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Dry powder in private equity

April 2018

Is dry powder anything to worry about, and is it a useful metric for the industry? Two McKinsey experts weigh in.

As private markets evolve, the industry must grapple with a number of questions shaping it. One area of interest is the mounting level of dry powder, which reached an estimated $1.8 trillion, according to our 2018 private markets annual review. In this video, McKinsey senior partner Aly Jeddy and partner Matt Portner talk through whether this is a concern, as well as whether dry powder is the right metric to focus on. An edited transcript of their remarks follows.

Interview transcript

Is dry powder anything to worry about?

Matt Portner: There's a lot of hand-wringing in the industry about dry powder, and there has been for a few years now. What we've said previously is that if you look at dry powder more as inventory on hand than as an absolute number, it's less of a concern, because deal activity has historically kept up with fundraising. That means that if you look at it over time, it's been fairly consistent how much dry powder the industry has on hand.

What's changed in the past couple years is deal activity has started to fall. And when deal activity starts to fall and dry powder continues to accumulate, that can become a problem overall. Now, add to that that limited partners are putting pressure on their external managers to deploy that capital, and you get an increase in multiples. You get external managers doing deals that they might not otherwise do, at multiples they might not otherwise pay—and that can become a problem.

Is dry powder a useful industry metric?

Aly Jeddy: The most disciplined investors have always resisted the idea of focusing on dry powder. The conventional logic has been that, when there is a lot of dry powder, two things can happen. One, fundraising might not occur as robustly, because people might say, "Well, what have you done with the money I already gave you?" Obviously, that's not happening. We continue to see very robust fundraising.

The other, bigger concern has been, "It'll burn a hole in your pocket." You as a GP [general partner] will say, "I've got all this undeployed money. So, I need to deploy it, and you'll become less disciplined." The most sophisticated GPs will say, "We have enough rigor and discipline around the investment process that we will not deploy money into a suboptimal investment simply because we happen to have it."

To my other point, the proxy of dry powder becomes a poor one when, in fact, that's not the only capital at my disposal. In fact, if I found a fabulous transaction that was far in excess of my dry powder, it would not take me long to amass the remainder of the capital from sophisticated investors who can analyze transactions on their own, have strong points of view, and have enormous amounts of capital to deploy alongside in interesting structures.

So that's why the metric of dry powder—while the industry continues to focus on it and talk about it, and we talk about it too because it does have implications for future J-curve evolution—again, if you're talking about the ability to do deals or the ability to be disciplined, it's not a useful proxy. □

Aly Jeddy is a senior partner in McKinsey's New York office, and **Matt Portner** is a partner in the Toronto office.