Beyond paper gains:

The rising prominence of DPI and its focus on real returns

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For professional investors only

The private equity industry is undergoing a mindset shift with regards to returns. As traditional exit routes remain gridlocked and liquidity scarce, investors unable to turn portfolio returns into cash are rethinking what successful private equity performance looks like.

Significant sums were raised and invested across the industry in the two decades to 2021, when interest rates were at historic lows and financing conditions loose. However, in more recent years, the industry has been forced to adjust to a new era of higher interest rates and the corresponding uncertainty has widened the 'bid-ask spread between buyer and seller. Against this backdrop, it has become increasingly difficult for GPs to exit companies they bought during the bull market. Today, an estimated $3.2trn[1] in unexited assets are sitting in GP portfolios and, 2024 is projected to be the second worst year for exits since 2016[2].

Across the industry, holding periods are being extended and the subsequent delay in distributions is leaving limited partners' money tied up in mature funds, unavailable to be redeployed into new opportunities.

Internal Rate of Return (IRR) vs. Distributions to Paid In Capital ratio (DPI)

Return estimates for PE portfolios have traditionally included the value of investments in companies that haven't yet been sold or exited. These are commonly known as 'paper' gains or losses and are evaluated using metrics such as the internal rate of return (IRR).

For many years, IRR was the industry's go-to measure of performance and sufficient in a world where cash was cheap and exit routes were generally open. However, the persistent disconnect between buyers and sellers means that what a portfolio might now be worth on paper, may no longer come to pass on the market.

Metaphorically, it is akin to owning a highly valued home in the middle of an untested market; it is impossible to know the real value of the asset until it is sold. In a private equity fund, the assets may look great on paper, but if they were to be sold on the secondary market, there is no guarantee they would achieve the expected pricing.

In the context of the ongoing liquidity crunch, when LPs are evaluating performance, they increasingly want to know whether these assets can be realised at the valuation they are currently held at. This is a question that IRR cannot answer. As a result, many LPs are no longer willing to accept the highest IRR as the sole measure of a fund's success. They are also looking at real money returned to investors, and the distribution to paid-in capital (DPI) ratio – which measures actual cash returns relative to the invested capital – has become an increasingly significant metric for investors.

At Federated Hermes, we see the market's renewed interest in DPI as a return to private equity's core purpose as an asset class: aligning GPs and LPs expectations through the measure of real cash-on-cash return. However, while DPI is rising in prominence, many in the industry will know that this metric is not new. At Federated Hermes, we have, over many years, maintained a core focus on delivering real rather than paper returns, and DPI has been the key metric that we use to communicate this focus to investors.

The differences between IRR and DPI

- DPI provides a snapshot of actual returns to investors, while IRR offers a forecasted rate of return based on expected cash flows.
- DPI accounts for the timing and magnitude of cash flows, offering a straightforward measure of cash return relative to invested capital.
- As investors focus on risk-adjusted returns and capital preservation, DPI is a relevant metric for evaluating performance.

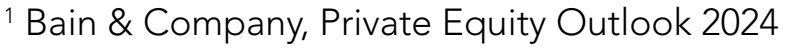
Federated Hermes' differentiated approach

At Federated Hermes, we are not just focused on making great investments and partnering with leading GPs, we also pay special attention to delivering real returns. We seek to maintain one of the industry's leading DPI ratios by taking a proactive and sometimes creative approach to exits.

We prepare for the sale of a company throughout the ownership period, applying a disciplined approach, the strength of which is demonstrated by our track record. As both a fund investor and a co-investor, we do not typically control the ultimate exit of an investment. However, the secondary market provides a platform for us to proactively engage in liquidity management.

Secondary transactions involve the sale or refinancing of existing private equity assets to buyers who are typically other specialist secondaries-focused private equity funds. To facilitate our access to this market, we have built a specialist in-house secondaries team with a track record in delivering our clients' liquidity needs in challenging market conditions.

Through our differentiated approach, we seek to not just navigate the challenges outlined above, but to lead the charge in redefining performance success by prioritising real cash over paper returns.



[1] Bain & Company, Private Equity Outlook 2024
[2] Bain & Company, Private Equity Outlook 2024

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