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Private Equity Under Pressure: Performance Divergence, Liquidity Strains, New Imperative of Operational Alpha

Insights Engine I Private Equity

RCK ANALYTICS

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Executive Summary

Private equity faces a structural reset as weak liquidity, record entry valuations, and $1T+ dry powder compress returns shifting the industry towards disciplined exits and operational value creation as the decisive performance driver.

> *"The next era of private equity will be defined less by leverage and more by operational capability and strategic transformation of portfolio companies."*

Stephen Schwarzman

Cofounder, Chairman & CEO,

Blackstone

Private equity has now underperformed public markets for the third consecutive year in 2025. Buyout fund IRR settled at approximately 6%, lagging the S&P 500's 18% return and the MSCI World Index's 22% gain, a structurally significant divergence. Liquidity has emerged as the defining LP concern: five-year rolling DPI stands at its lowest level on record, and distributions as a percentage of AUM have declined to roughly 6% in the six-month period ending June 2025.

High entry multiples of 11–12× EBITDA, portfolio congestion, weak exit markets, and capital saturation averaging over USD 1 trillion in dry powder have collectively compressed returns. Operational value creation historically underdeveloped within many GPs is now the critical differentiator. New vintage funds show promising returns near 15%, but structural liquidity risks echo earlier cycles. In this environment, LP capital will gravitate toward selective, operationally superior GPs, while co-investment strategies gain prominence as a risk-adjusted return lever.

6%
Distribution as Share of AUM

12X
Average Buyout Entry Valuation (EBIDTA Multiple)

1T
Private Equity Dry Powder Surpasses

6%
Average Buyout IRR

Three Years Down: PE's Performance Deficit

Buyout funds delivered ~6% IRR in 2025 trailing S&P 500 by 12 percentage points and MSCI World by 16% points.

Private equity has now recorded three consecutive years of underperformance against public equity benchmarks, a structural signal that demands rigorous analysis beyond cyclical explanations. In 2025, buyout funds generated an IRR of approximately 6% on a pooled basis, significantly trailing the S&P 500's 18% return and the MSCI World Index's 22% gain. The performance gap is not marginal; it represents a 12 to 16 percentage point shortfall against the most widely tracked public benchmarks in the world. Two primary forces are driving this divergence: sustained public equity outperformance fueled by technology sector earnings resilience, AI-driven multiple expansion, and monetary easing expectations and rising liquidity concerns among limited partners that are suppressing effective return realization. While new vintage funds launched in the same deployment year are showing promising gross returns near 15%, base effects from older, underperforming portfolio cohorts continue to drag pooled IRR figures downward, creating a structural overhang that distorts the headline performance narrative.

For US institutional investors and investment banking professionals evaluating PE allocations, 2025 marks a pivotal inflection point.

Annual Returns by MSCI, S&P500 and Top-Quartile Buyout

Private equity underperformed public equity for the third consecutive year in 2025.

Source: Private Asset Solution by MSCI

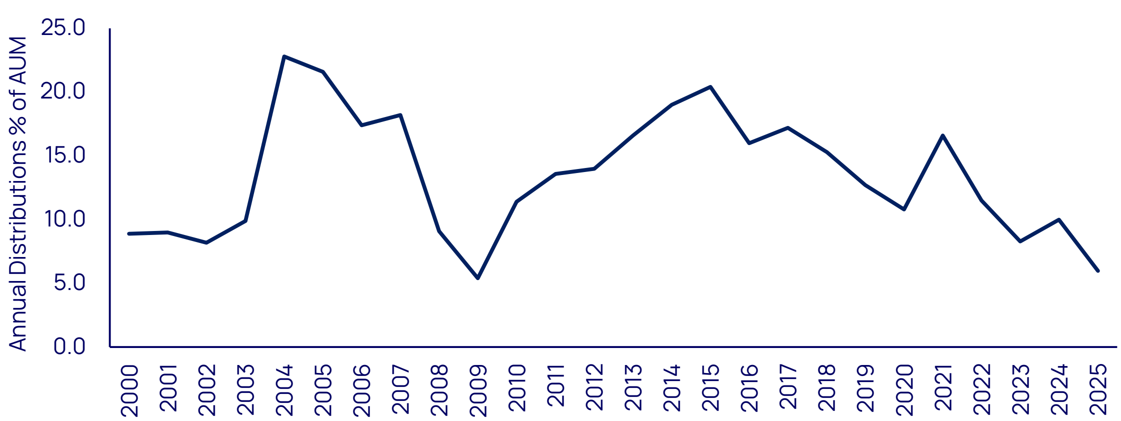
The Liquidity Crisis Reshaping LP Priorities

Five-year rolling DPI is at its lowest on record; distributions as a percentage of AUM fell to approximately 6% in H1 2025.

Liquidity has overtaken return generation as the foremost concern for limited partners globally, and the data reflects a crisis of capital velocity that threatens the long-term LP–GP relationship. The five-year rolling distributions-to-paid-in-capital (DPI) metric, the most direct measure of actual cash returned to investors, has fallen to its lowest level on record. Distributions as a percentage of AUM declined to approximately 6% in the six-month period ending June 2025, a sharp contraction that reflects the combined impact of extended portfolio holding periods, a structurally impaired exit environment, and a near-stalled IPO market. Portfolio congestion and the accumulation of unsold companies within fund structures has amplified the problem, with PE-owned businesses remaining in portfolios 20% to 30% longer than historical averages. Secondary markets have partially absorbed this pressure, but secondary transaction pricing has widened to discounts of 10% to 20% below NAV, further eroding realized returns. Long holding periods depress DPI, reduce re-deployment velocity for LPs, and create compounding pressure on portfolio companies that must sustain performance metrics without clear exit timelines. LPs are not retreating entirely from the asset class, but their tolerance for opacity, illiquidity premiums without delivery, and GP-driven capital calls without commensurate distributions is structurally diminishing.

Distributions as Percent of Assets Under Management

Distribution to paid-in capital as a share of assets under management hit its lowest recorded level in 2025.



Source: McKinsey & Company

Why PE Returns Collapsed: The Structural Breakdown

Buyout entry multiples of 11–12× EBITDA, record dry powder exceeding $1 trillion, weak exit markets, causes PE's return compression.

The underperformance of private equity is not the product of a single market disruption but the convergence of four structural failures that have been building for nearly a decade. First, elevated entry valuations have fundamentally compressed value creation potential: buyout purchase multiples averaged 11 to 12 times EBITDA in recent vintage years, leaving insufficient margin for multiple expansion, historically a core driver of PE returns. Second, exit markets have remained structurally weak, with strategic M&A activity depressed by elevated financing costs and corporate risk aversion, while the IPO pipeline has failed to reopen meaningfully. Third, portfolio congestion has reached critical levels; the accumulation of unsold assets across fund vintages has created a backlog that constrains new investment pacing and amplifies LP liquidity risk. Fourth, and perhaps most importantly, the era of returns driven by financial engineering has conclusively ended.

For years, PE generated outsized returns through leverage amplification on cheap debt, multiple expansion in a low-rate environment, and tax optimization structures none of which required genuine operational transformation of portfolio companies. When interest rates rose sharply, this model was exposed: highly leveraged buyouts faced debt service pressures, multiple expansion reversed, and portfolio companies without operational efficiency improvements struggled to maintain EBITDA growth. Capital saturation with global private equity dry powder exceeding USD 1 trillion has further compressed deal returns by intensifying competition for a finite universe of quality assets, systematically inflating entry prices across sectors. These factors, acting in concert, explain why PE returns are now more dependent on genuine operational value creation than at any prior point in the modern buyout era.

LPs: The Demand to Show Traction

LPs are demanding demonstrable traction selective deployment, co-investment access, and evidence of operational value creation.

Limited partners are undergoing one of the most significant behavioral shifts in private equity's modern history. Liquidity shortfalls, sustained underperformance, and record holding periods have fundamentally reshaped LP deployment strategies.

Rather than exiting the asset class, LPs are becoming far more selective, directing capital toward general partners with proven operational expertise, strong DPI track records, and transparent value creation frameworks. Co-investment has emerged as a key strategic tool in this environment. By investing directly alongside fund managers but outside the main fund structure, LPs gain exposure to portfolio companies with significantly Lower fees while improving diversification and maintaining greater control over sector and asset concentration. As a result, co-investment activity has expanded materially as investors seek stronger risk-adjusted returns without relying solely on fund-level performance.

GP selection criteria have also tightened considerably. Only managers with clear sector specialization, operational transformation capabilities, and credible EBITDA growth strategies are likely to attract capital at scale. For LPs, selectivity is no longer optional—it is a structural necessity. While new vintages showing returns near 15% offer optimism, LPs increasingly demand tangible exit progress and consistent cash distributions.

Private equity stands at a structural inflection point. Three consecutive years of underperformance, record-low DPI, and the collapse of financial engineering as a return driver demand a fundamental reset. The firms that survive and lead the next cycle will be those that build genuine operational value, deliver liquidity with discipline, and earn LP trust through demonstrated traction not capital promises.

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