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# Can Private Equity Reinvent Itself as Patient Capital?

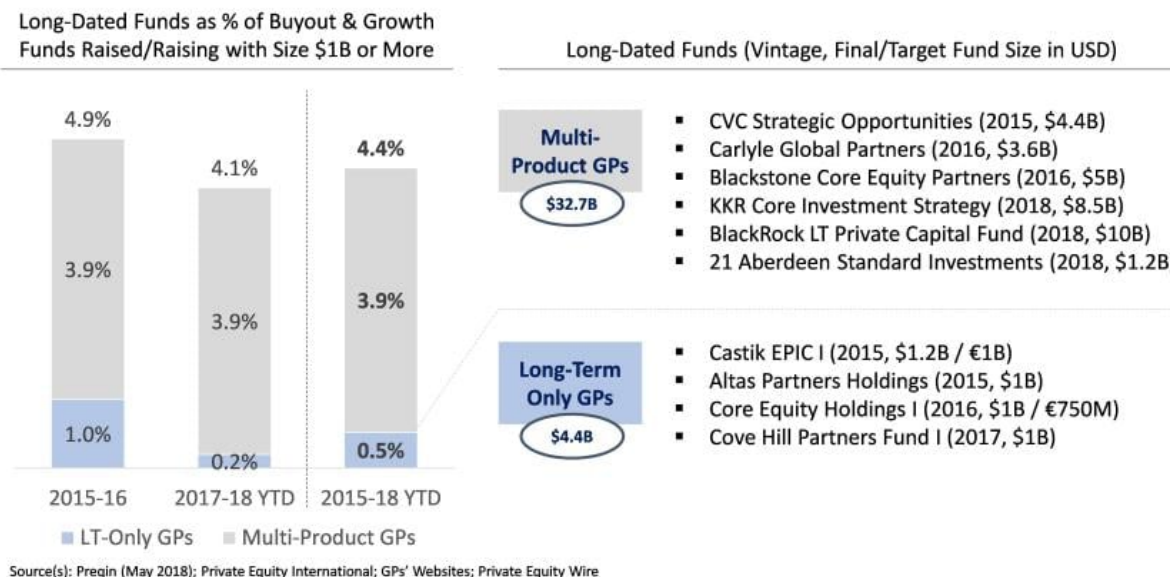


By Kyle Lee (INSEAD MBA '18J) and Konstantin Synetos (INSEAD MBA '18J)

## **There is a rising trend against short-termism in private equity.**

Private equity is seeing unprecedented capital inflows from institutional investors, amid sustained low interest rates, return compression across traditional asset classes and concerns that the longest-running bull market in post-war history may soon end. A new product has attracted a meaningful slice of those allocations – private equity funds with a life span of 15-20 years. Since 2015, and just counting funds larger than US\$1 billion in size, nearly US\$40 billion worth of long-dated funds has been raised, with new dedicated funds at multi-product firms such as KKR, Blackstone, CVC, Carlyle and BlackRock accounting for over 85 percent of that amount.

## Recent Examples - Long-Dated Funds Fundraising Statistics (2015-1Q'2018)



Structurally, such funds are willing and able to hold on to an investment beyond the typical PE three-to-seven year holding period and in some cases, forever. But that does not preclude investment managers from exiting businesses earlier if good opportunities arise. Private equity funds are not alone in this pursuit. Other sources of private capital -- most notably institutional investors (Canadian pensions in particular), sovereign wealth funds and family offices -- are also beginning to engage and show interest in undertaking deals with a longer investment horizon.

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

## Implications for corporations

The ideal private equity investment follows a tried and tested pattern: Invest at an attractively low valuation, add as much value as possible during the hold period and then sell for as much as possible roughly five years later. At times, however, exit timing is dictated not by business rationale but by fundraising pressure from limited partners (LPs) seeking distributions and a verifiable track record. In the standard holding period, PE model fees, taxes and other financial frictions – not to mention disruptions in management

when switching owners – lead to significant return leakage. Bain’s analysis of a theoretical deal reveals that returns from a 24-year holding period were almost twice those from a series of re-underwrites in the same deal (as would be required in the traditional PE model). Some private equity players are now changing their mindset.

*“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*

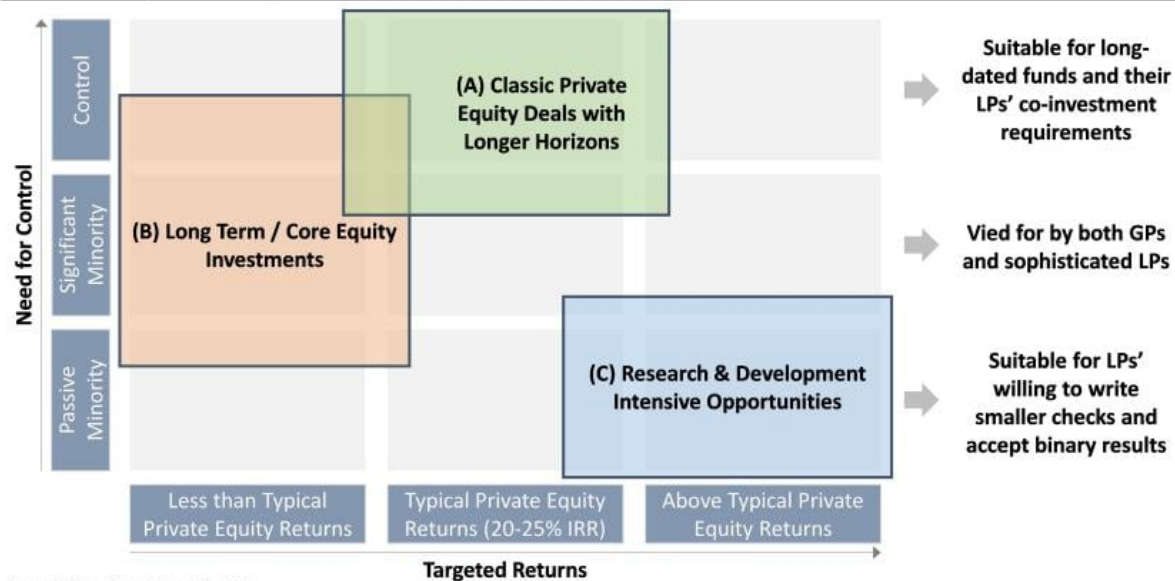
Business owners, too, have good reason to avoid the ‘PE treadmill’ of sprinting for short-term gains and constantly having to adjust to new strategic goals and processes with different PE owners. Longer holds afford the structural capacity to pursue strategic initiatives that are longer-term in nature with J-curves that are not ideal for shorter hold periods.

Long investment horizons also allow businesses and their owners to navigate economic cycles, perhaps even capitalising on downturns to engage in strategic acquisitions at accretive multiples. In short, this model may allow management teams to focus more on execution than upwards management.

### **Three long-term capital strategies**

It is important to know who you are working with. All funds are likely able to write very sizeable equity checks, but different pockets of long-term capital have different characteristics and expectations. There are three strategies that are commonplace in long-dated funds, LPs and other institutional investors pursuing long-horizon deals.

## Core Strategies of Long-Term Investing



Businesses with succession issues and those looking to sell control should consider dealing with independent long-term GPs or highly hands-on family offices/holding companies. These investors are looking for standard PE returns of 20-25 percent IRR but are willing to take a more long-term view to getting there. Expect them to be involved in initiatives such as a strategic transformation of the business or a series of bolt-on acquisitions as part of a massive buy-and-build play.

Those seeking patient growth capital can consider working with multi-product GPs who will consider either significant minority positions or control positions. Such investments, dubbed “core equity”, typically seek a lower return threshold (think low-to-mid teens IRR). Investors in core equity may not be as operationally involved as the independent GPs, instead opting to back secular growth/demographic trends and/or crisis resilient plays. Given the low resource intensity for investors, multi-product GPs are not alone here – institutional investors such as SWFs and sophisticated pensions will be keen too.

R&D-intensive businesses, with their deep J-curves and extreme hit-or-miss outcomes, do not have a place in long-dated funds. But SWFs and pension funds are beginning to consider opportunities such as 20-year patent royalties, new-age jet engines, genomics-focused biotechnology and autonomous driving as part of long-term investment portfolios.

*“Some sectors need more time for value extraction, with investors who can ride a downturn.” – Partner, Global Placement Agent*

## **Predictions**

Going forward, more investors will likely be willing to partner with corporations with stretched investment horizons. There is room in institutional investors’ growing alternatives assets programs to accommodate more long-term capital, and PE firms are going to respond with more long-dated funds, larger ones, a wider variety of instruments, and perhaps even forays into early-stage investing.

We expect to see more corporations and institutional investors cutting out the GP middle-man and pursuing deals directly. Operationally less intense, core equity type deals are well suited to this trend, with Canadian pension funds and select SWFs on the leading edge. But most institutional investors are still geared toward traditional PE deals, both in terms of their mind-set and talent pool. Therefore, education to shift boards’ and investment committees’ thinking toward a longer-term orientation will be crucial before long-term investing can scale.

Finally, it will be interesting to see how the GPs of long-dated funds will compete with traditional GPs in deal sourcing, as well as the type of operational and strategic value-add a GP can bring to a business over the course of 15-20 years. Will sellers place more value in the price investors are willing to pay, or the patience and long-term partnership benefits that could accrue in the longer run? Time will tell.

*This article is based on [a student research project](#) written under the supervision of Senior Affiliate Professor of Decision Sciences and Entrepreneurship and Family Enterprise [Claudia Zeisberger](#). The authors welcome feedback and comments.*

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