Long-Dated Private Equity: A Problem Solved?

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Background

As private equity has taken an ever-increasing allocation in many institutional portfolios, the challenges and issues associated with investing in the asset class have become more pronounced. According to BNP Paribas, in 2012 only 3% of the average institutional investor portfolio was allocated to private equity. This figure is now approaching, and often exceeding 10%, especially among endowments and family offices. DeMarche believes that this trend is not likely to abate anytime soon. Specifically, according to a 2019 PitchBook survey, two-thirds of respondents plan to increase allocations in private markets over the next five years. Investors typically cite multiple factors related to increasing exposure to private equity. These include reduced (yield) performance expectations for fixed income (given today's rate environment), diversification benefits/attendant risk mitigation and increased comfort level with the asset class, and recent strong trailing performance of private equity as an asset class.

Due to the increasing commitments, idiosyncratic situations like J-curve mitigation, capital drawdown lags, redeployment of returned capital, and accompanying vintage year risk are becoming more challenging, especially to investors with multiple job duties unrelated to investment management. Once a target allocation is reached, new problems rear their head, including avoiding concentration and simply staying invested as uneven distributions and monies set aside for anticipated capital calls create a cash drag on the portfolio. To address the problem, an increasing number of limited partners now seek specialized mandates, co-investment rights and sometimes joining syndications of direct (investment) deals. Limited partners are also taking note of some disturbing trends within the asset class. One noteworthy trend is the phenomenon whereby private companies are traded between private equity firms. This problem was highlighted in a recent Bain Capital report, identifying over 500 companies that have been owned by at least three PE firms in succession. While not prima facie evidence of a problem, limited partners often learn the result of a given transaction simply moved a company from one of their funds into another, with attendant fees (legal, advisory, accounting) borne by them as a limited partner. Limited partners have also caught on to the fact that many private equity firms have multiple funds in the market at any given period, generating layers of management fees, which are ostensibly in place to address the costs associated with running the firm.

This paper introduces two evolving potential solutions to some of these problems, utilizing long-dated private equity and so-called evergreen or permanent private equity.

Definitions

Before we get very far along, it is important to distinguish between the two approaches to addressing the aforementioned problem, beginning with time horizon. **Long-dated private equity strategies** typically have a stated goal of a 15-year life, with many exceeding 20 years. In contrast, evergreen or permanent structures are perpetual life investment vehicles promising immediate diversification and limited blind pool risk, with various gating and liquidity features. Both approaches represent a marked contrast to a standard closed-end private equity fund featuring a 10-year life with multiple one-year extensions. It is worth noting that while most funds state a 10-year life, the chance of the fund extending well beyond that point are more than half. As previously referenced, while the stated **"shelf life"** of a fund is typically 10 years, a recent PitchBook study noted that 53% of 2004 VY funds remained active at the end of 2019. These so-called **"zombie" funds** often held underperforming or lackluster companies or assets, but often continue to provide fee income for the General Partner (GP). However, a strong counterpoint exists that fund life should not dictate exit timing if there is an argument to be made for continued private ownership. Regardless, limited partners are often frustrated by these so-called tail-end fund situations, which has in turn fueled the secondary market.

To date, a limited number of (typically large and often publicly traded) private equity shops have launched long-dated strategies with most having a common thread as they intend to seek stable, defensive, cash-generating companies while utilizing modest leverage over (at least) a 10-year holding period. Long-dated strategies also promise fewer taxable events, allowing capital gain deferral and reinvestment of those gains in either new or existing portfolio companies, thereby boosting long-term capital appreciation. Interestingly, as far back as 2009, industry stalwarts like KKR co-founder Henry Kravis described Berkshire Hathaway's style as "the perfect private equity model." Commonly referred to as **"The Omaha Play,"** long-dated private equity funds often target net annual return of 10-14%, well below the 20% usually aimed for by conventional buyout funds, but these strategies promise less volatility and lower fees, typically 1% or less, rather than the customary 2%. Conversely, **evergreen funds** underwrite to typical private equity (buyout) standards in terms of producing higher anticipated Multiples on Invested Capital (MOIC) or Internal Rates of Return (IRR) while employing higher degrees of leverage and featuring management fees typically starting at 1.5%. Regardless, both sets of return expectations become more attractive as management fees are only assessed on invested equity. Finally, it's worth noting that illiquidity premiums for private equity have been decreasing (from 300 to 200 basis points) given stiff deal competition.

Increasing Asset Class Interest

As DeMarche highlighted during our 2019 Client Conference, investors should continue allocating to private equity given the growth of private companies to the economy - and investable universe. According to PitchBook, nearly $1 trillion has been invested into companies by global private equity investors over the prior decade, representing a record number of companies that are backed by private capital. Presently, there are nearly 14,000 privately-backed companies in the United States compared to fewer than 4,000 publicly-listed companies – down from nearly 7,000 in 2000. This steady growth has impacted where investable opportunities are located and created increased convergence with the public markets. One example of convergence is the IPO market, whereby the private markets serve as a pipeline of companies transitioning to the public markets.

Currently, 44% of companies listed on NASDAQ were formerly backed by private equity (including venture capital). Other points of intersection include disruption of public companies in established industries from agile private companies, the uptick in take-private transactions, and increased acquisitions of private companies. This is not to suggest that stock markets are going away anytime soon. Such an event seems highly unlikely given the sheer size of public markets which exceed $70 trillion in combined market capitalization, which easily dwarfs private companies which are estimated to presently represent no more than $3.5 trillion in enterprise value.

Private Equity Allocation Challenges

Until recently, managing the target allocation to private equity was not necessarily critical as most investors did not have significant allocations to the asset class. However, as allocations increase, it has become more important to proactively manage the asset class. What makes reaching and maintaining an allocation target so challenging? For starters, a private equity portfolio is dynamic, featuring simultaneous inflows and outflows of capital over an investment cycle. This often requires that investors overcommit dollars as limited partners will rarely have more than two-thirds of their committed capital "at work" at any one time because managers call funds over a period of (up to five) years and, during the same time period, distributions have (hopefully!) commenced. Returned capital creates another set of problems, as it is often "lumpy" and impossible to predict as to timing. Regardless, as referenced earlier, returned capital immediately presents reinvestment risk to the Limited Partner. In addition there is never a guarantee that all committed capital will be called by the General Partner. For example, during the Great Financial Crisis of 2008, a significant amount of committed capital remained uncalled due to the death of attractive investment opportunities.

At the same time, the investor's overall portfolio may be growing or contracting, either through market appreciation/depreciation and/or additional contributions or redemptions, further impacting the percentage of capital allocated to private markets. This phenomenon is referred to as the denominator effect.

The Mechanics of Valuation

Private equity valuations have long been controversial, and we will save a discussion (or white paper) on that topic for another day. While long-dated private equity does not look to break any new ground in terms of reporting/valuation, the same cannot be said for managers promoting evergreen structures. Because evergreen managers promote optionality via a fully paid-in open-ended structure (as opposed to the capital calls associated with typical closed-end, blind pool private equity investing), valuation is especially critical. In the case of these funds, managers offer either monthly or quarterly subscriptions with the investor (as opposed to the General Partner) deciding whether or not to invest, as well as the dollar amount. This requires the evergreen manager to strike a monthly NAV determined by the Fund's administrator. This ensures that new investors, as well as those desiring liquidity, are treated equitably. Needless to say, a key component of the due diligence associated with these strategies will be understanding and underwriting the valuation methodology that evergreen managers employ. Lastly, these investments are also unique in that they typically trade in units based on the vehicle's net asset value.

Carried Interest

Until now, we have avoided the proverbial elephant in the room, namely carried interest. For the uninitiated, carried interest (or "carry") refers to the share of profits paid to an investment manager once a (return) hurdle rate has been reached. It is essentially a performance fee that rewards the manager for enhancing returns. What happens to carry is one of the things that makes long-dated and evergreen capital somewhat unique. Since NAV is determined periodically, carry can be converted at designated times into "permanent capital" and continue in the fund in the same way as investor's capital. This can go on until the investment is sold or the carry can be withdrawn using the same redemption rights available to other investors. The circumstances in which carried interest can be earned and the time period for payout are important considerations as "carry" is typically a very important component of overall compensation for private equity professionals.

Summary

The question remains as to whether either of these two approaches, long-dated private equity or evergreen funds, represent long-term solutions to the issues associated with investing in private equity. Are these vehicles simply a creation of Wall Street in an effort to perpetuate asset gathering in support of a broader fee-based model? It is worth noting that the majority of firms offering these structures are now publicly traded and desirous of reliable revenue streams. Regardless, early efforts seem to be gaining traction, and the fact that managers can avoid dedicating time and resources to raise new funds about every three years should not be ignored.

For more information on this study and the DeMarche Universes, please contact your DeMarche Consultant.

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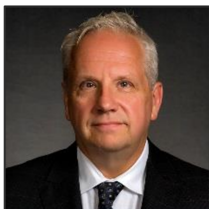

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