looked set to increase and (3) why portfolio performance relied on diversification across high quality issuers, industries and asset classes, combined with clear alignment with top

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private equity owners. Finally (4), we highlighted how private capital providers' increasingly sophisticated financing tools would meet the market's complex needs and generate strong risk-adjusted returns for investors.

The year unfolded much as we had expected. In credit, banks resumed close to normal issuance as lower interest rate expectations energized collateralized loan obligation (CLO) buyers. Direct lenders maintained market share for new leveraged buy-out (LBO) activity by matching the banks' terms on large-cap issuances. Meanwhile, as a traditional middle-market manager, we saw high demand for a range of private capital solutions, including holding company and PIK notes to provide issuers with flexibility, secondaries and continuation vehicle capital as a source of liquidity for both limited partners (LPs) and general partners (GPs), and co-investment capital to secure high quality deals.

We expect these trends to continue in 2025, but they will be set against a different macro backdrop that will accommodate new deal activity.

The U.S. Federal Reserve has seemingly orchestrated a soft landing: interest rates have reduced and inflation is also down, for now. Yet the U.S. economy's persistent strength will keep rates higher than expected through 2025. This should sustain the investor-friendly private debt terms — lower borrower leverage and higher yields — that supported the golden age moment we have experienced over recent years.

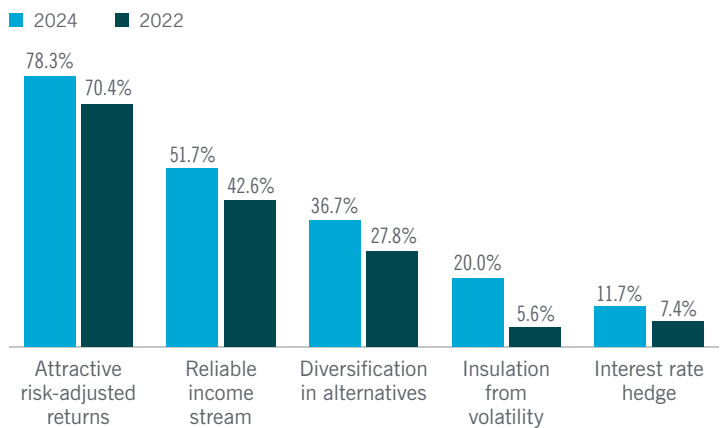
Lower financing costs should help bring private equity buyers and sellers closer together on valuations, narrowing what has until recently been a stubbornly wide price expectations gap. Improved valuation certainty kicks off a virtuous cycle as more realizations increase private capital fundraising, which leads to more deployment. This, combined with solid U.S. GDP growth, creates favorable currents for private capital investment, a set of circumstances that could make 2025 a notable vintage for returns and income generation.

With geopolitical tensions in the ascendent, private capital's active management style and long-term investment horizons should offer investor portfolios shelter, diversification and added

resilience in the face of current and future risks. Indeed, our recent survey found that investors are increasingly allocating to private debt markets to insulate against volatility: 20% said this was a main reason for investing in private debt, up from 6% in 2022¹ (Figure 1).

Figure 1: A notable increase in investors looking for insulation from volatility

Q: What are your main reasons for investing in private debt now?



Source: Churchill Q4 2024 Pulse on Private Debt Survey.¹

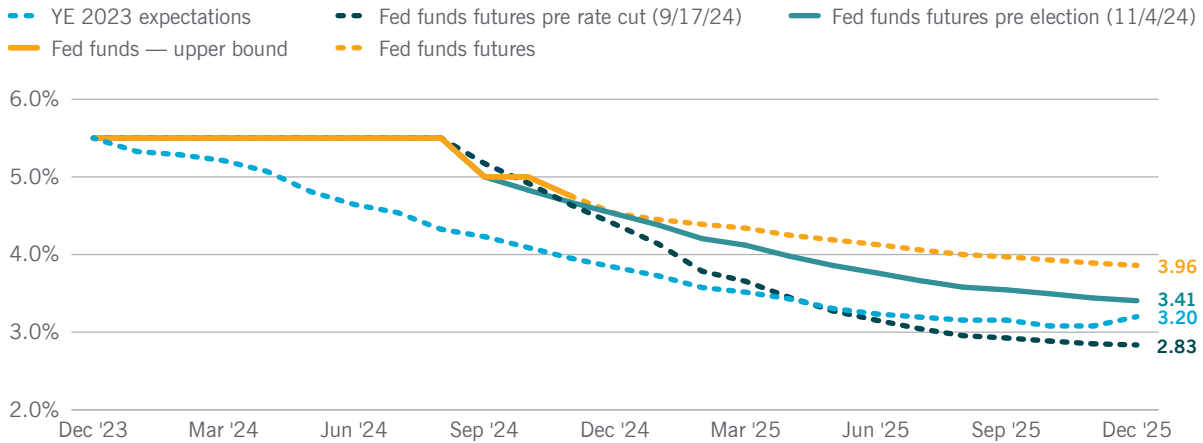
Building on last year's themes and drawing on the broader backdrop, we have identified five trends we expect to play out through 2025 and what they mean for private capital and its investors.

1. SOMEWHAT HIGHER FOR LONGER: WHAT SLOWER RATE CUTS MEAN FOR PRIVATE CAPITAL INVESTORS

As we enter 2025, the U.S. Federal Reserve appears to have pulled off a tricky balancing act, taking the heat out of inflation while also keeping the U.S. economy running smoothly. With reference rates down by 100bps in 2024,² companies have had some relief in the cost of capital and interest burden. Yet any further cuts are expected to come through slowly through 2025 (Figure 2) and we appear to have reached terminal rate levels.

Slower rate cuts are a positive reflection of the U.S. economy moving in the right direction. With

Figure 2: Fed rates to remain higher than expected



Source: Bloomberg. YE 2023 expectations as of December 29, 2023; Fed Funds futures pre-rate cut as of September 17, 2024; Fed Funds futures pre-election as of November 4, 2024; Current Fed Funds futures as of December 30, 2024.

U.S. inflation at 2.7%,³ GDP growth at 2.8%,⁴ unemployment at just 4.2% and 227,000 new jobs added in November,⁵ investors are drawing confidence from a resilient backdrop. At a micro level, we have also seen company behavior adapt to the reality of higher-for-longer rates, managing spending to keep cash levels robust.

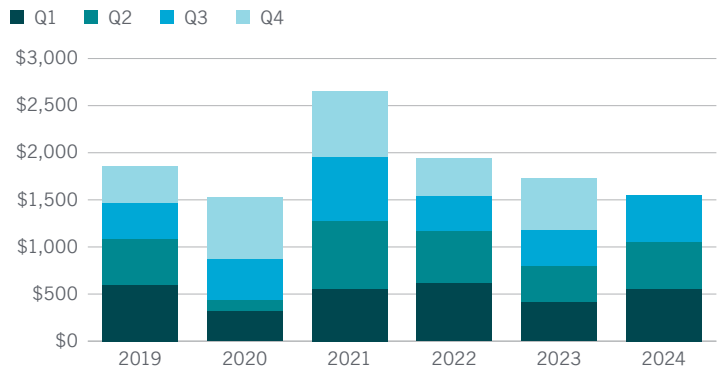
As more stable interest rates create greater certainty around valuations, we expect to see a sustained and meaningful pick-up in merger and acquisition (M&A) activity. This builds on the increased value we saw in 2024, when North American M&A value reached over \$1.5 trillion by the end of Q3, not far off the 2023 full-year \$1.7 trillion total⁶ (Figure 3).

For private capital investors, the consequences of slower rate cuts set against the context of a solid economic outlook for the U.S. are that:

Improved rate and valuations clarity, combined with an easing cost of finance, will draw out private capital that has been waiting on the sidelines. Private debt investors now have more visibility in issuers’ loan to value and debt servicing capacity, while private equity investors will find it easier to price risk and arrive at enterprise value multiples. With firmer valuations in public equity markets, too, these conditions will coax out private equity sellers that have so far held back on exits, helping to normalize distributions to LPs as the M&A cycle moves back to a more regular cadence.

Figure 3: M&A activity picked up in 2024

North America M&A deal value (\$Bn)



Source: PitchBook data as of 30 Sep 2024. Includes deal value.

Private debt investors will benefit from higher all-in yields for longer, which, although lower than during peak interest rates, are still close to historic highs. With businesses having proven they can withstand and expand in the current rate environment, we see the potential for highly favorable risk-adjusted returns in 2025.

Investor focus will shift back to the fundamentals of company earnings as the shock of peak interest rates is now behind us and there is greater certainty for the 12 months ahead. Valuations will be less sensitive to interest rates than they have been over the past two years.

A favorable macro backdrop will lead to more supplemental ways of exiting transactions, such as continuation vehicles.

Fund managers will be keen to capitalize on these tailwinds by holding on to their best assets and supporting them through the next stage of growth, while offering LPs the option of liquidity. Annual GP-led deal values are expected to grow from around \$50 billion to \$60 billion in 2024 to up to \$105 billion by 2028.⁷

2. A BUSIER MARKET: PROVIDERS OF CREATIVE AND FLEXIBLE CAPITAL SOLUTIONS WILL FIND FAVOR

As a brightening macro picture starts to release the pent-up demand for private capital dealmaking through the year — there was \$2.6 trillion of dry powder among global buyout and venture capital firms waiting in the wings at the end of H1 2024⁸ — issuers and private equity firms will seek out bespoke financing that meets their specific needs.

Private debt has consistently proven its capacity to achieve this. Over the past decade, direct lending, for example, has taken an ever-greater share of LBO acquisition finance, so that by the first three quarters of 2024, it was the debt funding source of choice in 92% of US LBO deals (Figure 4).

At the same, institutional investors are planning to further increase their commitments to private

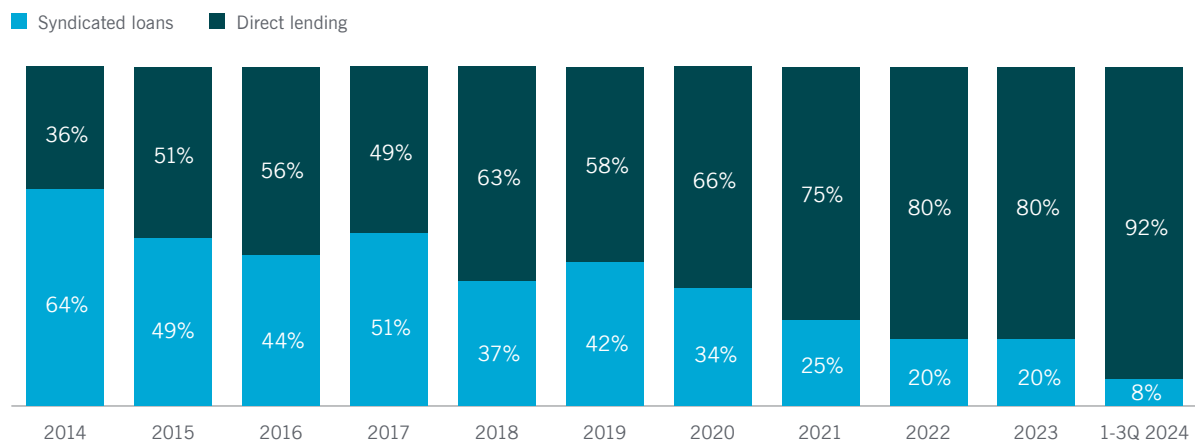
capital. A recent survey found that 57% of LPs are expecting to invest more in private debt during 2025 than last year, the highest proportion since 2020.⁹ Our own survey paints a similar picture: 65% of investors are planning to increase allocations to private debt in 2025.¹⁰ With more capital flowing to private debt, high quality issuers and sponsors should have plenty of options.

In an overall busier private capital market, winning deals with the strongest risk-return characteristics will require a laser-sharp focus on building flexible and creative capital solutions that help businesses and firms achieve their current and future objectives.

Private capital providers that keep a close watch on their existing positions and benefit from strong relationships with their private equity owners will find high-potential opportunities in the market through 2025. A firm’s incumbent portfolio can be its greatest asset — the visibility and familiarity that comes from being an existing investor positions a manager to be responsive to company refinancing and other upcoming capital needs. Further, as exits start to come through in higher volumes and as sponsor-to-sponsor deals return in force to the market (excluding public listings, they accounted for 51% of exits in Q3 2024, up from 47.4% the previous quarter¹¹), incumbent private capital investors are well placed to support the new deal’s financing requirements.

Figure 4: Direct lending continues to dominate LBO activity

% of U.S. LBO volume by debt funding source



Source: LSEG

Investors with deep-rooted private equity relationships forged via a range of touchpoints beyond private debt, including through fund commitments and as co-investment partners and secondary deal investors, have unique insights into the likely capital needs of sponsors and their portfolio companies. Taking a whiteboard approach to capital structures, they can bring new ideas to sponsors for creative financing solutions tailored to a specific set of circumstances.

And, in what we expect to be a faster-paced transaction environment during 2025, speed of execution, transparency and the capacity to provide solutions up and down the capital stack will be essential to securing the highest quality deals. Those without the scale to move swiftly and commit a deal's whole financing need are likely to be on the outside looking in.

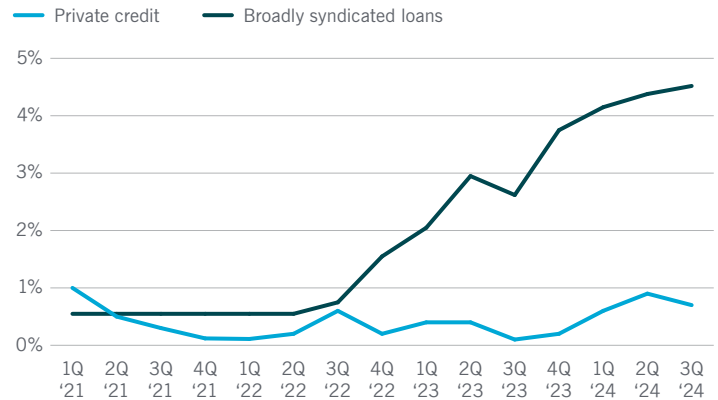
3. DEFAULT POSITION: KEEPING PORTFOLIOS CLEAN AMID EXUBERANCE

There are clear reasons for a more bullish sentiment to take hold in private capital investment in 2025. A more certain macro backdrop, a decisive election result, U.S. companies reporting above-expectation results, and the S&P 500 building on a strong 2023 by rising more than 25% in 2024,¹² are building optimism.

Adding to this is the default environment, which remains benign for managers that structured deals appropriately over previous years. In private debt, the payment and bankruptcy default rate stood at just 0.70% in Q3 2024, which compares favorably with the 4.47% default rate reported by Fitch Ratings for broadly syndicated loans at the same point in time (Figure 5). This slight increase over the previous few years comes from an unusually low base and the rate remains well below the near-ninefold increase seen in the Fitch index. Further, with yields higher than long-term averages, net returns have some cushion, even if defaults tick gently upwards.

Amid so many positive signals, there is a risk that optimism spills over into exuberance, especially as committed capital ages. With 26% of global buyout dry powder four or more years' old by the end of

Figure 5: Private credit vs Broadly syndicated loans' payment and bankruptcy default rate



Sources: Proskauer and Fitch Ratings, as of 30 Sep 2024. Private credit default data is represented by Proskauer, while broadly syndicated loan default rates are represented by Fitch Ratings.

2023¹³ and relatively low deal activity in 2024, pressure to invest could intensify in 2025. However, prudent investors recognize that today's investments form the bedrock for tomorrow's portfolio health.

In this environment, we believe four main tenets should keep portfolios clean. Successful private capital investors will:

Maintain discipline when capitalizing on what looks set to be a strong vintage. That means sticking to the strategies that have historically made them successful and investing based on fundamentals and cash flow generation. It also means being prepared to walk away if a deal does not make sense and, for those that do, allowing for a margin of error in earnings and valuations, while building in multiple ways out. One of private markets' biggest advantages is that owners can control their exits, so evaluating and investing for the long haul are vital for both equity and debt providers.

Build all-weather portfolios that perform well regardless of external conditions. Diversification is an essential element here for all private capital investors, but especially so in credit – diversifying by industry sector, position size, deal structure, leverage profile, sponsor relationship and company model are all critical. For example, our average position size is around 1% across the portfolio, which minimizes the impact of any challenged investment. Successful managers will also be constructing their portfolios for a different, less buoyant, environment, running

detailed performance sensitivity analysis according to a variety of scenarios.

Be active and proactive capital providers that support value creation in the businesses they back, while also being prepared to course-correct on existing investments when necessary. Experience and lessons learned help investors see round corners to identify potential opportunities and preemptively strike as new risks emerge. Decisiveness will win out in a fast-moving market.

Work with trusted partners who have been through cycles and are closely aligned. Lenders and sponsors with strong relationships can work collaboratively through good and bad times to build and protect value in the portfolio.

4. PLATFORM EXCELLENCE: HOW MANAGERS WILL WIN BUSINESS TOMORROW

Even as the liquidity squeeze loosens over the coming year, it's clear that LPs are becoming ever-more selective in the managers they back. So, while private markets retain their appeal — nearly all (96%) of respondents to a recent survey said they expected to increase or maintain their exposure to alternative assets in the next 12 months¹⁴ — the bar for attracting new commitments from existing and new LPs is rising. The same survey found that 88% were expecting to refuse a re-up with an existing manager.¹⁵

In today's sophisticated market, where capital is concentrated among a smaller number of managers, only the highest quality platforms garner investor dollars. A consistent track record, low or no key person turnover, scale and diverse capabilities, and alignment with LPs are the bare minimum in today's market. They may get a manager a foot in the door, but they are far from sufficient to secure a commitment.

Increasingly, an asset manager's success relies on being responsive to investors' needs. This includes developing innovative structures that cater for the varying investment horizons, risk-return objectives and liquidity requirements of different investors. The plain vanilla commingled fund is giving way to product technologies that offer more tailored access points and routes to liquidity, such

as collateralized fund obligations and structured products, rated feeder products and perpetual funds for retail investors. Meanwhile, levered and unlevered sleeves offer investors a choice of risk-return characteristics, and co-investment side-car structures are helping to meet investor demand for more direct investment exposure.

In what has been a liquidity-constrained environment, LPs value managers that efficiently return capital to them — and this is true of asset managers and private equity sponsors alike. Over the coming year, the most successful private equity firms will be those that evaluate multiple ways of improving their distributions to LPs, covering all bases by exploring parallel continuation vehicle processes in addition to full exits to new buyers.

Private equity firms also need to think carefully about their portfolio companies' liquidity needs. For longer-hold assets, this means positioning company capital structures to achieve growth and generate value. Refinancings can provide both liquidity and a longer runway to maturity, while junior capital can expand the capacity of a company's capital structure to pursue acquisition strategies.

5. A BREATH OF FRESH AIR: INVESTING AND FUNDRAISING IN 2025

As private capital's virtuous cycle sets in motion, 2025 should present plenty of attractive investment opportunities across the capital stack.

Private debt

For senior debt investors, the direct lending climate will continue to be constructive as the reduced but somewhat higher for longer rate environment persists. We expect public debt spreads to continue compressing, leading to the relative risk-reward and income rewards increasingly skewing towards private debt. Financing conditions will allow for higher leverage and a closer alignment between buyer and seller price expectations, which will accelerate M&A flow. This increased activity will put the brakes on spread compression in the traditional middle market and as a result, we believe that structures and terms will strike a favorable balance for both issuers and investors.

Meanwhile, we expect high demand for junior debt and structured capital as sponsors and issuers seek flexible financing options that help them free up capital for growth and to pursue acquisition opportunities in a more active market. Lenders providing these financial solutions benefit from downside protection and can offer investors an interest rate hedge, given their primarily fixed-rate exposure.

Private equity

In private equity, there are clear signs of a return to optimism for 2025. A recent survey found that 38% of LPs are expecting private equity performance to exceed benchmarks this year, the highest proportion since 2021, and nearly half (45%) are expecting to increase their allocations to private equity in the next 12 months.¹⁶

Investors leaning back into private equity will complement their traditional buyout portfolios by capitalizing on a widening aperture of LP access points as the asset class's ecosystem continues to evolve. Secondaries, fresh from what is predicted to be a record year for activity in 2024,¹⁷ will continue to see brisk deal flow. GPs will turn to continuation funds to extend their trophy assets' value creation runway while giving LPs the option of crystallizing their return and LPs will sell portfolios to fine-tune their exposures and generate liquidity. GP stake investments are also on the rise, offering investors predictable and reliable cash

flow from management fees and upside from a share of the manager's carried interest. Emerging managers, meanwhile, will provide investors with differentiated exposure to private equity, offering the opportunity to build meaningful relationships with potentially innovative and fresh GPs.

Fundraising

The cycle of fewer exits, leading to fewer distributions and therefore fewer LP dollars to invest is reversing and moving into a more virtuous cycle. Easing financing conditions will draw out more buyers, increasing the competition in new deals. Higher confidence levels and demand for assets will help private equity sellers get closer to achieving their desired returns on assets they bought in a much lower rate environment and so we expect to see a meaningful pick-up in exits. As we have demonstrated, LP appetite for private capital remains robust, so the increase in distributions will flow back to managers in the form of new commitments.

We expect private equity fundraising to increase first – this part of the market has been the most impacted by LP liquidity issues – followed by private debt fundraising, as the middle market opportunity set continues to grow. Yet, as we have outlined, LPs are ever-more discerning in their manager selection. Improved fundraising conditions will therefore favor the best performing managers with scale and proven capabilities through previous cycles for investing consistently, safely and profitably.

CONCLUSION

The Goldilocks era for private capital is taking shape as the virtuous cycle of realizations, fundraising and new deals is kicking in, supported by:

- Increased clarity on interest rates and a positive macro backdrop
- The development and growth of flexible finance and innovative structures tailored to sponsors' and companies' specific needs and objectives
- Managers with a long and consistent track record of generating returns throughout various market cycles maintaining discipline in what may become a more exuberant private capital market
- LPs choosing to back the best quality managers that offer them comprehensive products and solutions
- Strong return opportunities across the capital stack in private debt and private equity

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Endnotes

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