Video killed the radio star: why private equity investors need to rethink the re-up

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42 years ago, MTV introduced itself to the world with a song as prophetic as it was catchy. The Buggle's hit song "Video Killed the Radio Star" ushered in a wildly different era for the consumption of music.

We think private equity is facing its own MTV moment.

Investors have long relied on a set of influential factors that have remained unchanged for over half a century. However, the world is changing rapidly, with many of these factors set to change with it. To quote a recent report by Bain Capital "the global economy is presenting investors with conditions few among them have ever seen before."

Adapting to the new environment will be disruptive and unsettling for many investors.

Private equity investors will need to adjust their strategies to account for this new world order.

Changing the record

When video "killed the radio star", the reign of the radio top 40 was over. Even so, plenty clung to the old way of doing things, refusing to believe that music television had a future. It is no different in private equity today.

The extended period of low rates, excessive public equity multiples and IPOs has been a heyday for general partners (GPs). In the new investment era, the investment results from more "traditional" private equity are unlikely to produce the same opportunities.

Inflation has been ignited by the "3D Reset"[1] of decarbonisation, demographics and a re-defining of globalisation, driving the most rapid-fire Federal Reserve (Fed) action in over 40 years.

In the second half of 2022, rising interest rates led the banking industry to stop lending to large leveraged transactions, and high yield bond issuance to drop to cyclical lows. This caused a material decrease in the capital that is fundamental to complete large leveraged buyouts. As a result, smaller transactions - not dependent on public capital markets and requiring less debt - gained share in the overall totals.

We believe a significant number of investors will need to make adjustments as the world undergoes this monumental shift by diversifying into different sectors or geographies, such as Europe and India. Additionally, prospective limited partners (LPs) may need to consider implications of slower economic growth, shorter periods of time between market cycles, and a shrinking working population.

This could mean investors need to be more selective in their investments, and focus on smaller deals and mid-cap companies. Investors may also need to consider the implications of increased regulation and the need for more sustainable investments.

Over the past decade the top 25 managers in private equity have accounted for an average of 36% of the total fundraising. This increased last year, and seems poised to continue into 2023.

The overhang of capital created by this excess participation with the "big guys" is a cause for worry.

It is a simple supply and demand equation. The demand for large buyout projects is at extremely high levels due to the excess amount of capital raised, while there is a reduced supply of viable acquisitions offering appropriate target returns without leverage. Given that the demand is inelastic, prices will have to adjust up for the interesting projects reducing the potential for large buyout returns.

In the coming years, we anticipate that small and mid-sized buyouts will outperform large buyouts, driven in part by a more favourable dry powder environment for smaller transactions. Furthermore, the more attractive growth dynamics generally available among small and mid-sized buyouts is such that financial leverage is typically not a critical driver to attain an attractive exit.

Success with these investments stems from achieving transformational growth and the subsequent attractiveness to larger bidders. Similarly, we expect seed and early-stage disruptive investments to be more resilient than later-stage or growth investments, owing to the same dynamics.

Moreover, we believe that being highly selective in private equity investments is a critical success factor. Specifically, we recommend focusing on investments that align with long-term trends. We also seek opportunities with the potential to capture a complexity premium; those requiring the deployment of unique skills to drive both organic and inorganic growth in portfolio companies.

The end of the era for depending on illiquidity and leverage as the source of PE returns might leave investors wondering what to do next. We believe the complexity premium and the ability to drive returns through operational capabilities, unique access, and a global perspective will define excess returns in the new regime.

What are your options?

1. Think small

Many asset allocators have overlooked lower middle market private equity. These investments can offer higher returns, access to new markets and industries, and in the right areas and sectors - diversification. However, they can also be less transparent and more complex. The skill and track record of a manager are crucial.

2. Think outside the States

In order to further enhance diversification, and access the divergence of global growth across unique markets, we believe US investors need to reconsider their strong home country bias. Europe benefits from a fragmented market, compelling entry valuations in lower middle market companies and the sustainable return driver of structural shifts on the continent including the fading memory of historical alliances and potential re-onshoring of some supply chains.

Asia - which many would consider a "loser" during the re-definition of globalisation - offers access to unique sources of growth via growing domestic consumption, and the evolution of "China +1". Investors just need to think differently about their approach in Asia. India, in particular, has very exciting investment opportunities wrapped up in an established private equity market, favorable demographics, and a low correlation to rest of world.

The release of "Video Killed the Radio Star" on August 1, 1981, brought immediate change, but the long-term implications were not fully understood. Since then, we have seen further structural shifts in music consumption. But an investor can't look too far into the future or to the past.

Consider the 3D Reset. Rethink the re-up.

FOOTNOTE

1 https://www.schroders.com/en-us/us/institutional/insights/the-3d-reset-the-worlds-disruptive-return-to-the-old-normal/

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