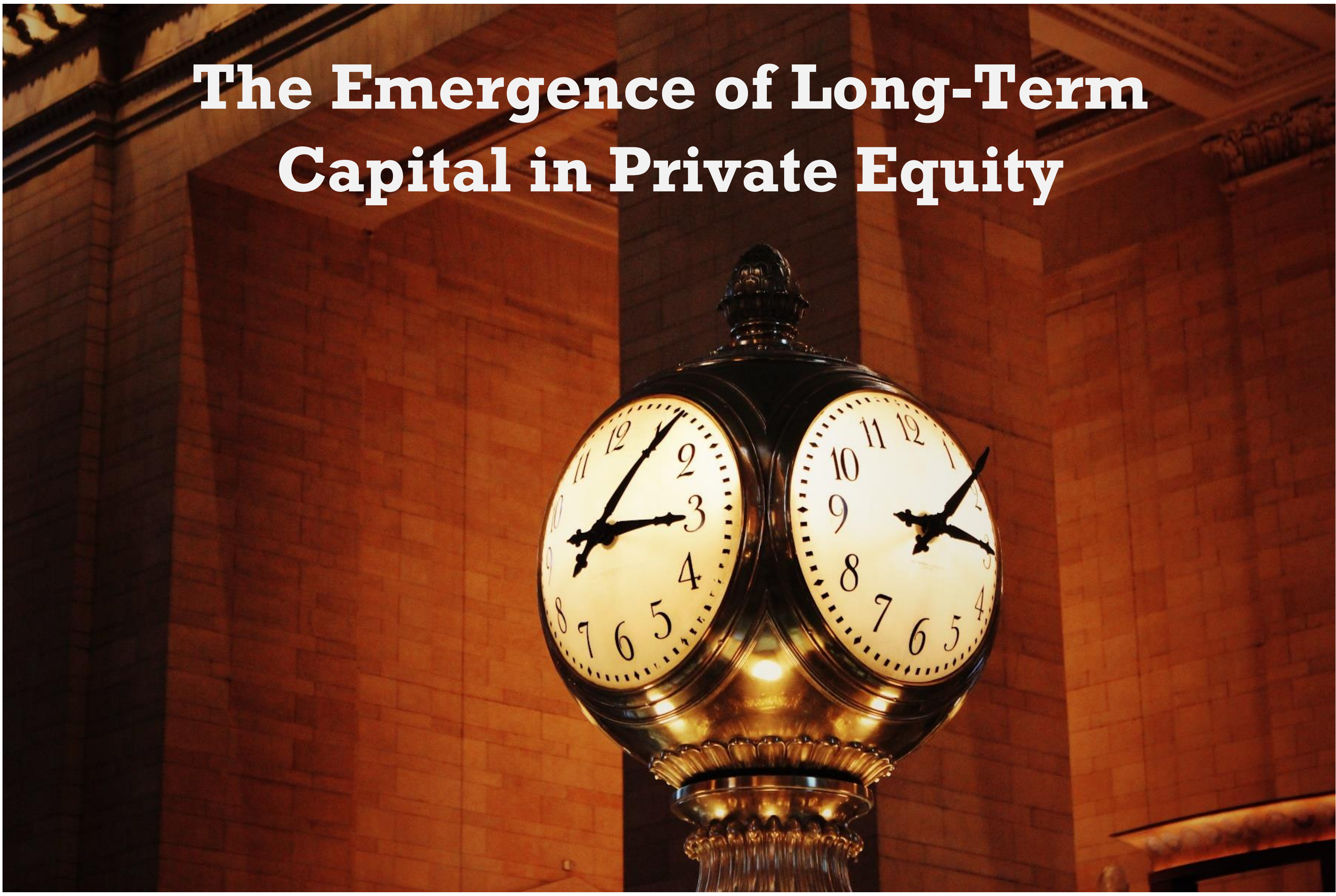
INSEAD

The Business School for the World®

The Emergence of Long-Term Capital in Private Equity



June 2018

This independent study project was authored by Kyle Lee and Konstantin Synetos (INSEAD MBA Candidates, Class of July 2018) under the supervision of Claudia Zeisberger, Senior Affiliate Professor of Decision Sciences and Entrepreneurship & Family Enterprise at INSEAD and Academic Director of its Global Private Equity Initiative (GPEI).

Abstract

Private equity, or PE in short, has seen a nascent but visible surge of general partners (GPs) raising long-dated funds in recent years, with fund lives in the range of 15-20 years. While this may be nothing new to those familiar with infrastructure investing, this is a meaningful deviation from the traditional PE model of a ten-year fund. GPs of long-dated funds are structurally equipped to pursue significantly longer holding periods. Select limited partners (LPs) are also starting to participate in direct long-term investments more deliberately. Why is this trend surfacing? Who are the main players today? What are the potential challenges, for both institutional investors and GPs? Through a series of interviews that we have conducted with an assortment of industry participants, including GPs, LPs, legal advisors, placement agents and consultants, this whitepaper aims to integrate the key insights to shed some early light and thoughts on the inner workings of long-dated funds, investing with a longer-term horizon, and how these can redefine or shape the various facets of traditional private equity.

Contents

** Credit on the cover image goes to Jon Tyson on Unsplash*

Part I: The Advent of Long-Term Investing in Private Equity

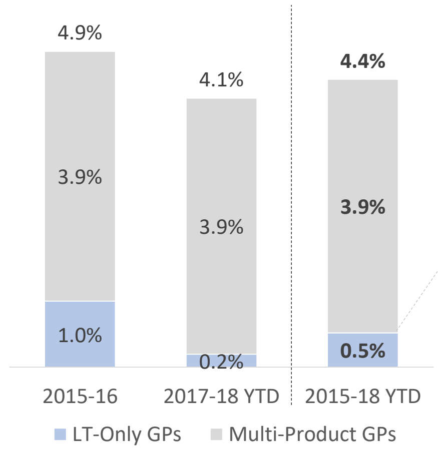
> *"In fact, when we own portions of outstanding businesses with outstanding management, our favorite holding period is forever."*
>
> – *Warren Buffett* (Berkshire Hathaway Inc., 1989)

Introduction

Private equity, or PE in short, has seen a nascent but visible surge of general partners (GPs) raising long-dated funds in recent years, with fund lives in the range of 15-20 years. While this may be nothing new to those familiar with infrastructure investing, this is a significant deviation from the traditional PE model of a ten-year fund. Most recently in early 2018, KKR announced the launch of their $8.5 billion[1] Core Investment Strategy Fund, and in the same week, BlackRock announced plans to raise $10 billion for its Long Term Private Capital Fund. As a percentage of funds larger than $1 billion, long-dated funds accounted for c.4.4% of buyout/growth capital raised since 2015, with over 85% of capital for long-dated funds raised by multi-product private equity fund managers. The rest was raised by independent long-term only GPs who are relatively new to the market. Altas Partners, a pioneer in long-dated funds, was founded only in 2012[2], whereas other players such as Castik Capital, Core Equity Holdings and Cove Hill Partners only raised their first funds between 2015 and 2017.

Exhibit A: Recent Examples - Long-Dated Funds Fundraising Statistics (2015-1Q'2018)

Long-Dated Funds as % of Buyout & Growth Funds Raised/Raising with Size $1B or More



Long-Dated Funds (Vintage, Final/Target Fund Size in USD)

Multi-Product GPs ($32.7B)

- CVC Strategic Opportunities (2015, $4.4B)
- Carlyle Global Partners (2016, $3.6B)
- Blackstone Core Equity Partners (2016, $5B)
- KKR Core Investment Strategy (2018, $8.5B)
- BlackRock LT Private Capital Fund (2018, $10B)
- 21 Aberdeen Standard Investments (2018, $1.2B)

Long-Term Only GPs ($4.4B)

- Castik EPIC I (2015, $1.2B / €1B)
- Altas Partners Holdings (2015, $1B)
- Core Equity Holdings I (2016, $1B / €750M)
- Cove Hill Partners Fund I (2017, $1B)

Source(s): Preqin (May 2018); Private Equity International; GPs' Websites; Private Equity Wire

GPs' interest in long-dated fund products is growing. It is hard to identify up-and-coming long-term only entrants, but there are signs of other multi-product GPs considering the addition of a long-dated fund model or a permanent capital vehicle to complement their existing portfolio of fund offerings. Apollo Global Management is currently working on Hybrid Value, a long-term vehicle that combines credit and equity (Private Equity International, 2017). Similarly, software and technology-focused Vista

[1] Out of the $8.5 billion, $5.5 billion comes from two undisclosed strategic partners and the remaining $3 billion comes from KKR's balance sheet (Private Equity International, 2018)

[2] Altas Partners was reported to have operated on a fundless sponsor model between inception and their first fund (Primack, 2015).

Equity Partners is in talks to launch Perennial Investing, a permanent capital vehicle that will allow for longer holding periods (PE Hub, 2017).

On the limited partner (LP) side, while some are still in the dark about such funds or decided to not actively consider them as part of their private equity programs, early adopters have already carved out target allocations within their private equity portfolios for longer term vehicles and assets. A few sophisticated LPs have even gone down the route of pursuing longer-term direct deals with dedicated teams. However, there are also LPs criticizing long-dated funds of multi-product platforms merely as new avenues for GPs to accumulate fees.

> *"Long-dated funds seem to be a low hanging fruit for GPs to raise more capital and accumulate fees. What does a ten-year fund not offer that a long-dated fund does?"*
>
> *– Former Chief Investment Officer, SWF*

Who are the main players today? Why is this trend surfacing? What are the potential challenges, for both LPs and GPs? Before attempting to answer these questions, we will define long-term investing.

Defining Long-Term Investing in Private Equity

Traditional growth and buyout funds invest with a goal to exit within the typical ten-year fund life cycle, resulting in an average target holding period[3] of three to seven years for a deal. In this paper, long-term investing, or long-horizon investing, is defined as the willingness and ability of an investor to hold an investment for a holding period beyond the seven years, and in some cases, forever. The definition does not necessitate that GPs of long-dated funds underwrite deals with a view to hold the investments for more than seven years from day one. In fact, several GPs of long-dated funds have instituted processes to re-underwrite their deals periodically, anywhere from every two to every six years, hence the emphasis on "willingness and ability". This is applicable not just to GPs, but also to sophisticated family offices, sovereign wealth funds (SWFs) and pension funds who have the capacity to invest directly or co-invest in deals with a long horizon in mind. Each investor has his/her own set of criteria to decide whether to continue holding or to launch a sale process as they revisit their portfolio companies.

> *"When we believe that we are no longer the best parent to own the business, we will trigger the exit process. This can be in year three, year seven or year 20."*
>
> *– Managing Director, European Family Office*

Although the ultimate point of access to a long-term investment is a direct investment, LPs can also gain access through long-dated funds. The most sophisticated LPs, which tend to have the largest assets under management (AUM), are well-equipped with teams and processes to consider direct investments or co-investments alongside GPs and corporate/strategic partners. Family offices interestingly show up on both ends of the spectrum. A few interviewed had never heard of long-dated funds, while others have teams in place to evaluate long-dated funds and direct deals.

Evergreen funds were also approached as part of this research. Though the evergreen fund structure provides GPs with the ability to hold an investment for long durations, most, if not all, deals are underwritten with the standard three to seven-year holding period in mind. For example, in a major evergreen fund interviewed, the longest holding period of any portfolio company since inception was 12 years, and that was an exception compared to the portfolio average. As the core strategy of a

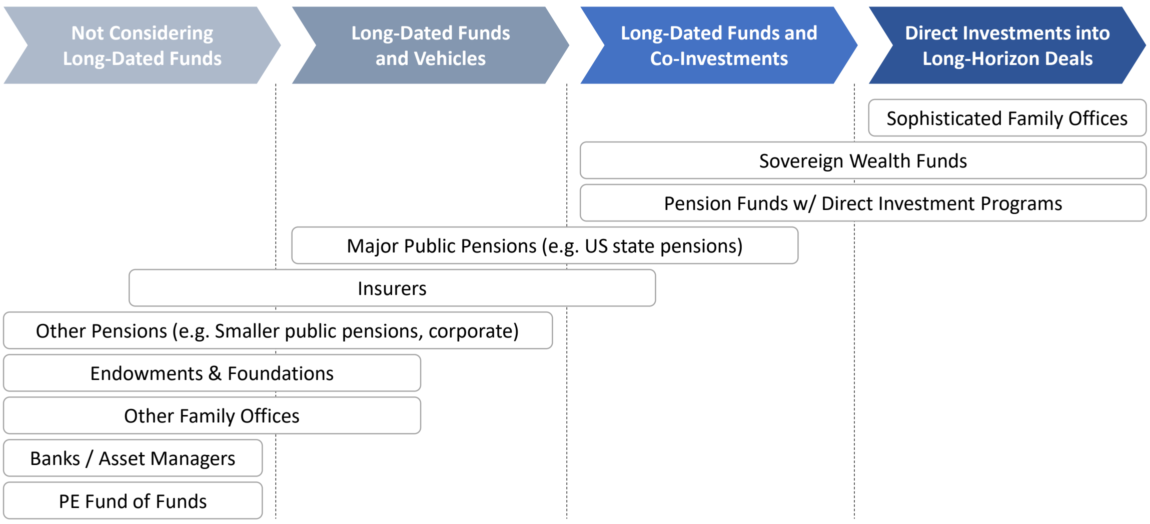
[3] Preferred holding periods differ from GP to GP. Certain GPs target three to five-year holding periods.

targeted three to seven-year hold fails the willing-and-able test, evergreen funds have been deprioritized in discussions for this whitepaper, as have the infrastructure and real estate asset classes.

Types of LPs and Institutional Investors Active in Long-Term Investing

Having interviewed a broad cross-section of institutional investors, there is distinct self-selection on the LP side. To consider investing in long-dated funds, institutional investors need to be comfortable locking up capital for longer periods of time, have permanent capital sources, the institutional set-up (notably the alignment of incentives) as well as the willingness to invest in an as yet unproven asset class. Further, given that the desire to derive meaningful co-investment flow from long-dated funds is a large driver for some LPs to consider commitment, proven co-investment capabilities and appetite are a plus. As a result, the biggest players by far are long-duration LPs such as pension funds (Canadian pension funds with large co-investment program first and foremost) and select sovereign wealth funds. Beyond that, some larger single-family offices with capital preservation mandates have allocated capital to longer term strategies, and so have a select number of insurers and endowments interested by long-dated funds' potential for improved liability matching versus traditional buyout funds. Fund-of-funds, banks, asset managers and smaller single or multi-family offices were found to have little awareness of or interest in long-dated funds as yet.

Exhibit B: Tiered Levels of Interest in Long-Term Investments



Source(s): Interviews; Internal Analysis

A more immediate form of participation is through longer-horizon direct investing by LPs themselves. Certain large single-family offices have been at this for quite some time. The Wendel Group, for instance, has held on to its stake in Bureau Veritas, an international certification agency, since its initial investment in 1995. Wendel's "Strategic Orientation 2017-20" explicitly states that their "first and foremost objective is to create value by developing assets over the long term" (Wendel, 2016). Similarly, Belgium-based Verlinvest[4] remains an active investor in Armonea, a private senior care service provider, for almost 15 years to-date.

[4] The investment holding company of the de Mevius and de Spoelberch families, two of the founding families of Anheuser-Busch InBev.

On a larger scale, the most sophisticated pension funds and sovereign wealth funds have co-investment and direct investment teams evaluating long-term deals, be it on an ad-hoc or deliberate basis. Today, most rely on relationships and commitments in long-dated funds to gain access to co-investments in such opportunities. With a seemingly ever-increasing demand for co-investments, LPs committing to long-dated funds – typically sophisticated LPs with large co-investment programs – are expecting sizeable amounts of co-investments, often even as a pre-requisite to their commitment.

> *"Some have created a box to house longer-term investments, but most LPs are opportunistic."*
>
> *– Managing Director, Multi-Product GP*

LPs with adequately-staffed deal teams and well-developed sourcing efforts are also opportunistically, or in some cases systematically, pursuing such deals on their own, bypassing GPs and competing head on with them. Some sovereign wealth funds today are strategically repositioning themselves as investment holding companies, organizing themselves into sectors and/or country-focused teams to chase direct deals and manage them for the long haul.

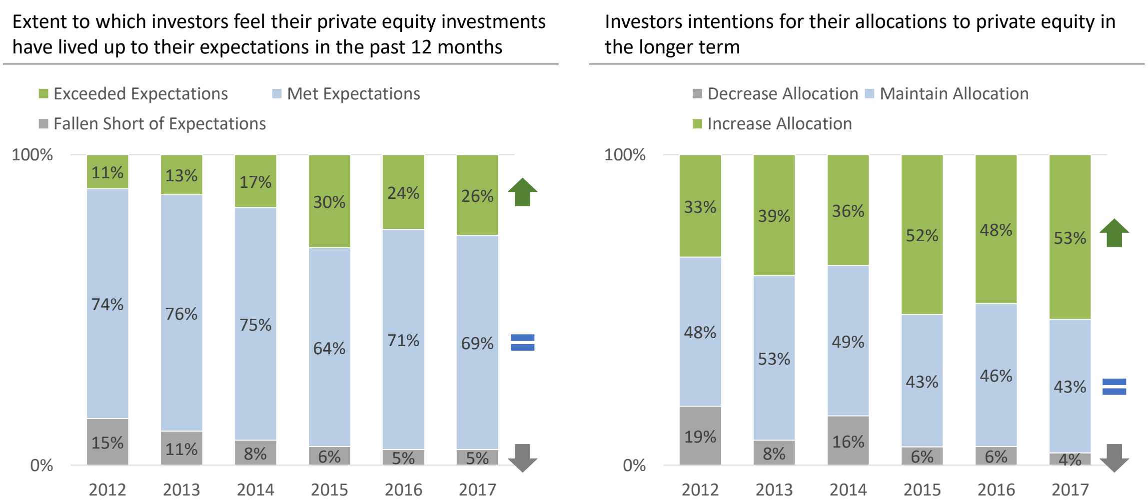
> *"We have a long-term sector-specific portfolio comprising of one major asset. The plan is to grow it with no target shelf life, bearing in mind that nothing is permanent."*
>
> *– Head of Sector, Government Holding Company*

Part II: Drivers of the Emergence of Long-Term Capital

Unprecedented Influx of Institutional Capital into the Private Equity Asset Class

The line of argumentation that gained the broadest support centered on variations on the theme of macroeconomic conditions stimulating demand for alternative assets, which created the impetus to broaden the opportunity set within private equity. Sustained low interest rates since the global financial crisis has put unprecedented pressure on institutional investors to generate alpha in order to match liabilities that have been revalued upwards. This coincides with return compressions across fixed income and other traditional asset classes and fears of equity markets overheating following the longest bull run in post-war history. Private market asset classes, first and foremost amongst them private equity, have as a result seen unprecedented capital inflows as institutional investors tilt allocation targets in their favor. As much as 53% of investors surveyed indicated an intention to increase allocation to PE in the longer term (Preqin, 2018).

Exhibit C: Institutional Investors' Perception of Private Equity and Forward Allocation Trends



Source(s): Preqin Investor Outlook: Alternative Assets, H1 2018

This has led to an era of benign fundraising conditions for GPs. Top performing GPs in particular have seen their funds heavily oversubscribed. Private equity dry powder has correspondingly soared to an estimated $962 billion by 2Q 2017 (Pitchbook, 2018). With concerns that this capital overhang in the buyout space will inevitably result in unsustainably high valuations and vintages with moderate returns, market participants are looking for less competitive segments within private markets.

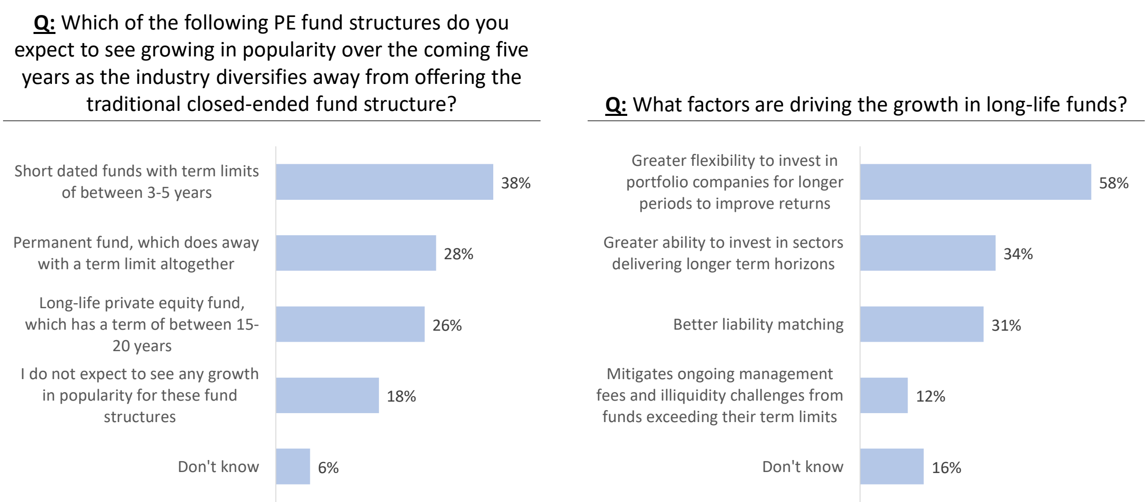
> *"We are now in a very unique and incredible period for access to capital. GPs are all competing for capital for their larger-than-ever flagship funds and not the least, new fund products."*
>
> *– Partner, Global Placement Agent*

Assets that have historically fallen in the cracks between infrastructure and PE allocations fit the bill. For assets offering better downside protection, less volatility, better cash flow visibility and likely less exciting growth – lower risk in aggregate – investors should be willing to accept commensurately lower returns. In order to get to total cash-on-cash returns in line with traditional buyout funds, investors need to be willing to lock up their capital for longer periods. Even as some LPs target such deals directly in order to retain maximal investment discretion and minimize fee leakages, the industries' stalwarts have mobilized resources to provide a solution in the form of long-dated funds to institutional investors that do not yet have the capabilities or desire to invest in team infrastructure. Long-dated funds allow multi-product GPs themselves to target deals they previously had to pass on and LPs are correspondingly acknowledging their reliance on GPs' sourcing networks to access such deals to accelerate their buildup of PE exposure, on top of traditional shorter-hold growth and buyout deals.

> *"Our long-term fund is for LPs who believe that, for the nature of their institution and corresponding risk-reward, longer holds are acceptable. One, LPs do away with the need to reallocate capital every four to five years. Two, they can now underwrite opportunities that they once were unable to pursue themselves."*
>
> *– Managing Director, Multi-Product GP*

Some LPs view long-dated funds as a natural extension of the fund offering, covering a risk-return spectrum previously not explicitly targeted. They argue that most LPs' funding targets leave sufficient room to consider a broader spectrum of returns, especially in a low-interest rate environment, and that these new long-dated vehicles provide a welcome opportunity to allocate larger portions of institutional capital to PE while limiting the risk of cannibalizing returns in traditional buyouts. In a survey conducted by InterTrust, 58% of institutional investors surveyed sought after flexibility in investing in portfolio companies over the long run for better returns, and 34% believe that long-life funds provide the ability to engage with specific sectors that are better suited for longer-horizon investing (Intertrust Group, 2017). In addition, the lower risk, long-dated nature of these funds is potentially well suited for select LPs' liability matching.

Exhibit D: InterTrust's Industry Survey on Long-Dated Fund Structures



Source(s): InterTrust Group – Private Equity Market 2017

Important also is recognizing that there could be both push and pull factors at work here. We hypothesize that select sizeable and influential LPs could be indirectly pushing multi-product GPs to consider setting up long-term or permanent capital vehicles. These LPs may even be encouraging and anchor investing in team spin-offs from traditional buyout funds, having them form the new wave of long-term only independent GPs.

Potential Fee-Stacking Mechanism

Critical LPs view this emergence of new long-dated vehicles merely as the latest addition to multi-product GPs' growing families of funds and evidence of their ambitions to evolve into asset gatherers with a management fee-based business model that augments, where applicable, their public valuations. These LPs have argued that GPs' deal flows are generally strong and that there is operational leverage in layering on one additional product, in this case geared towards LPs with sizeable co-investment appetite and correspondingly larger fund commitments, coming with an attractive stream of fees that could last 15 years or longer.

> *"Yes, GPs may indeed be trying to fill that genuine gap in alternatives, but we have to acknowledge that a driver of that is a desire to overweight on the asset gathering, management fee-led business model."*
>
> *– Head of Private Equity, Canadian Pension Fund*

GPs running long-dated funds are countering the aforementioned by pointing to revamped fee structures that blend down headline management fees whilst assuring investors that they are relying on entirely new teams of professionals to manage the long-dated funds. Additionally, several GPs are committed to delivering upon co-investment flow for their LPs, be it on an ad-hoc basis or via co-investment side car vehicles. While not all of these are free of fees and carry, they typically have lower fees and carry, which further contributes to the averaging down of overall gross-to-net spread for LPs.

> *"Our deals have got to be significant and generate sizeable room for co-investments."*
>
> *– Managing Director, Multi-Product GP*

LP Portfolio Rationalization and Deepening of Partnerships

Long-dated funds raised to date were not widely marketed, with major LPs in the respective traditional flagship funds accounting for the majority of commitments. A theme repeatedly identified is that several sophisticated LPs are in the process of rationalizing their portfolios and GP relationships with the goal of creating better co-investment partnerships to supplement their growing direct investing appetite, not forgetting that 53% of LPs intend to increase allocation to PE. This helps explain why upper-quartile GPs today see their funds heavily oversubscribed. Many of these GPs are now granting preferential access to LPs who can commit to multiple products beyond the GPs' flagship buyout funds, entrenching GPs and LPs into deeper partnerships.

Assets targeted through long-dated funds lend themselves to co-investment in terms of risk/reward, reduced operational intensity (thus resource efficiency) and large ticket sizes. By opening long-dated funds to a select group of LPs with co-investment capabilities and appetite, GPs are able to cater to investor demand while reducing the pressure to generate co-investments through their larger-than-before flagship funds. For some LPs, sizeable flow of co-investments from long-term funds could help offset co-investments underperforming corresponding fund performances, a relationship first pointed to by academic research in 2014 (Fang, Ivashina, & Lerner, 2014)[5].

> *"We are only taking money from large institutional investors with solid direct/co-investment programs and a primary capital base."*
>
> *– Managing Partner, Long-Term Only GP*

[5] Alternative research found no evidence of co-invest underperformance from adverse selection (Braun, Jenkinson, & Schemmerl, 2016).

Correcting Shortcomings in the Traditional Model

Several LPs pursue long-dated funds with the possibility of correcting some of the shortcomings of the traditional fund model. First, there is the notion that fund life rather than business rationale oftentimes dictates exit timing. GPs are frequently under pressure to sell strong performers prematurely in order to facilitate fundraising efforts with LPs demanding distributions and verifiable track records. Long-dated funds allow GPs to hold on to good investments for longer periods of time whilst not compromising their fundraising success.

> *"Quite often we found ourselves in situations where the structure of the funds we were involved in dictated the decision making at the investment level."*
>
> *– Partner, Long-Term Only GP*

LPs have also pointed out that a good portion of deals have generated consistently strong returns despite being rotated through different funds, with as much as 40% of private equity exits in recent years taking the form of secondary buyouts (Degeorge, Martin, & Phalippou, 2015). For larger LPs, these investments can end up on their books several times over the years, with new layers of fees and taxes accruing to LPs each time. Long-dated funds provide GPs with the leeway to satisfy fee-conscious investors by reducing leakages from frictional costs upon entry and exit, which can be considerable when aggregated across multiple vintages.

To illustrate the effect of this leakage on returns, Bain & Company recently modeled the costs and returns for the same theoretical portfolio company held (a) for 24 years in a long-hold fund and (b) sold four times over the same time period by a traditional buyout fund. The analysis shows that "by eliminating transaction fees, deferring capital gains taxation and keeping capital fully invested, the long-hold fund outperforms the short-duration fund by almost two times on an after-tax basis" (Bain & Company, 2018).

> *"It is increasingly hard to find a good company to buy. So, when we find one, I want to own it for as long as it makes sense."*
>
> *– Managing Partner, Asian Permanent Capital GP*

Finally, long-term structures can, in theory, better align incentives between LPs and GPs as compensation differences between LPs and GPs, who derive larger portions of their total compensations from successful realizations defined by IRRs, propagate a bias towards IRR over cash-on-cash maximization in the traditional model.

Getting Business Owners Off the "PE Treadmill"

Certain GPs that we spoke to highlighted the desire to create a structural advantage to target deals that cannot be done within the confines of traditional fund structures as the principle driver for creating longer-term fund structures. In particular, the GPs mentioned transactions with long lock-up periods, minority situation without full control over liquidity and more structured deals.

A few pure play long-term capital players highlighted the ability to offer a solution to families and founders adverse to "quick flips" or traditional PE ownership as well as the ability to pursue longer term buy-and-build strategies. GPs claim that founders and management teams oftentimes prefer a stable partner that can work alongside them for a decade or more, rather than rotate from GP to GP[6],

[6] Funds within this category are not necessarily marketed as lower risk/return but tend to pursue returns comparable to traditional PE.

which further exacerbates the frictional costs of switching PE owners. The select number of LPs that elected to target long-term equity deals directly attested to receiving inbound deal flow fitting the investment criteria from owners frustrated with being passed between PE firms and instead, looking for partners with longer investment horizons.

> *"Management teams are often surprised to see a PE fund that gets them off the 'PE treadmill'. Even if we don't win an auction, we know the team like us."*
>
> *– Investment Manager, Long-Term Only GP*

As a positive side effect, longer holds result in fewer distractions to portfolio company management who in the traditional model typically have little time to implement operational change before preparing their business for re-sale. Rather than the mere focus on shorter-term gains and quick wins, management can also better engage in a wider range of value-add initiatives.

> *"The nature and difficulty of execution is reduced in a longer-hold structure."*
>
> *– Managing Director, Multi-Product GP*

Downturn Management

Several critical institutional investors decry long-dated funds as "peak-of-the-market" products. Some GPs actively acknowledge that this development would have been unlikely at the beginning of the bull run at the turn of the global financial crisis. However, they point to long-dated funds' ability to better align exit timing with optimal hold periods (rather than fund life maturities) as a key advantage because it permits portfolio companies to traverse market cycles. In combination with the more defensive asset characteristics often sought by long-duration funds, this increased structural flexibility around exit timing positions their funds well to weather a potential downturn in macroeconomic conditions and ride longer on its subsequent recovery. One GP even expressed indifference to a market downturn as it may likely present opportunities to execute on roll-up plays at attractive multiples. Noting that deals can, but do not have to, be held for longer periods than in the traditional PE model, GPs further make a point that this product can exist across cycles.

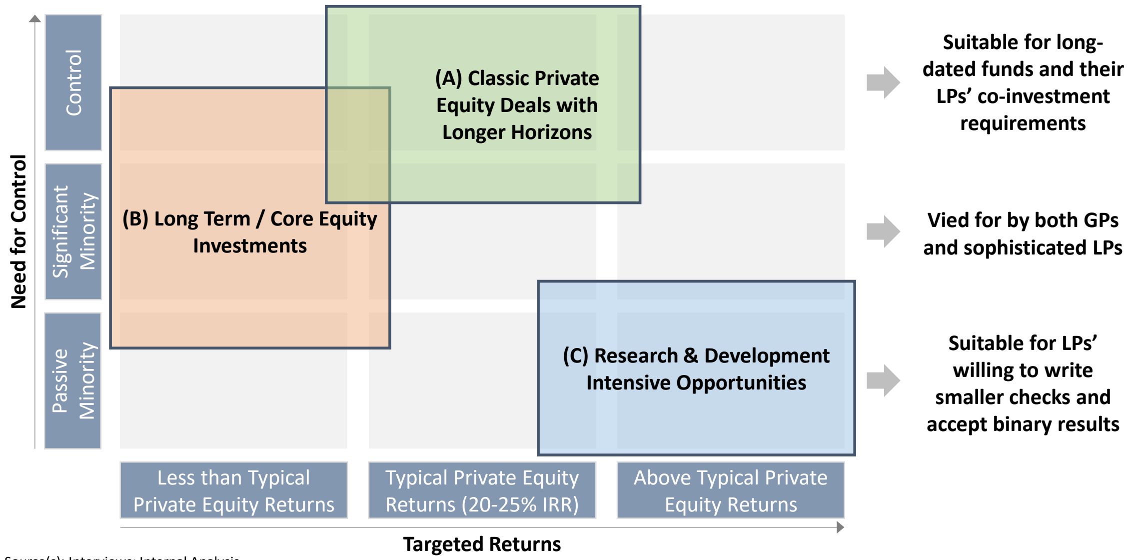
> *"While we can't foresee when the market will turn, I think it is only prudent to plan for the eventuality that it could happen within the life of the next PE vintage. We think that long-duration funds offer that flexibility for downturn management while not foregoing any of the upside in case it doesn't happen."*
>
> *– Managing Director, Long-Term Only GP*

Part III: Strategies for Long-Term Private Equity

Three Core Strategies in Long-Term Investing

There are three strategies that are presently commonplace in long-dated funds or in LPs pursuing long-horizon deals – (A) Classic Private Equity Deals with Longer Horizons, (B) Long Term / Core Equity Investments, and (C) Research & Development Intensive Opportunities. Exhibit E attempts to reflect the above on the basis of each strategy's need for control and their respective range of target returns.

Exhibit E: Core Strategies of Long-Term Investing



Source(s): Interviews; Internal Analysis

(A) Classic Private Equity Deals with Longer Horizons

Most independent long-term GPs are refusing to compromise on returns in their long-dated funds and continue to target IRRs of 20-25% or more. These GPs are typically on the look-out for crisis-resilient opportunities that allow for strategic value-add on initiatives that may need a longer time to implement and mature. Such initiatives could include strategic transformations, operational improvements and buy-and-builds. Consequently, these GPs have indicated a strong preference for control but will also consider significant minority positions provided strong governance mechanisms are in put in place. That said, GPs are looking to partner for the long run rather than execute on 100% buyouts, and as a result prefer working with owners, founders or families who will retain a meaningful ownership stake. Because there are substantial levels of portfolio management and involvement, LPs going direct alone have tended to shy away from these deals and prefer to access such opportunities by co-investing alongside GPs.

(B) Long Term / Core Equity Investments

A larger portion of capital is flowing into what is dubbed "core" equity investments[7]. GPs pursuing the core equity strategy are usually multi-product GPs who run flagship buyout funds. This strategy seeks a lower return threshold. According to press coverage, Blackstone's Core Equity Partners is targeting

[7] Taking the name from core infrastructure funds covering the lower risk/return opportunity set of the infrastructure asset class

an annualized net return of 15% (Fortune, 2016), CVC's Strategic Opportunities fund targets an IRR of 12-14% (Bain & Company, 2018), whereas some other GPs are reportedly targeting even lower annualized net returns of 10-12% (The Economist, 2016). Assets that tend to fall within this deal category are safer, high cash yield businesses with leading and sustainable market positions and strong management teams in place. Non-cyclicality of the business has, however, been a debated topic in our interviews. There are proponents who strongly advocate the pursuit of crisis-resilient assets, but others have widened the deal funnel to include growth opportunities that capture secular trends in an industry or a geography, especially demographical shifts. As a result, core equity GPs appear more flexible in their need for control and pursue opportunities ranging from passive minorities up to control situations. But GPs and their co-investing LPs are not alone in the core equity space given the generally lower resource intensity and involvement needed by target businesses. Interviewees have cited market participants such as Temasek, GIC, OMERS and large family offices as LPs that compete head on with GPs for core equity deals - both minority and significant minority opportunities.

(C) Research & Development Intensive Opportunities

A strategy unlikely to find its way into long-dated funds is that of research and development (R&D) intensive opportunities. Such deals tend to have deep J-curves and binary outcomes, and hence, are pursued mostly by LPs with the ability to stomach such return volatility within their portfolios over the long haul. 20-year patent royalty deals, new-age jet engines, genomics-focused biotechnology businesses and autonomous driving technologies are examples that interviewees have quoted as deals that have either been done or were considered as part of their long-term investment portfolios. For most R&D-intensive investments, LPs' preference has been to pursue them opportunistically with smaller equity tickets into passive minority positions, some sourced through existing venture capital relationships looking for new investors in follow-on rounds. But it would not be inconceivable that larger LPs would be willing to underwrite larger tickets given the size of their private equity portfolios.

"Some sectors need more time for value extraction, with investors who can ride a downturn."

– Partner, Global Placement Agent

Concentrated Portfolios. Limited Diversification.

Within the context of a long-dated fund as a whole, it is worthwhile noting that GPs are planning to build concentrated portfolios. Based on our conversations, we understand that the average long-hold GP is targeting three to six deals per fund. For a $1 billion fund, that equates to equity tickets anywhere between $150 million to $400 million per deal, with further access to funding through co-investors. Several GPs we spoke with suggested that portfolio and concentration risk should be mitigated by the inherently lower risk of the assets targeted. With an average investment pace of zero to two deals a year, long-term investing is highly opportunistic. Chasing deals for the sake of diversification has therefore not been a reason that resonated well with GPs. If treated as a complementary strategy to traditional private equity exposure, LPs should also be less concerned with portfolio concentration at the level of long-dated funds because LPs' core private equity portfolios are already well diversified.

"We should be, and we are, 100% opportunistic. Portfolio construction does not work here."

– Investment Manager, Long-Term Only GP

Part IV: Considerations and Challenges with the Long-Term Capital Model

Highly Bespoke Fund Structures

Given the limited number of long-dated funds in the market, no standard terms have been established yet. Indeed, fund structures and terms are often the result of discussions between a GP and its cornerstone investors and are hence highly bespoke vehicles. Exhibit F summarizes the variations of key terms and structures of long-dated funds that we have observed in the market. This list is by no means exhaustive.

Exhibit F: Comparison of Fund Terms and Features

Traditional Funds		Sample Variations of Long-Dated Funds
10 yrs + two 1-yr extensions	**Fund Life**	8 yrs + seven 1-yr extensions; 15/17/20 yrs + up to two 1-yr extensions
1.5-2.0% on commitment during investment period, and after, on unrealized investment cost	**Management Fees**	1% of invested capital + one-time 1% fee for each transaction at entry; 1% on commitments during investment, and after, on unrealized cost; Up to 2% of invested net asset value
8%	**Hurdle**	5% hard hurdle (no carry paid on first 5% of returns); 8% normal hurdle
20% (American Deal-by Deal or European depending on GPs)	**Carry**	Carry ranges from 10% to 27.5%. Most long-term only GPs use deal-by-deal; multi-product GPs consider both American and European carry
75-100%	**GP Catch-Up**	0-100% (one GP with zero catch-up commanded carry of >20%)
Offered on an ad-hoc basis to select LPs in the flagship fund	**Co-Investment**	Offered on an ad-hoc basis to LPs in the long-dated fund; Embedded co-investment rights in the LPA (highly tailored); Co-investment side car that invests alongside the long-dated fund
GPs' discretion	**Liquidity**	GPs' discretion (periodic re-underwriting to meet internal hold criteria); Deal recalibration with LPs every 6 years to recommend hold/sell

Source(s): Preqin; Private Equity International; Interviews

Increased Risk of Zombies

In the traditional fund model, management fees are typically an annual 1.5-2.0% on commitments during the investment period, ramping down to a similar percentage range on unrealized investment cost during the holding period. A key concern for LPs is therefore the risk of GPs holding underperforming assets through the end of a fund's life in order to continue receiving management fees on the associated unrealized investment cost. The risk of potential fee extraction through these so called "zombies" is larger in long-dated funds.

Some GPs of long-dated funds have taken preemptive steps by basing fees on invested net asset value (or fair value) of the portfolio company, rather than charging percentage fees on commitments or unrealized investment cost. Though this does not entirely eliminate the risk of keeping zombies for fees, it ameliorates the status quo offering. How the said fair value on which the fees are charged is being determined, a point of potential contention between GPs and LPs, is not deliberated further in this paper.

Lowering the Gross-Net Spread

Management fees are a big factor in determining the gross-net spread. Several GPs that are explicitly targeting lower returns through core equity strategies are charging lower management fees to ensure that their products are attractive to LPs on a net-return basis. This is feasible for multi-product GPs with the requisite platform scale and synergies, but conversely, could result in tight fund economics for long-term only GPs.

Co-investing alongside GPs can also lower LPs' gross-net spread. Co-investments are usually offered on an ad-hoc basis in traditional funds, with allocation to LPs determined by factors such as their relative importance and their ability to react and decide quickly. In long-dated funds, we have seen GPs accede to more structured forms of co-investment arrangements, such as raising capital for a co-investment vehicle that runs parallel to the main long-dated fund. Legal advisors have also indicated the embedment of co-investment rights or "guarantees" within LPAs. Though little has been shared, such terms could include the provision of co-investments for equity tickets above a certain quantum and/or a stepdown or a rebate in fees in the absence of sufficient qualified co-investments[8].

> *"Our LPs want a mechanism that can make co-investments more plannable for them."*
>
> *– Partner, Long-Term Only GP*

Liquidity in an Illiquid Asset Class

Industry practitioners consistently highlight the issue of illiquidity in long-dated funds and long-term investments, notably as the secondary market will necessarily be less efficient than for traditional PE funds. How should deals or fund structures be tailored to ensure adequate liquidity for LPs and investors when they need it? GPs are aware of LPs' desire have liquidity provisions, but to avoid being overly prescriptive in LPAs, quite a few have decided to defer this issue to LP advisory committees to deliberate and suggest solutions when such situations arise. One GP interviewed instituted a soft-feature to have the GP present a "hold or sell" recommendation for each deal every 6 years to their LP advisory committee. Another GP built a facility into its LPA whereby the GP will organize a market for any LP wishing to sell their stake after the first 10 years, with other LPs retaining a right of first refusal. Practitioners are also considering the listing of portfolio companies, or entire fund vehicles, at some point in the investment, have LPs absorb distributions-in-kind (full or in partial), and have them self-manage their liquidity needs, though conscious that in-kind distributions are disliked by many LPs. Ultimately, however, LPs subscribing to long-dated funds should underwrite the longer-term illiquidity risk prior to committing.

> *"It's new, so exit rights are still not well thought out, and legal protection only goes so far."*
>
> *– Managing Director, Bulge-Bracket Private Funds Team*

Deal Allocation Governance for Multi-Product GPs

LPs are acutely aware of potential conflicts of interest in the allocation of deals and resources between multi-product GPs' flagship funds and their respective long-dated funds. As deal allocation for some long-dated funds take place at the global investment committee level, many LPs have encouraged the tightening of governance mechanisms within the LPA early on, specifically on how deals will be

[8] Co-investments that were offered to an LP, and that were eventually executed by the GP.

allocated. But in an era where the power balance is tilted towards GPs, it could be hard to appropriately tighten such mechanisms.

> *"A sponsor pitched to us a long-hold co-investment as part of the long-term fund, but it did not seem appropriate. We ended up recommending them to allocate the deal to the normal buyout fund, which they did."*
>
> *– Senior Director, Pension Fund*

Using Long-Term 'Carry' for Team Retention

GPs of traditional whole-fund European carry structures usually start receiving carry only in the seventh year or later in a ten-year fund's life, which is why the use of a deal-by-deal carry has been a preferred structure for most long-term GPs, even for those based in Europe, to address team retention issues. The earlier the crystallization of carry, the earlier investment professionals can be compensated. However, that does not solve for the fact that these funds are potentially holding on to investments for as long as 15 to 20 years, or in the case of permanent vehicles and some family offices, forever. How does one then incentivize individuals before the full realization of a deal?

There is no one-size-fits-all approach. GPs continue to innovate incentive plans for their investment teams, with listed private equity firms and family offices with a listed business having the flexibility of using stock options and restricted shares to partially replace carry in the short/mid-term. Large multi-product GPs who gravitated towards a global carry model would find team retention to be less of an issue compared to tying team incentives directly to long-dated funds that the teams manage. This might be trickier for independent long-term only GPs to do. While few have shared details of how they would incentivize their teams, consultants and advisors have put forth a few suggestions. One of which includes an annual revaluation of the portfolio in year 7/8 onwards, coupled with an allocation of reserved carry or an increase in GP commitment (or co-investment).

Recalibration of LPs' Infrastructure. Establishing a Long-Term Mindset.

LPs seeking a more active exposure to long-term investments in their portfolio should first consider recalibrating their team infrastructure and organizational mindset to deal with longer-term investments and the corresponding illiquidity. Team compensation, incentive structures, return benchmarks, performance measurement, monitoring processes and systems, and the institutionalization of relationship management are just some fundamental aspects that should be revisited to realign teams and processes for long-term investments. More importantly, because such products and assets may likely traverse market cycles, LPs should preemptively prepare for contingencies down the road in a long-term investment or a long-term fund and lay out pre-approved guidelines and/or processes on how they will be handled. A consultant to SWFs and pensions further noted that not many governments and institutions are set up to handle longer-term investments. Therefore, education to shift boards' mindsets to being longer-term oriented is pertinent.

> *"LPs are not that long-term minded, especially when a crisis hits. A long-term mindset requires institutional experience to be comfortable with illiquidity."*
>
> *– Chief Risk Officer (PE), SWF*

Is Deal Flow Really That Differentiated?

GPs have claimed that the willingness of management teams and entrepreneurs to engage is different in the context of a long-term fund. But the origination could be no different from that of traditional private equity, and deal-making is arguably no less competitive. One family office interviewed sensed that the market today is increasingly competitive for long-term deals, especially with long-term GPs now on the rise and with more single-family offices joining the fray of direct investments. Another long-term GP also indicated that they participate in all auctions within their sweet spot of equity ticket size, bumping into most traditional GPs in their market. Ultimately, it appears that most long-term capital bidders are competing on valuations with just about everyone else.

> *"The structure of your fund does not differentiate the deal flow you get."*
>
> *– COO, Evergreen GP*

Part V: What Lies Ahead?

Sustainable Strategy or a Fad?

There was broad consensus amongst the parties we spoke to that the sustained low interest rate environment following the financial crisis and the resulting capital overhang in private markets is a key driver for the evolution of long-term capital in private equity. Opinions as to its sustainability once these conducive conditions abate, however, differed considerably. A managing director at a pension fund targeting core equity deals directly offered a nuanced viewpoint: funds, be it long-dated funds or LPs targeting these deals directly, using long-term capital allocations as a way to “fool” their investors/shareholders and themselves into accepting lower returns without a commensurate reduction in risk, especially as this may coincide timing wise with an inevitable market correction, are unlikely to survive a potential shakeout following the first fully-realized vintage.

> *“The truth is, LPs have nowhere else to put their money. GPs know this too, so everyone is participating in this distorted market.”*
>
> *– Portfolio Manager, SWF*

On the flipside, where investors get into this asset class extension as a genuine differentiated risk-reward play, there is no reason why it should be more or less sustainable than traditional buyout as there is room in institutional investors’ growing alternative assets programs for both to co-exist. LPs will however need to calibrate institutional infrastructure and mindset to accommodate the long-term capital asset class, before any reasonable form of allocation can be properly contemplated. Some have already done so, but the large majority of LPs today have prudently decided to first take an opportunistic stance. Long-term capital in private equity is after all a sub-asset class with immature track records and one where the understanding of risk is comparatively more opaque for now.

> *“There is a lot of capital out there. So long as the playbook is clear, there is no reason why the longer-term asset class cannot be amplified further.”*
>
> *– Senior Director, Pension Fund*

Predictions by the Authors for the Road Ahead

In this final section, we propose some predictions informed by our research and conversations, but ultimately representing our thoughts regarding the likely further evolution of long-term capital in private equity:

- Whether long-dated funds develop into a private equity staple or remain the preserve of the largest long-duration LPs with co-investment capabilities will depend to a large part on the performance of the first one to two vintages. Many LPs are holding off from carving out dedicated allocations until GPs are able to point to a track record. Right now, the raising of second vintages is already underway. CVC, for instance, is reported to be targeting €4B for Strategic Opportunities II (Private Equity International, 2018), and a long-term only GP is planning to launch their second fund within 2018. Timing wise, the third vintages could be particularly interesting to observe for shake-outs as by that time track records may start to crystalize and market conditions may be less conducive than today’s benign fundraising environment.

- For institutional investors targeting long-term investments directly, access to quality deal flow of sufficient size and acceptable valuation levels will be the key determinant of sustainable success. As a result, we believe that only institutional investors dedicating adequate and specialized resources to this effort alongside existing direct programs for PE and infrastructure will have a chance to compete with long-duration GPs. It would also not be implausible for some LPs already invested in long-dated funds to do away with those funds when a shakeout happens in the future, poach talent from GPs, and go direct altogether.

- For GPs, the scalability of the model will depend on how broad an LP set it can appeal to, which in turn depends on how the problem of illiquidity can be properly addressed. Fund structures and innovative exit mechanisms may try to solve for that, but the true catalyst might be the development of a liquid and effective secondary market for long-dated fund investments. If the secondaries market matures sooner and becomes more liquid, perhaps even ascend into electronic platforms, it could be game changing and may accelerate the inflow of capital to long-dated funds and other illiquid assets. Going forward, secondary players may even contemplate including in their strategies direct secondaries into portfolio companies previously positioned as long-term investments.

- More asset management houses may follow in the footsteps of BlackRock and Aberdeen Standard Investments and join the game of providing long-term capital solutions for institutional investors. Those that do will augment their teams with new hires (e.g. BlackRock) or seek partnerships with GPs (e.g. Aberdeen Standard Investments with 21 Partners). This diversification into private equity could be one angle of the seeming convergence of private equity with traditional asset management, further blurring the lines between private and public equity.

- Long-term capital will likely find its way into other sub-asset classes of private capital. Indeed, this has already started. Apollo is working on Hybrid Value, which could invest in structured equity and non-control positions in distressed companies, targeting low to mid-teens returns (Private Equity News, 2018). In a hypothetical example, where private equity straddles into earlier stage investing with capital as patient as 20 years (e.g. into biotechnological or pharmaceutical research), venture capitalists could find new capital providers competing at their doorsteps.

- We expect to see more corporate tie-ups with institutional investors in their strategic pursuit of inorganic growth or acquisition of strategic assets. Lower return thresholds in certain pockets of long-term capital allow corporations to now access capital that is more closely aligned with theirs in terms of cost and patience. Major institutional investors seem to have already made inroads in this direction, at times with a wider mandate than just long-term investing. For instance, GIC set up the Integrated Strategies Group in 2012 to facilitate group-wide cross-asset class investments and to build strategic global relationships with key investors and corporations (GIC, 2013), and similarly for Relationship Investing teams in a few Canadian pension funds.

References

Bain & Company. (2018). *Global Private Equity Report.* Bain & Company.

Berkshire Hathaway Inc. (1989, February 28). *Berkshire Hathaway Inc.* Retrieved from http://www.berkshirehathaway.com/letters/1988.html

Braun, R., Jenkinson, T., & Schemmerl, C. (2016). Adverse Selection and the Performance of Private Equity Co-Investments. *Available at SSRN*.

Degeorge, F., Martin, J., & Phalippou, L. (2015). On Secondary Buyouts. *Journal of Financial Economics*.

Fang, L., Ivashina, V., & Lerner, J. (2014). The Disintermediation of Financial Markets: Direct Investing in Private Equity. *Journal of Financial Economics*.

Fortune. (2016, June 13). *Private Equity Firm Blackstone Is Channeling Warren Buffett*. Retrieved from http://fortune.com/2016/06/13/blackstone-warren-buffett/

GIC. (2013, March 1). *GIC*. Retrieved from https://www.gic.com.sg/news-and-insights/new-management-appointments-2/

Intertrust Group. (2017). *Private Equity Market 2017.* Intertrust Group.

PE Hub. (2017, November 29). *Vista is said to launch permanent capital fund for long-term holds*. Retrieved from https://www.pehub.com/buyouts/vista-is-said-to-launch-permanent-capital-fund-for-long-term-holds/

Pitchbook. (2018). *Private Market Playbook (1Q 2018 Edition).* Pitchbook.

Preqin. (2018). *Preqin Investor Outlook: Alternative Assets, H1 2018.*

Primack, D. (2015, August 18). *Term Sheet*. Retrieved from http://fortune.com/2015/08/18/term-sheet-tuesday-august-18/

Private Equity International. (2017, December 6). *Apollo plans long-term hybrid credit, equity fund*. Retrieved from https://www.privateequityinternational.com/apollo-plans-long-term-hybrid-credit-equity-fund/

Private Equity International. (2018, February 19). *CVC seeks EUR4bn for second long-life vehicle*. Retrieved from https://www.privateequityinternational.com/cvc-seeks-e4bn-for-second-long-life-vehicle-exclusive/

Private Equity International. (2018, February 8). *KKR gathers $8.5bn for long-term investments*. Retrieved from https://www.privateequityinternational.com/kkr-gathers-long-term-investments/

Private Equity News. (2018, February 2). *Apollo Launching Hybrid Value Fund*. Retrieved from https://www.penews.com/articles/apollo-launching-hybrid-value-fund-20180202

The Economist. (2016, September 8). *The Omaha play*. Retrieved from https://www.economist.com/news/finance-and-economics/21706506-buy-out-firms-are-seeking-out-longer-term-investments-omaha-play

Wendel. (2016, December 1). *Investor Day 2016.* Retrieved from https://www.wendelgroup.com/sites/default/files/pdfs/presse/wendel_2016_investor_day_cp_en_0.pdf

Acknowledgements

We would like to thank the GPs, LPs, legal advisors, placement agents, consultants and all other industry practitioners whom we have engaged with since the start of this research project. This would not have been possible without their inputs. Many of our interviewees have been extremely generous with their time and candor, and for good and understandable reasons, have requested anonymity for purposes of this research. Our sincere thanks to all the anonymous contributors and the industry experts listed below:

Guo Sun Lee, Partner, King & Wood Mallesons

Jean-Philippe Keravec, Partner, Campbell Lutyens

Yong Hak Huh, CEO, First Bridge Strategy Limited

We would also like to thank Professor Claudia Zeisberger and the INSEAD Global Private Equity Initiative (GPEI). Their patience and guidance throughout the course of this research project have been instrumental, pointing us in the right direction and to the right people at critical junctures. Thank you.

For additional information about this report and for any comments or feedback, please contact:

Kyle Lee	kyle.lee@insead.edu
Konstantin Synetos	konstantin.synetos@insead.edu
Claudia Zeisberger	claudia.zeisberger@insead.edu