



The Price of Patience

How Private Equity is Buying Time

Private markets are a growing interest for the institutional and individual investor.

Institutional investors, who have long been attracted to the strong earnings of private equity, need to follow the trends in relationships between the fund-investing Limited Partners (LPs) and the managing General Partners (GPs) to access the whole class of alternative investments. While private markets have long been restricted to institutions and accredited investors, the large alternative managers have begun finding ways to market private assets to individual investors through ETFs and, in the future, the introduction of private assets into 401Ks. Individual investors should be literate in private market developments to help determine if these investments are an appropriate choice for their portfolio.

Private equity has been the golden child of capital markets in the decade after the Great Financial Crisis (GFC)ⁱ. High, safe returns have attracted floods of Limited Partner capital from cash-heavy pension funds, insurers, and family offices. The number of fundsⁱⁱ continues to grow and accelerate as sponsoring firms are able to recoup strong fees and tax-incentivizedⁱⁱⁱ compensation. A post-pandemic boom drove the industry to records^{iv} in deal volume and transaction value (\$2.2 trillion), as buyout firms benefited from easy access to cheap debt and a wealth of exit opportunities from cash heavy buyers. The industry, however, fell victim to the inflation and rate hikes of 2022 and 2023; traditional exit opportunities through Initial Public Offerings (IPOs) or trade sales jammed up^v against rising interest rates and uncertainty.

In a down market, GPs have reverted to value growth through operational management and margin expansion^{vi} rather than market-driven multiple expansion. Organic growth is harder to come by so funds have extended holding periods—up to 3 years^{vii} over historical periods. The other option is a 3rd way of exits: a wave of financial innovation. As the lifespan on funds continues to grow, LPs are demanding their cash back before committing to follow up funds^{viii}. To hold on to promising cash-producing holdings while returning cash to liquidity-concerned investors, funds have turned to novel mechanisms like continuation funds, net asset value (NAV) loans/ subscription line credit, and the secondary market.

Enter the Minsky Instability Hypothesis. Formalized by Hyman Minsky and extended by Steve Keen^{ix}, the Minsky cycle provides a framework for understanding the growth and decay of modern financial economies. The first step is growth. Initially, financialized assets with strong cash flows attract investment. As these assets appreciate, rising valuations

encourage more investors to enter the market, fueling further price increases. Easy enough. Then, as asset prices continue to see sustainable growth, firms—rationally—begin borrowing against these assets to maximize returns. Over time, rational borrowing shifts to speculative excess. Participants begin to value assets based on resale potential rather than intrinsic cash flow generation; leverage becomes self-reinforcing—borrowers rely on rising prices to justify additional debt. Eventually, some investors appropriately value risk and begin selling, but the market doesn't recognize the underlying fragility. As soon as asset prices stagnate or decline, over-leveraged investors face margin calls and issues with debt service, forcing them to sell at a discount. This dynamic amplifies the downturn, triggering a broader market collapse.

Inflation plays a critical role in potentially extending the duration of the cycle. If the market crests during an inflationary environment, the underlying assets may still report strong nominal cashflows. By leveraging these inflated valuations, firms can use financial engineering and debt restructuring to prolong asset holding periods, rather than facing realized losses in the open market.

Sound familiar? The growing use of continuation funds, NAV financing^x, and secondary markets reflects an industry-wide attempt to buy time against an interest rate-driven constriction of the exit market. Faced with limited traditional exits, funds are engineering boosted returns and synthetic liquidity for LPs^{xi}, hoping that future market conditions will improve.

This optimism is rational for individual actors, as each GP seeks to maximize its fund's performance and may have strong performing underlying assets. However, in aggregate, levered optimism introduces structural weaknesses into private markets. Valuations remain artificially high, leverage deepens through all levels of the fund structure, and liquidity mismatches grow.

In Minsky's terms, private markets are in the space between rational financing and speculative excess, where price discovery is replaced by financial engineering. The opaque nature of private markets obscures these risks, making it difficult to assess how deep these structural weaknesses run. To understand whether these mechanisms prevent a large correction or delay the inevitable, we must examine the nature of these techniques and their contributions to valuation trends, secondary market pricing, and the liquidity profile of the market.

Since 2022, continuation funds have surged in popularity. The idea is simple^{xii}: a fund's sponsoring firm creates a new fund, raises money for the continuation fund, and buys portfolio companies from the original fund. LPs of the original fund are given the option to

roll their investments into the continuation fund or to take their share of the proceeds from the transfer process.

The modern use of continuation funds has a compelling case^{xiii}, despite early concerns about ‘zombie funds’^{xiv} and the use of continuation funds to shelter tail-end assets^{xv}. Now, GPs tend to selectively transfer over their highest performing holdings. Historically, this positive selection has led to comparable returns to buyout funds with less volatility. The transfer process also mitigates blind pool risk: LPs have more information on their investment’s holdings before deciding whether to roll over or divest.

Faced with limited exit opportunities, the market has increasingly turned to continuation funds as an alternative liquidity solution, even as concerns over valuation transparency persist. The past two years have seen a record number of continuation funds closing with 65 in 2024, beating the previous record of 57 in 2023. In the first half of 2024, continuation funds made up 86% of GP-led activity^{xvi} in the secondary market. Particularly, the use of single-asset continuation vehicles (SACVs) has boomed, between 2021 and 2023. SACV volume topped \$70 billion, over triple the previous three years. In 2024, SACVs accounted for over half of continuation fund activity.

While continuation funds provide GPs a method to avoid selling premier assets at a loss, they can introduce structural friction^{xvii} into the GP-LP relationship. The first concern is the valuation of the underlying assets in the transfer between the original fund and its continuation vehicle. Since the same sponsoring firm represents both sides of a continuation transaction, fund managers have oversized weight in the price-discovery process.

Moreover, GPs have an incentive and an ability^{xviii} to set the price that is most favorable to themselves, especially in an environment where inflation has nominally supported valuations. Rising price levels can mask underlying stagnation, allowing firms to justify higher NAVs based on price-driven revenue growth rather than fundamental cash flow strength. By setting their own prices, GPs not only report stronger IRRs to attract secondary investors but also mitigate markdown risks that could trigger broader valuation concerns. This effect is amplified as continuation funds become a dominant liquidity mechanism in an exit-limited economy.

This pricing ecosystem sustains higher NAVs across the private equity market, potentially delaying necessary corrections. This impact is less pronounced when LPs roll over their investments, as they continue benefiting from the same pricing dynamics as their GPs. However, in the last few liquidity-strapped years, 80-90% of LPs^{xix} have opted to cash out rather than reinvest, requiring GPs to bring in new buyers—further reinforcing the incentive

to set valuations at optimistic levels. These factors and macroeconomic conditions exacerbate informational asymmetry in private equity markets, where market-clearing prices remain obscured by internal transactions rather than external price discovery.

In addition to the continuation mechanism, funds have adapted to a weakened transaction market through the expansion of leverage. Traditionally, buy-out funds have siloed debt between individual portfolio companies; one asset defaulting does not affect the credit of the rest of the portfolio. However, increasingly private equity has turned toward fund level finance to manage liquidity during a down market or to improve the performance metrics of its portfolio. The two primary fund-level tools—subscription line credit and net asset value loans—serve different functions at different stages of a fund’s life cycle. Both introduce leverage risks in the hope of improved future pricing for the underlying assets.

Subscription line credits (SLC) are a debt structure^{xx} that allows funds to borrow against their LPs’ outstanding capital commitments. Since the value of these capital commitments decreases over a fund’s lifespan, SLCs are primarily used early in a fund’s life. The use of SLCs has become increasingly popular in PE’s Zero Interest Rate Period-era boom^{xxi}. In 2010, less than 5% of all funds used SLCs, in 2024 around 35%; in 2010 10% of one-year old funds used them, in 2024 more than 75% had SLCs.

The nominal goal of this debt is generally to support portfolio companies during the gap between portfolio investments and the drawdown of capital commitments. However, funds have leaned on this debt to provide synthetically increased returns through cash flow-derived metrics and early returns of capital. Fund sponsors levered with SLCs^{xxii} call their capital later and less frequently. Internal metrics can be manipulated by SLC use; annualized IRR increases by 1.9 percentage points—12.6% over the standard deviation; the public market equivalent increase by 0.03—11.3% increase over the sample. The timing of adding on leverage is dependent on a fund’s fundraising and fee structure. GPs are 21% more likely to use an SLC in the 12 quarters before follow-on fundraising and 12% more likely in the period before reaching the hurdle rate. Most notably, GPs with public pension LPs—who may have weaker governance control than family offices or insurance companies—are significantly more likely to lean on fund-level finance before fundraising. Early-stage fund financing can help manage investor expectations, but it prioritizes fundraising optics over organic growth.

Since SLCs rely on LP commitments that decline over time, NAV loans emerge as a funding alternative later in a fund’s lifecycle. These loans^{xxiii} are backed by the underlying value of the fund’s portfolio and cashflow, which grow and peak into a fund’s harvesting stage. The market for NAV loans has surged^{xxiv}, growing at 30% annually since 2019. The market, now at \$100B in outstanding loans, is expected to hit \$600 billion by 2030, driven by private

credit expansion and increased adoption. Due to the lack of transparency in private markets, aggregated information on the market is reliant on self-reported survey information from lenders^{xxv}. Most financing agreements have conservative loan-to-value relationships between 10% and 20%; though a not insignificant portion (16%) of the loan market has LTVs greater than 20%.

Funds may use leverage to accelerate distributions, finance add-on investments, or manage expenses. The market has priced NAV loans cheaper^{xxvi} than direct company-level debt, assuming a more diversified pool of assets disperses risk. However, this assumption may be misleading. The low cost of NAV loans—especially in a high-interest rate environment—can encourage fund managers to add unnecessary leverage on a new level of the capital structure^{xxvii}.

The double-edged sword of NAV financing's more diverse set of underlying assets is the risks associated with cross-collateralization. Unlike traditional PE portfolio debt, where each company's obligations are siloed, NAV loans tie multiple assets together as collateral, meaning distress in one company impacts the entire fund. If a single asset loses value or faces liquidity stress, the lender may require additional collateral across multiple companies, amplifying contagion effects.

Moreover, NAV-based financing relies on accurate portfolio valuation—but inflation can allow NAV loans to be collateralized against asset prices supported by price level-driven revenue. This cycle can create a liquidity trap where GPs, instead of exiting assets at depreciated values, use additional borrowing to maintain portfolio valuations, worsening systemic fragility and pushing it into the future.

The rapid expansion of fund-level finance is not happening in isolation—it is deeply tied to the surge in private credit markets, which in turn rely on collateralized loan obligations (CLOs) as a key liquidity provider. In the same period of booming growth in NAV financing, private credit issuance has ballooned^{xxviii} from \$1 trillion in 2020 to \$1.5 trillion in 2024 and projected to reach almost \$3 trillion by 2029. The derisking of bank balance sheets^{xxix} have left an open gap for private credit funds to supply a growing demand for fund finance. Concurrently, CLOs have seen a record year in issuance^{xxx} with an increasing share of private credit CLOs. By securitizing these loans, CLOs can link private equity and its fund level finance to private credit to the broader institutional debt markets. If credit markets tighten, the flows might run in the other direction, and GPs relying on NAV loans may struggle to refinance, triggering forced sales of portfolio assets at discounted prices.

While NAV loans offer flexibility and may be a good option for some funds, their rapid growth suggests a dependency on fund-level leverage rather than organic performance. For

NAV loans to remain a healthy part of private equity's financing toolkit, greater transparency in asset valuations and risk pricing is essential to avoid potential liquidity challenges.

The private equity industry sits at a crossroads, navigating a fragile balance between financial engineering^{xxxix} and real economic fundamentals^{xxxix}. As fund managers increasingly rely on continuation vehicles and fund-level lending to sustain valuations, we need to ask ourselves: is this a necessary adaptation to survive a downturn or the buildup of systemic risk?

In the *most optimistic* scenario, private equity's long-term bullishness is well-founded. A business-friendly administration, continued strength from macro indicators, and healthy financing options lead to a revival of M&A activity and IPO markets. With traditional exit routes cleared, GPs can offload assets at strong multiples, justifying the extended holding periods enabled by financial engineering. The secondary market continues to provide liquidity solutions without distorting the accuracy of valuations, and private credit maintains stability. Private equity smooths prices through a downturn in the business cycle with minimal structural damage.

In the *worst* case, private equity has deferred their reckoning. Prolonged duration on assets through synthetic liquidity and leverage is like water building up behind a paper dam. A credit crunch, macroeconomic instability, sticky inflation, and elevated long-term interest rates could all undermine the industry's assumptions about sustained growth, mispriced nominal cash flows, and stable exit opportunities. If a liquidity squeeze forces widespread asset sales, funds relying on NAV loans and continuation funds may face sudden markdowns, triggering a self-fulfilling cycle of declining valuations, forced equity injections, and fire sales.

The systemic risk could be further amplified by the link between private equity, private credit, and institutional debt markets. CLOs—major buyers of leveraged loans issued by private credit funds—are increasingly likely to receive favorable regulatory treatment^{xxxix} under Basel III. If AAA-rated CLO tranches are mispriced and overleveraged—and the tranches are affected by declining valuations of the second-order underlying assets—we may see a cascading effect into the banking sector.

Large, well-capitalized funds may be able to weather the storm, but mid-market PE firms—who disproportionately rely on fund-level financing^{xxxix}—would be the first casualties.

Ultimately, however, financial engineering is not *inherently* a sign of weakness—it can be a rational response to illiquid markets, changing macro conditions, and pressure from investors. But if these tools obscure legitimate risks rather than manage them, private

equity may be setting itself up for a harsher reckoning in the future. Opacity has long been a hallmark of private markets, but as financial engineering expands, so does systemic risk. Without standardized valuation methods, greater transparency on fund-level leverage, and regulatory oversight of private credit-macroeconomic linkages, the market may be sleepwalking into its next crisis.

Addendum: Another great resource is a new working paper by Elham Saeidinezhad, “Banks as Synthetic Hedge Funds”, which discusses SLCs from a bank’s perspective. A part of her argument is that underpriced SLCs allow banks to act as synthetic LPs in private markets.

Definitions

Limited Partnership— A legal partnership between *General Partners*, who are responsible for managing the business, and *Limited Partners*, who have no rights in managing the business but in return have limited liability for debts and legal obligations. Most private equity funds are structured as Limited Partnerships.

General Partnership— A legal partnership in which all partners equally share management responsibility and liabilities.

Net Asset Value (NAV) Loans— A loan to a private equity fund itself—rather than its portfolio companies— which is secured by the value of the fund’s investments.

Collateralized Loan Obligation (CLO)— A CLO is a securitized pool of leveraged loans. Investors buy tranches, with risk and return determined by their priority in the payment structure. The safest tranche (AAA-rated) is paid first but earns the lowest yield, while the riskiest (equity tranche) is paid last and earns the highest potential returns.

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