For the longest time

An analysis of long-dated private equity fund structures

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Key takeaways

- Long-dated funds afford managers flexibility in timing the entrance and exit of investments, as well as greater latitude to enact long-term operational improvements. From the limited partner (LP) perspective, long-dated funds generally have lower management fees, less reinvestment risk and fewer taxable events; the tradeoff, however, is greater illiquidity and key man risk.

- LPs with the longest investment horizons (such as endowments, sovereign wealth funds and family offices) are a natural fit for long-dated PE funds. While any fund commitment warrants deep scrutiny and extensive due diligence of the manager, LPs need to place an even higher premium on these reviews when considering long-dated funds given the likelihood of a multi-decade relationship.

Background

53% of 2004-vintage buyout funds are still active.

The lifespan of PE funds is often perceived to be between eight and 10 years, but in reality, most funds take much longer to wind down. On average, it takes between 11 and 14 years for funds to reach an RVPI of less than .05x. Despite this reality, most limited partnership agreements reflect the traditional eight to 10 year timeline, which has led to fund extensions—typically in one-year increments upon LP approval—becoming the norm. For example, our data shows that 53% of 2004-vintage buyout funds are still active.[1] More recently, portfolio company hold times have extended to around six years, driven by the industry's focus on add-ons and operational improvements, as well as the challenges posed by generating positive returns for portfolio companies held through the financial crisis.

Some PE firms have begun to adjust their fund offerings to meet the reality of longer timelines. Industry giants CVC Capital Partners, Blackstone and The Carlyle Group have all recently completed fundraising for vehicles with stated durations of at least 15 years. Vista Equity Partners is reportedly targeting $3 billion for an evergreen vehicle of its own, while KKR has announced it will pursue long-term investments using capital from its own balance sheet.

While long-dated funds are not necessarily a new phenomenon, established general partners (GPs) are gravitating to the strategy for a variety of reasons. Firms such as Golden Gate Capital and General Atlantic are known for offering evergreen—or permanent capital—funds, similar to the long-dated funds discussed above but without a designated end date. In the past, PE managers have publicly admired Berkshire Hathaway's holding company model, citing the flexibility and long-term investment theses that the firm is able to pursue. Here, we will explore additional factors driving the advent of these funds, as well as considerations for LPs who may be interested in allocating to such vehicles.

1: In this case, "active" is defined as having an RVPI of greater than 0.05x and "vintage" is defined as the year in which the fund held its final close.

Select long-dated funds

Including vehicles that have held a final close, are currently fundraising, or have been officially announced by the fund manager.

Fund name	Fund size	Vintage	Status
Carlyle Global Partners	$3.6 billion	2016	Closed
Cove Hill Partners Fund I	$1.0 billion	2017	Closed
CVC Strategic Opportunities I	$4.4 billion	2016	Closed
Core Equity Holdings I	$1.3 billion	2017	Closed
Blackstone Core Equity Partners	$4.1 billion	N/A	Open
Apollo Hybrid Value Fund	$3.0 billion (target)	N/A	Open
CVC Strategic Opportunities II	$4.7 billion (target)	N/A	Upcoming

Source: PitchBook
*As of May 31, 2018

Pros

Longer hold times... will allow funds to defer capital gains taxes and reinvest those gains in new or existing portfolio companies, thereby increasing long-term capital appreciation.

Fewer taxable events

With longer hold times and fund timelines, investors will face fewer taxable events. This will allow funds to defer capital gains taxes and reinvest those gains in new or existing portfolio companies, thereby increasing long-term capital appreciation. Of course, GPs would also have the option of making distributions to LPs during the hold period, but the optionality remains a valuable tool.[2]

Lower transaction costs

In addition to deferred capital gains taxes, investors will likely benefit from fewer transaction costs in long-dated funds. Each time a company is bought and sold, it incurs transaction costs including legal, advisory, accounting and due diligence expenses. These costs are usually charged to the portfolio company, rather than the fund itself, but affect LPs in either case. Whereas an investor in a traditional fund structure will have to reallocate prior distributions to another fund and pay transaction fees upon entering new portfolio companies, investors in long-dated funds will face fewer instances of these fees (although fees are unlikely to change as a proportion of transaction size).

2: Most PE investments already meet the three-year hold time requirement for taxation as capital gains rather than ordinary income, so they would not benefit from this difference by allocating to long-dated funds. Dividends will also likely be taxed in the same way under a longer hold period.

Operational improvements

The PE industry has become more dependent on operational improvements in recent years, as the traditional levers of paying down debt and relying on multiple expansion have become less effective. One form of improvement is organic: Provide the capital, expertise or strategic direction to increase top-line growth or improve margins. Another is inorganic: Integrate add-ons with the original platform—a strategy that has become more prevalent in recent years—with the intention of producing immediate top-line growth and creating cost savings once the two (or more) companies are integrated. Long-dated funds will allow for more add-ons, which GPs increasingly argue are a major value proposition of the industry.

Timing

Long-dated funds afford managers more flexibility in timing their capital deployment and exits. The ability to wait for more favorable market conditions, whether that means patience in deal sourcing or waiting for the capital markets to heat up ahead of a planned IPO, is undoubtedly an advantage. In the current environment, for instance, EV/EBITDA multiples have nearly doubled since the last downturn, creating a difficult situation for buyers but a lucrative one for many sellers.

Shorter fund lives require more frequent diligence efforts on the part of LPs, while making it difficult to keep capital deployed for a greater proportion of the total available time.

Reinvestment risk

LPs will also face less reinvestment risk by contributing to long-dated funds. It's possible for funds to return capital quickly, generating attractive IRRs, without growing long-term capital. And even if the cash multiple is impressive, LPs need to recommit that capital to maintain their PE allocation. In these situations, the GP may have met stated goals, but LPs must spend considerable time and resources to find another investment opportunity. Regardless of the performance of the first fund, shorter fund lives require more frequent diligence efforts on the part of LPs, while making it difficult to keep capital deployed for a greater proportion of the total available time.

Fee/carry structure

Long-dated funds are likely to offer lower fees than their traditional counterparts. For example, Carlyle Global Partners will reportedly charge a 1% management fee and 15% carry, with no fees charged on uncalled capital. Though GPs may be ceding ground on the headline rates, they are gaining a more stable, long-term stream of fee income—something that shareholders of publicly traded PE firms have long demanded. In this way, long-dated funds represent a more passive version of PE, bringing to mind the shift toward indexing in public markets.

Cons

Liquidity

With longer fund lives, of course, comes less liquidity. Instead of having capital locked up for 12-15 years, LPs may have to wait as long as 20 years to fully realize their investment. However, these longer fund lives should come with an added liquidity premium. That is, in exchange for locking up capital for a longer period, investors will expect higher annual returns, which is possible through the realization of lower fees and other structural advantages discussed previously.

Investors should consider the opportunity cost of having capital tied up for so long, which may make future allocations to emerging managers and asset classes difficult to achieve.

In addition, investors should consider the opportunity cost of having capital tied up for so long, which may make future allocations to emerging managers and asset classes difficult to achieve. For example, investors who committed to a long-dated fund a decade ago would have had trouble making private debt (a relatively new and growing asset class) a significant portion of their allocation to alternatives, without relying on secondary markets or other alternative forms of liquidity.

Key man risk

With longer hold times, there is greater key man risk with the fund's investment team. A 20-year fund life could span half a career, creating greater risk that decision makers will pursue other opportunities in the meantime. Therefore, larger GPs, which tend to be more dependent on the firm's processes rather than the genius of any one individual, may be better suited to manage long-term strategies.

Value-add?

If GPs are to take the same operational approach in long-dated funds as they do with vehicles that have traditional investment periods, there is a risk that they will add little additional value after the first half-decade of ownership. Either the target portfolio companies should require fundamentally different improvements that take longer than five to six years (the current average hold time for portfolio companies), or GPs should provide specific operational improvement plans for further into the investment horizon. That said, two of the three traditional levers of leveraged buyout returns—debt repayment and multiple expansion—should work just as well.

Asset class considerations

The advent of long-dated, closed-end funds reflects the increasing number of offerings available in the PE marketplace. Critics will argue the expansion of offerings in recent years is simply a way for managers to increase assets under management and lock in long-term fee income without offering real differentiation or superior returns. But proponents maintain that the broad range of hold periods, fee structures and strategies (including PE, debt, real estate, hedge funds, etc.) allows LPs to choose a fund, or terms within that fund, that meet their individual preferences. Meanwhile, some LPs are seeking to decrease administrative costs by consolidating manager relationships, sometimes demanding bespoke options such as separately managed accounts with a broad range of exposures and co-investment rights.

Critics will argue the expansion of offerings in recent years is simply a way for managers to increase assets under management and lock in long-term fee income without offering real differentiation or superior returns.

Given the pros and cons listed above, long-dated funds are more suitable for some LPs than others. Those with the longest investment horizons (such as endowments, sovereign wealth funds and family offices) are a natural fit for long-dated PE funds. While any fund commitment warrants deep scrutiny and extensive due diligence of the manager, LPs need to place an even higher premium on these reviews when considering long-dated funds given the likelihood of a multi-decade relationship.