PitchBook

Exploring Long-Dated PE Funds

Structures, strategies, and outlook

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Contents

Key takeaways

- Long-dated PE funds (defined as 15 years or more in length, plus extensions) aim to provide value by compounding capital over longer investment periods than do traditional PE funds. Long-dated funds have developed over the past half decade alongside other innovations in PE designed to capture this economic opportunity, including evergreen funds, LP direct investments, GP-led secondaries, independent sponsor investments, and single-asset strategic partnerships.

- Long-dated funds can be broadly divided into two types: core and non-core. Core funds, which are offered by some of the largest PE firms, invest in companies with a lower risk/return profile than traditional PE but seek to compound that capital over 10+ years to achieve a comparable multiple on invested capital (MOIC). Non-core long-dated funds, which are run by emerging managers, invest in companies with traditional PE risk/return rates and anticipate holding only a proportion of these companies for 10+ years.

- To some extent, the growth of LP direct investment may pose a competitive challenge to long-dated funds going forward. In theory, many LPs would prefer to buy and own companies over long durations directly, eliminating the fee layer. In fact, LPs represent the most significant competition for deal flow for long-dated fund GPs. However, most LPs are capacity-constrained in their ability to do this.

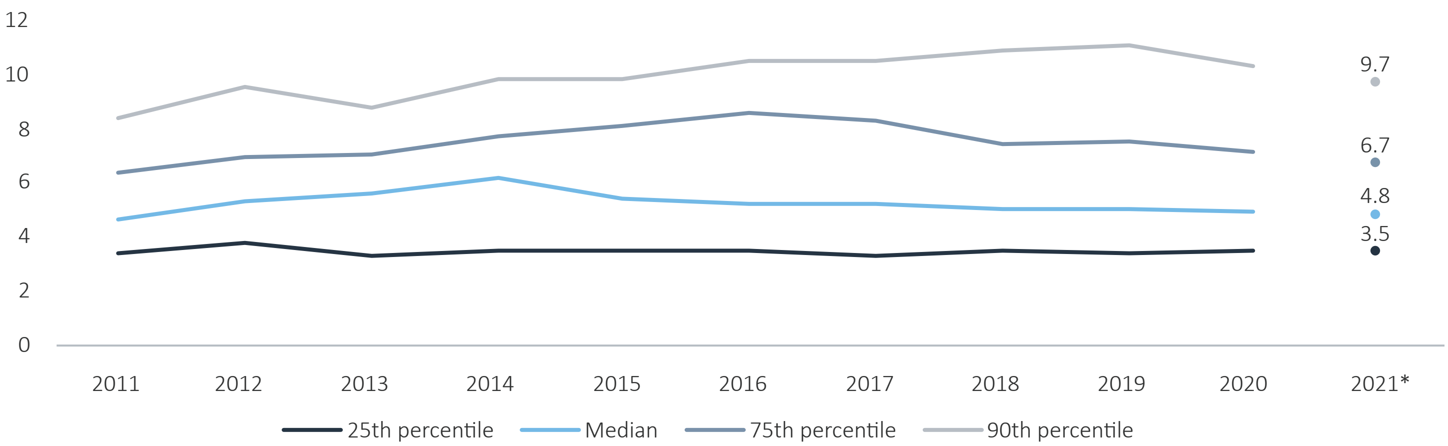
- GP-led secondaries also alter the competitive landscape because they allow traditional buyout funds to act like long-dated funds. However, many LPs are wary of the complexities and conflicts of interest that can arise in GP-led secondary transactions, and long-dated funds may be able to differentiate themselves through deal sourcing and discipline in building high-quality, concentrated portfolios.

Introduction

As the PE industry has matured, variations on the traditional 10+1+1 buyout fund structure have emerged. Among these are fund and non-fund structures that enable investments beyond the industry-standard three to five years. Some companies reward long holding times: They are non-cyclical, consistent cash generators that can compound growth over a long time horizon.

Long-dated PE funds—defined as closed-end buyout or growth funds with a duration of 15 years or more, excluding extensions—are one of several innovations in PE fund structure meant to capture this economic opportunity.[1] Other models include LP direct investment (by the large Canadian pensions, sovereign wealth funds (SWFs), and some family offices), GP-led secondaries, independent sponsor investments, and single-asset strategic partnerships. The proliferation of these models can be seen in the long tail of PE holding times. While the median holding time for PE portfolio companies is approximately five years, 10% of companies are held for around 10 years or longer.

Distribution of PE holding times (years) by exit year



Source: PitchBook | **Geography:** Global
*As of May 14, 2021

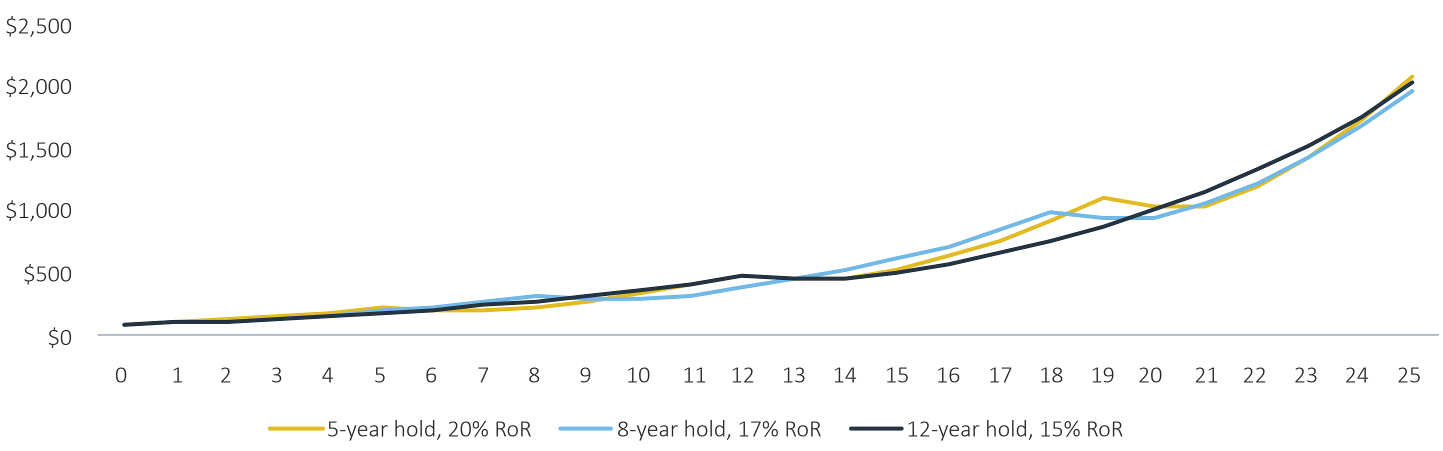
1: Secondary funds and funds of funds typically have longer fund structures, often 12 to 15 years, plus extensions. Additionally, some PE funds are set up with a long or perpetual structure in order to invest in specific, nontraditional asset types, such as GP stakes or sports teams. These are not the focus of this note.

Value proposition of long-dated funds

Long-dated funds offer investors the opportunity to benefit from owning growing, non-cyclical companies for a longer period. In describing the rationale for the strategy, long-dated fund GPs often reminisce about companies that they managed within traditional funds and were forced to sell prematurely, or that they wanted to own but that did not fit the risk/return profile of a traditional fund. Another touted advantage to long-hold strategies is greater flexibility to strategically time exits in case of market volatility. Finally, long-dated funds aim to compound investment returns over a longer period than would be possible in a traditional 10+1+1 fund, while also deferring the transaction costs and inefficiencies associated with buying and selling companies. Certain LPs find long-dated funds attractive because they reduce reinvestment risk, meaning they are less likely to receive and redeploy capital into a lower return environment and less time is spent holding on to cash in anticipation of capital calls. Long-dated funds also present some tax advantages and disadvantages, depending on a number of factors; these are laid out in the appendix of this note.

Most importantly, long-dated funds can generate MOIC returns comparable to investing in traditional PE while achieving a lower internal rate of return (IRR) and presumably incurring lower risk. The accompanying chart illustrates this concept. It shows the growth over 25 years of a hypothetical $100 million contribution to a series of PE funds with various hold periods and annual rates of return, with lower rates of return (RoR) for longer hold periods. The model accounts for transaction costs and assumes a 0% RoR on uninvested capital for two years between each fund investment. Under these conditions, each strategy yields a net asset value (NAV) of approximately $2 billion at 25 years. This model does not account for differences in fees or carry, which may be lower for long-dated funds than for traditional funds. Additionally, as discussed later, long-dated funds vary significantly in their target risk/return profiles.

Hypothetical 25-year growth of $100 million committed to a series of funds ($M)



Source: PitchBook

Types of long-dated funds

Long-dated funds can be broadly categorized into two buckets: core funds and other (non-core) long-dated funds. Both core and non-core long-dated funds can hold companies for 10 years or longer. They also tend to build relatively concentrated portfolios, investing in anywhere from six to 15 companies over a five-year investment period. This portfolio concentration is both a strategic choice and a function of fund size constraints, since long-dated funds tend to invest in mature companies with higher EVs, all else equal, than traditional buyout funds. However, there are several key differences between core and non-core long-dated funds.

Select long-dated and evergreen funds, 2015 vintage and later

Investor	Fund name	Vintage	Fund size ($B)*
21 Invest and Aberdeen Standard Investments (joint venture)	21 Aberdeen Standard Investments Fund I	2018	$1.2 (target)
Accel-KKR	Accel-KKR Emerging Buyout Partners	2020	$0.6
Altas Partners	Altas Partners Holdings	2016	$1.0
	Altas Partners Holdings Fund II	2019	$3.0
BlackRock Alternative Investors	BlackRock Long-Term Private Capital	2019	$3.4
The Blackstone Group	Blackstone Core Equity Partners	2017	$4.8
	Blackstone Core Equity Partners II	2020	$8.2
The Carlyle Group	Carlyle Global Partners	2015	$3.6
	Carlyle Global Partners II	Open	$1.8
Core Equity Holdings	Core Equity Holdings Fund I	2017	$1.2
Cove Hill Partners	Cove Hill Partners Fund I	2017	$1.0
	Cove Hill Partners Fund II	2020	$1.5
CVC Capital Partners	CVC Strategic Opportunities	2016	$4.4
	CVC Strategic Opportunities II	2019	$5.2
Castik Capital	European Private Investment Club Fund I	2015	$1.2
	European Private Investment Club Fund II	2020	$1.5
Golden Gate Capital	Golden Gate Capital Opportunity Fund	2020	$1.5
Kohlberg Kravis Roberts	KKR Core Investment Strategy	2017	$8.5
Permanent Equity	Permanent Equity I	2018	$0.05
	Permanent Equity II	2020	$0.3
Vista Equity Partners	Vista Equity Partners Perennial	2019	$1.5

Source: PitchBook | **Geography:** Global
*As of May 14, 2021

Core funds

Pioneered in the mid-2010s, the core fund strategy draws inspiration from Core Plus real estate and is now offered by several of the largest PE firms, including KKR, Blackstone, Carlyle, and CVC Capital Partners. BlackRock Long Term Private Capital (LTPC) can also be considered a core fund, though it has an evergreen structure, as discussed below. These closed-end vehicles typically have a 15+ year lifespan—a standard structure would be a five-year investment period, 10-year hold period, and three years of extensions. Core funds tend to employ a similar fund structure to standard 10+1+1 funds and do not recycle capital. They typically incorporate lower management fees, carry, and hurdle rates than would be found in a traditional fund.

Core funds can be further divided into two types. CVC Capital Partners and Carlyle primarily make structured minority investments up and down the cap table, while Blackstone and KKR exclusively make control equity investments. (BlackRock LTPC sits between the two, with a willingness to build toward control stakes through a series of minority investments.) Core funds target established companies with a risk/return profile that differs from what a flagship buyout fund would pursue, with gross annual IRR targets in the mid-teens. Outperformance is possible, of course: KKR's core investment strategy is at 23% gross IRR since inception,[2] and Blackstone's Core Equity Partners I is at 23% net IRR.[3] The goal, however, is to generate high cash-on-cash returns by compounding equity value and returning dividends to LPs over a longer period. For instance, a core fund may perform a dividend recapitalization a few years after a portfolio company acquisition, then manage down the leverage ratio to 3x to 4x EBITDA while distributing free cash flow back to LPs for the remainder of the holding period. Although core funds are technically willing to exit investments after a shorter (three-to-five year) holding period given a compelling opportunity, their base-case scenario is 10-year+ holds for all portfolio companies.

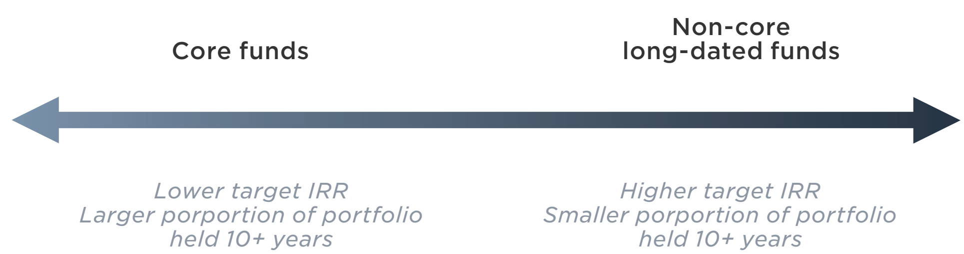
Although it is technically an evergreen fund, BlackRock's LTPC is worth briefly touching on as the latest entrant into the core fund space. Rather than gradually calling down committed capital, the fund takes LP commitments in full at the beginning of the investment period and recycles capital. LPs are given annual opportunities to increase their commitments or gain access to liquidity. Like other core funds, BlackRock LTPC targets investments with a lower risk/return profile. However, the fund takes a somewhat more flexible strategic approach than its peers. In addition to mixing minority and control investments, it also builds in the possibility of exiting investments within a shorter timeframe, underwriting investments for both five- and 10-year holds.

2: "KKR June 2021 Investor Presentation," KKR, June 1, 2021.
3: "Blackstone First Quarter 2021 Supplemental Financial Data," Blackstone, April 22, 2021.

Other long-dated funds

A handful of emerging managers also run long-dated funds that differ from the "core" model—including Altas Partners, Cove Hill Partners, and Core Equity Partners in the upper middle market, and Permanent Equity in the lower middle market. Like core funds, most non-core long-dated funds have a closed-end structure of 15 years, plus extensions, though there are exceptions.[4] Cove Hill Partners employs a unique, quasi-evergreen structure whereby assets can be rolled over from the closed-end, long-dated fund to a special-purpose vehicle at any point in the life of the fund, contingent on LP approval. This structure mimics some of the optionality of a GP-led secondary transaction. At the same time, it mitigates some of the conflicts of interest that can arise in GP-led secondary transactions while incentivizing deal professionals with earlier crystallization of carry. Fees and incentives for non-core long-dated funds are highly bespoke as well, and they may employ nontraditional mechanisms such as a hard hurdle (no carried interest is paid below the hurdle, and there is no GP catch-up), a management fee step-up from invested to committed capital, or even a carry-only fee structure. In general, these funds offer at least a discount compared to traditional funds.

Unlike core funds, non-core long-dated funds typically target standard buyout returns of 20%+ IRR. In other words, non-core long-dated funds often act like traditional PE funds, but with more concentrated portfolios and greater optionality to hold their best-performing companies for longer without the need to embark on a complex single- or multi-asset restructuring. Because of the concentrated nature of their portfolios, these firms seek to only buy companies that they believe are good candidates for an extended holding period. However, non-core long-dated funds vary in what proportion of their commitments they plan to hold over a long period. Altas Partners, for instance, may hold only one or two out of 10 portfolio companies for the 10+ years allowed by the elongated fund structure. This helps mitigate the downside risk of portfolio companies succumbing to unforeseeable market changes 10 years down the line, while maximizing upside potential for those companies that do prove to have staying power. With that said, every long-dated fund sets its equation of return targets and holding period expectations differently.



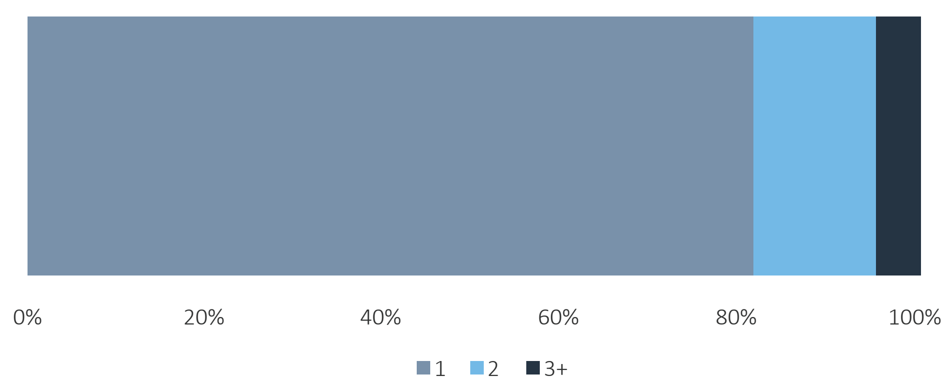
4: Permanent Equity does not fit neatly into this category and serves to illustrate the diversity possible in non-core long-dated fund structures. The firm's first and second funds are each 27 years in length, plus optional extensions, and operate more like a perpetual holding company than a PE fund, primarily returning capital to LPs via excess cash flow distributions rather than an eventual exit.

Deal flow

An additional advantage of long-dated funds concerns deal flow. Some businesses strongly prefer partnering with a single GP over a longer time horizon to the prospect of being traded among several PE firms in successive sponsor-to-sponsor buyouts. In this context, family owner-operators are frequently interested in partnering with long-dated funds and may roll over their equity stake to help lower the purchase price while aligning interests. This preference can open up proprietary deal flow options that would otherwise be unavailable. The largest core funds are often able to preempt auction processes and negotiate deals bilaterally.

The universe of companies appropriate for a long-dated fund is limited, and the competitive dynamics of deal flow vary by strategy. We can gain an initial approximation by examining companies that have been in multiple PE portfolios. As of this writing, 5.0% of buyout-backed companies globally (1,257 companies) have undergone three consecutive buyouts. While some of these companies presumably underperformed under previous sponsors, a proportion of them could have been successfully held by the same sponsor over a longer time horizon.

Proportion of buyout-backed companies by number of consecutive buyouts*



Source: PitchBook | **Geography:** Global
*As of May 14, 2021

However, long-dated funds emphasize discipline and selectivity when sourcing deals. Predicting in year zero which companies will still perform well in year 10 is extremely difficult, and the concentration of long-dated fund portfolios raises the stakes. For this reason, long-dated fund GPs look for companies with extensive track records and resilient business models to strengthen their convictions. Blackstone's Core Equity Partners funds, for instance, target companies that can demonstrate 10 to 20 years of strong financial performance, while KKR's Core Investment Strategy seeks businesses with secular tailwinds and minimal disruption risk.

The variation in strategy among long-dated funds also affects competition for deals. Core funds that seek lower risk/return profiles have the advantage of playing in a smaller competitive arena, since there are only a handful of firms currently employing the strategy. In fact, competition for core-style deals is more likely to come from the subset of sophisticated LPs that have built out direct investment shops than from other sponsors. As a result, most core fund deals are executed bilaterally. There are exceptions: In buying USI Insurance Services, KKR and Caisse de dépôt et placement du Québec (CDPQ) had to fend off rival bids from Carlyle and CVC, both firms that also operate core strategies.[5] By contrast, long-dated funds that target higher risk/return profiles and have greater flexibility to mix short and long hold periods within their portfolios invest in a broader universe of potential targets. However, these funds are more likely to compete with traditional PE firms for deal flow.

Fundraising

The LP base for both core and non-core long-dated funds is diverse. Investments in core funds skew toward SWFs, insurance companies, and select pension plans, while non-core long-dated funds lean more heavily on foundations and endowments, family offices, and HNWIs.

Both core and non-core funds have seen fundraising success thus far. Most recently, Blackstone's Core Equity Partners II raised $8.2 billion in late 2020, a 70% step-up from its predecessor. However, it is unclear how much of this fundraising success is more than a product of the current auspicious fundraising environment, particularly for the largest managers. LPs want to increase their PE allocations and often prefer to do so within existing manager relationships; core funds have benefited from this.

Non-core long-dated funds have also seen noteworthy fundraising success; for instance, Altas Partners Fund II pulled in $3.0 billion in 2019, a 200% step-up from Fund I. The universe of LPs that are willing to not only invest in a first-time fund, but to lock up capital for an extended duration, is small, meaning that only top-tier managers are likely to succeed. This helps to explain sizable ($1 billion+) first-time fundraises of the three most prominent non-core long-dated funds—Altas Partners, Cove Hill Partners, and Core Equity Partners—all of which were pedigreed spinouts. We've heard LPs are pushing new managers seeking to raise long-dated funds to dial back their ambitions to a traditional fund structure, at least for the first fund.

For this reason, any new long-dated fund strategies are more likely to come from the other large PE firms jumping on the core bandwagon. In addition to diversifying product offerings, raising a core fund can give large managers the opportunity to do deals that fall outside the risk/return profile sought by their traditional PE funds. KKR closed two deals within the months of its initial Core Investment Strategy fundraise based on the deals it already had in the pipeline. Large PE firms can either assign dedicated professionals to their core strategy, as Carlyle and CVC have done, or, like KKR and Blackstone, manage the core strategy alongside traditional buyout funds without adding headcount. The former promotes concentrated focus on the core strategy, while the latter facilitates deal sourcing and access to sector expertise across the organization.

5: "Caisse Joins KKR in $4.3 Billion Deal for Onex's USI Insurance," Bloomberg, Devin Banerjee, Scott Deveau, and Frederic Tomesco, March 17, 2017.

The lower middle market could also see new long-dated fund entrants. Lower-middle-market funds can seek smaller commitments from family offices and HNWIs and operate in a completely different market space from the larger core and non-core long-dated funds. Permanent Equity, a firm which targets family-owned companies with $2.5 million to $15.0 million EBITDA, raised $300.0 million for its second fund—an impressive step-up from its $50.0 million Fund I.

Outlook for long-hold strategies

In evaluating the prospects of long-dated funds, one key question is whether market forces will continue to advantage long-hold strategies. There are several competing factors at play. Many of the companies which long-dated funds have invested in, such as KKR's Heartland Dental Care, are clear buy-and-build plays, an increasingly popular strategy in PE. Our data reveals that the largest roll-ups are overwhelmingly passed from one sponsor to the next. Long-dated funds represent an alternative to this, allowing firms to continue driving inorganic growth for a successful buy-and-build rather than passing it along to the next sponsor.

At the same time, median holding times are on the decline across PE overall. Whereas many expected that the COVID-19 pandemic, like the global financial crisis (GFC), would force GPs to hold portfolio companies for elongated periods, the runaway market recovery has instead pushed holding times down in 2021. According to Anthony DeCandido, partner and financial services senior analyst at RSM, many GPs are seeing an IRR pop post-pandemic that could incentivize them to exit and collect carry sooner than was initially planned.[6] This is particularly true in technology and tech-enabled sectors. Going forward, the PE industry could see these trends growing in parallel, with more GPs finding ways to compound steady cash flows over longer time horizons while others focus on shorter investments in high-growth companies. The largest firms, of course, can play both games at once, and have already begun to do so.

Another key question in evaluating the outlook for long-dated funds is whether the growing popularity of LP direct investments, GP-led secondaries, and single-asset strategic partnerships/joint ventures represents a competitive threat. Many LPs with extended investment horizons would prefer to make long-term investments directly, and will do this to the extent that resources allow. However, only a handful of LPs have developed internal teams that can successfully execute a direct investment strategy on a large scale. This means that many LPs that want exposure to a long-term appreciation strategy will allocate to long-dated funds even if they partially view them as a "fee grab" by the largest managers. It is also why the coinvestment opportunities offered by some long-dated funds have been particularly attractive to LPs.

GP-led secondaries represent another avenue for LPs to gain access to long-term compounding gains without committing to a traditional long-dated fund. For one thing, LPs can now invest in single- or

6: Anthony DeCandido, telephone interview with Rebecca Springer, May 12, 2021.

multiple-asset continuation vehicles, some of which have a long or perpetual life. Examples include Blackstone's massive recapitalization of BioMed Realty; Clearlake's rapid fundraise of a continuation vehicle for Ivanti;[7] and TA Associates' Select Opportunities Funds I and II, which invest in companies sold by TA Associates' own flagship funds. We've heard there are more continuation funds currently in the market than ever before. While the types of assets purchased by continuation funds vary, they include companies with a comparable risk/return profile to that targeted by core funds. Additionally, some LPs have also teamed up with GPs on strategic partnerships, recycling pools of capital through multiple deals over a long time horizon. In a noteworthy partnership, Mubadala bought a stake in Silver Lake while contributing $2.0 billion to seed a 25-year investment strategy.

The rising popularity of GP-led secondaries may also change the calculus for LPs in a different way. It erodes the differentiation between a long-dated fund, which is essentially a more concentrated buyout fund with built-in long-hold optionality, and a traditional buyout fund that is willing to run a restructuring process at the end of the fund's life. BayPine, a tech-focused first-time fund GP led by Silver Lake co-founder David Roux, advertises its plan to hold companies for longer periods than traditional PE funds, even though BayPine is not a long-dated fund. Of course, not all managers are willing to run secondaries processes on their funds. (Large managers with core funds may be particularly wary of transferring fund assets into continuation vehicles because of the risk of cannibalizing potential core fund investments.)[8] Moreover, the potential conflicts of interest that can arise when assets are sold from one fund to another managed by the same GP may steer LPs away from this option. Still, the growth of GP-led secondaries means that long-dated fund managers must differentiate themselves through exceptional deal sourcing, discipline, and execution.

Conclusion

The immaturity of long-dated funds as a strategy—especially relative to the time horizons involved—means that the initial value proposition is still being tested. We will be watching how the current long-dated funds perform over the coming years, and whether significant performance variations emerge among the current cohort. Ultimately, the prospects for long-dated funds will depend on whether they can deliver as promised on deal sourcing and long-term MOIC growth over the next decade and beyond.

7: "Big Names Line Up for Clearlake's Ivanti in 'Fastest-ever' GP-led Secondary," Buyouts Insider, Chris Witkowsky, September 25, 2020.
8: For example, in 2017 Carlyle's 2007-vintage flagship and 2008-vintage financial services funds exited their investment in The TCW Group partly by selling a minority stake to Carlyle Global Partners.

Appendix: Tax considerations for long-dated funds

Previous analysis of long-dated funds has claimed they offer advantages to LPs by delaying and reducing exposure to taxable events caused by portfolio company exits. However, according to Michael Nader, Partner and North East Region leader of the Investment Fund Tax practice at RSM, the real picture is more nuanced.[9] Long-dated funds have the potential to pose both tax advantages and disadvantages to LPs, depending on a number of factors.

The 2018 Tax Cuts and Jobs Act generally ended the ability to deduct dead deal transaction costs and professional fees as portfolio investment expenses for individual tax returns. This means that some (taxable) LPs enjoy less shelter from the sizable professional fees associated with buying and selling portfolio companies—advantaging long-dated funds that buy and sell companies less frequently.

However, Nader also described a tax disadvantage for long-dated funds: disqualification from making an electing investment partnership (EIP) election under §743(e). When interest in a partnership is transferred between partners and there is an unrealized loss in the partnership greater than $250,000, tax law requires the partnership to calculate the basis for the unrealized underlying property periodically to track changes in the transferred interest—an intensive process that can increase tax preparation costs. This can be avoided by making an EIP election. However, the EIP election criteria exclude funds with a duration of greater than 15 years, including extensions. Although the circumstances that lead to the need to make an EIP election are uncommon, they can arise when an LP transfers interest in a fund to another LP, as is sometimes facilitated as an early liquidity option for long-dated funds.

Finally, according to Nader, long-hold strategies offer significant tax advantages to GPs because their investments easily clear the three-year threshold for treatment of carried interest at the long-term, rather than short-term, capital gains rate. Although PE firms usually hold portfolio investments for more than three years, exits in a shorter timeframe are not unheard of, especially in the current high-multiple environment. (For example, Blackstone bought Refinitiv on October 1, 2018 and sold it on January 29, 2021). LPAs for traditional PE funds typically include carried interest waivers to work around this possibility, necessitating a delay in realizing carried interest. By contrast, many long-dated funds avoid this risk altogether.

None of these tax considerations will likely serve as deciding factors in a GP offering, or an LP investing in, a long-dated fund. The ability to compound returns over an elongated period and to incur transaction fees less frequently—not to mention fund performance and discounted fees and carry—will have a much greater impact on an LP's bottom line. Nevertheless, it is important to recognize the additional complexities introduced by employing a nontraditional fund structure and to weigh these incentives and disincentives against the alternatives.

9: Michael Nader, telephone interview with Rebecca Springer, May 12, 2021.