WHITE PAPER

Buy and hold: the role of long-term private capital in your portfolio

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PRIVATE EQUITY

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Key takeaways:

- Recently there has been an increase in private equity funds being raised with a focus on longer-dated investment strategies, often referred to as Long-Term Private Capital (LTPC).
- Seen as a natural evolution from traditional private equity, LTPC strategies tend to focus on economically durable operating assets that are suitable for holding over a long time horizon (15 to 20 years).
- LTPC strategies aim to connect institutional investors wanting long-term exposure to high-quality, well established companies with businesses seeking long-term patient capital.
- LTPC strategies can fill a valuable gap for institutional investors within their private markets asset allocation and, given the investment strategy focuses on resilient, well-established companies, it allows institutional investors to allocate larger portions of capital to this private markets strategy.
- LTPC strategies also provide a vehicle that aligns with many of the objectives institutional investors are focused on, including:
  - the ability to compound returns over the long term;
  - reduced fee leakage and lower portfolio churn;
  - material co-investment opportunities;
  - lower gross to net spreads than traditional private equity; and
  - the ability to make a true impact on the ESG footprint of a business over the long term, which in turn increases the potential to add value.

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Private equity investing has largely been synonymous with the model of a 10-year fund. However, over the last few years general partners (GPs) have been raising longer-dated funds with fund lives of up to 20 years, representing a new chapter for private equity.

Under the traditional approach, the GP looks to implement a series of value-adding initiatives in quick succession before the fund life matures. Consequently, the average holding period of an asset for a private equity owner is between three and five years.

While the traditional private equity approach has been highly successful, there is a large set of businesses that do not conform to the traditional criteria, but nonetheless have attractive qualities and the ability to create value over the longer term. Specialist long-dated private equity strategies have formed to address this gap. These LTPC strategies are complementary to traditional private equity models and the benefits they offer may help investors fill specific niches in their alternative asset allocations.

What is Long-Term Private Capital?

LTPC strategies provide investors with access to economically durable, operating companies that are suitable for holding over a longer time horizon than is typical for private equity investments. These strategies aim to connect investors wanting long-term exposure to high-quality and well-established companies with businesses seeking stable capital over a similar long term horizon.

There is a large cohort of productive businesses that cannot be accessed through public markets or buy-out style private equity simply because these ownership models are not appealing to them. The typical playbook of buyout funds involves higher levels of leverage, intensive value-adding activity and resale after a few years. This approach has been highly effective for businesses that have capacity for rapid operational improvement and earnings growth, but may not work with more mature businesses that are looking for a true long-term approach to growth (see Figure 1).

LTPC strategies allow an investor to access businesses with strong market positions and

FIGURE 1 CHARACTERISTICS OF COMPANIES SUITED TO DIFFERENT OWNERSHIP MODELS

Company characteristics	Traditional buyouts	Long-term private capital
Growth profile	Potential for significant change in EBITDA in short and medium term	Focused on sustainable, long-term growth over time
Operational performance at purchase	Varies depending on whether driver is growth or operational efficiency	Strong, usually market leading position
Management team	Approaches vary - management change can be part of value creation, but may also be incentivised by the short-term exit time horizon of the buyout fund	High-quality, committed management is a key part of the investment proposition. Succession planning is important over the long-term
Time horizon	Focus on 3-to-5-year timeframe	Focus on long-term ownership and compounding returns over 10+ years
Leverage	Higher levels of leverage	Low to moderate levels of leverage

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resilient financial profiles, whose management teams are taking a long-term view of growth and value creation. There are several advantages of having a stable, patient, long-term partner for founders and management teams as opposed to cycling through a number of private equity firms.

The longer hold period allows company management to focus on strategy and operational improvements without the cyclical distraction of preparing for the business resale every few years. In traditional private equity, strategic decisions which will drive longer term value are often postponed if an exit is anticipated within 12-24 months, as the sponsor is unlikely to make a return on that investment. However, with the support of long-term investors, these businesses can focus on delivering strategic multi-year, value-enhancing activities and unrealised opportunities that drive a continued step up in EBITDA. This, in turn, helps to create compounding shareholder returns over a longer period (see Figure 4).

LTPC strategies allow investors to better manage exit timings to match business performance, strategy, and overall economic conditions. This contrasts sharply with traditional private equity strategies, where exits are often driven by the fund-life ending and therefore the need to exit investments prematurely before the full value-creation plans are achieved.

A long term investment horizon promotes greater flexibility around exit timing and allows companies to weather economic conditions, thereby reducing the timing risk associated with when an asset is bought or sold. More broadly, taking a longer-term investment horizon and more conservative approach to leverage provides a marked level of resilience against potential turbulence across economic cycles.

The companies that are typically relevant for LTPC strategies are mainly found within three or four groups, including:

- family and closely held companies
- large corporates selling or spinning off non-core businesses
- publicly listed companies that are better suited to private ownership
- businesses being sold by private equity firms.

Where LTPC strategies fit as part of investors' asset allocations

For investors, an LTPC strategy can fill a valuable gap within their private markets asset allocation. LTPC strategies have different risk return profiles to traditional private equity, however can be viewed as a natural extension of the asset class (see Figure 2).

Opportunities that are suited to a LTPC strategy do not fit the parameters of traditional private equity, infrastructure, or listed equities investments. However, they can still generate attractive risk-adjusted returns. These are assets with key characteristics including:

- being in markets with favourable industry structures
- enjoying strong market positions and high cashflow conversion
- having resilient business models and highly capable management teams.

Built-in liquidity windows

While long-term investment is the central tenet of LTPC, one of the key structural points of an LTPC strategy is the ability to provide investors with liquidity when required. One of the better liquidity mechanisms available is for the GP to appoint a secondary market maker for limited partners (LPs) who wish to sell some or all of their stake, with other LPs having a first right of refusal. There exist well-established secondary markets including dedicated secondary funds that are able to provide this liquidity to investors. GPs, however, may only provide this liquidity after a certain period of time has elapsed (e.g. five years).

FIGURE 2 LTPC STRATEGIES RELATIVE TO OTHER EQUITY INVESTMENT CLASSES

Indicative Gross IRR: Lower → Higher

Category	Core Infrastructure	Core + Infrastructure	Long-term Capital	Traditional Private Equity	Venture Capital
Capital Intensity	High	High	Variable	Typically Less	Typically low
Typical Characteristics	▪ Monopoly or exclusive right to operate ▪ Formal regulatory framework or Concession Agreement	▪ Dominant market positions or exclusive rights to operate ▪ Long term contracted cash flows ▪ Limited or no regulation ▪ Significant hard asset backing	▪ Favourable industry structures ▪ Strong market position ▪ Ability to withstand disruption ▪ Cash flow positive ▪ Contracted or habitually recurring cash flows ▪ Ability to pay sustainable dividends ▪ Potential for some cyclicality ▪ Limited or no regulation ▪ Platform for long term growth (product, geography)	▪ Good market position(s) ▪ Growth options ▪ Cost out opportunities ▪ Unregulated (typically) ▪ Require multiple exit options	▪ Early stage ▪ Typically not cash flow positive ▪ High loss rates
Example Industry / Sector	▪ Land registries ▪ Pipelines ▪ Air and sea ports ▪ Toll roads ▪ Utilities	▪ Car parks, parking meters ▪ Data centres ▪ Embedded infra (gas gathering lines, processing plants) ▪ Market exchanges	▪ Business services ▪ Consumer staples ▪ Distribution networks ▪ Embedded technology service providers ▪ Healthcare and aged care ▪ Logistics ▪ Packaging ▪ Waste / environmental	▪ Sector agnostic (ex. Infrastructure, Real Estate, Mining)	▪ Sector agnostic but a general focus on technology and medtech

Typical Leverage: Higher → Lower

Overall, target assets are more economically durable and are likely to have lower growth profiles than traditional private equity targets.

As a result of the economically durable and resilient profiles of businesses LTPC strategies tend to invest in and the typically larger transaction sizes of these investments, investors are also able to deploy scale dollars at relatively lower risk levels while also providing the opportunity for more meaningful co-investment. We expect many investors seeking to increase their exposure to private equity may consider these long-dated funds as a useful vehicle.

Great things take time: the benefits of a longer-term investing model

From compounding returns to less portfolio churn, we believe LTPC strategies provide vehicles that are well aligned with many objectives institutional investors are focused on.

Compounding returns over a longer term

As noted earlier, in traditional PE investments, exit timings have often been driven by fund life and the payment of carried interest rather than business rationale. GPs are often incentivised to divest a company early in order to crystallise the payment of carried interest or to pave the way for a successor fund to be raised. LTPC strategies may help alleviate some of these alignment issues and allow investment returns to compound over the longer term.

Public markets will continue to be an important part of an investor's portfolio, providing returns and liquidity to investors. However, taking a longer-term investment approach provides GPs with the ability to hold onto good investments and allow returns to compound over time, avoiding the short-termism that has developed in public markets. Having long-term investors also allows business management teams to focus on long-term value creation and development activities, rather than meeting short-term market expectations. This strategy is a marked departure from the one seen in today's heavily-traded listed markets, where management teams are largely beholden (and incentivised) to manage in short-term windows governed by regular public reporting (see Figure 3).[1] The short-termism of today's public markets is at odds with the long-term outlook of investors such as pension funds, whose investment decisions are made for the benefit of members many decades from now.

FIGURE 3 KEY FOCUS AREAS FOR LONG-TERM INVESTING: COMPARISON OF LISTED EQUITY MARKETS AND LTPC STRATEGIES

	Listed equity markets	LTPC
Short Termism	▪ Next reporting date focus	▪ Long term focus
Capital Management	▪ Dividend yield focus (in Australia) can limit capital for growth initiatives/ long term value creation	▪ Prudent leverage ▪ Regular dividend payments or ability to support high ROI initiatives
Management Distraction	▪ Multifaceted stakeholders constantly distract senior executive teams ▪ Reasonable amount of CEO's time spent on investor relations ▪ Directors independent vs aligned	▪ Flexibility to compound shareholder value over longer term ▪ Aligned directors
Liquidity	▪ Daily	▪ Liquidity facilitated annually
Compliance/ Regulation	▪ Increasingly burdensome	▪ Commercially focused governance
Regulation	▪ Agency risk. Short term focus can drive inappropriate decision making which negatively impacts shareholder value over the long term	▪ Focused on long term performance
Management Incentives	▪ Various	▪ Asset owner aligned fee structure ▪ Greater capture of alpha by investors ▪ Compounding effect of reduced transaction fee leakage and lower fees arrangements

[1] Harvard Business Review, Does Business Need a New Model, 2021

Pension funds and other investors with long-dated liabilities need a model that leverages the advantages of traditional private equity, but is structured in a way that is better aligned with their objectives. Through LTPC strategies, investors can capture the best of both worlds.

Similarly, while they have undoubtedly performed well for institutional investors, when the goal is maintaining long-term exposure to quality investments, the structure of traditional private equity strategies is not a good fit. At worst, this can create a misalignment of interests.

In the context of traditional buyout funds, the shorter fund life means that LPs are often accepting distributions more frequently as assets are sold and funds wind down. As a result, a significant amount of time and resources are spent by LPs re-deploying capital into funds on a yearly basis.

A long-term ownership model helps to alleviate the re-deployment issues and creates a better alignment of interests between LPs and GPs. Pension funds and other investors with long-dated liabilities need a model that leverages the advantages of traditional private equity, but is structured in a way that is better aligned with their objectives. Through LTPC strategies, investors can capture the best of both worlds.

Reduced fee/cost leakages from lower portfolio churn

The private equity buyout market has grown and matured over the last 30 years. In the search for alpha in the prevailing macroeconomic conditions, LPs have been increasingly looking to their private equity allocations. This has resulted in the asset class becoming crowded and significant competition for quality investments.

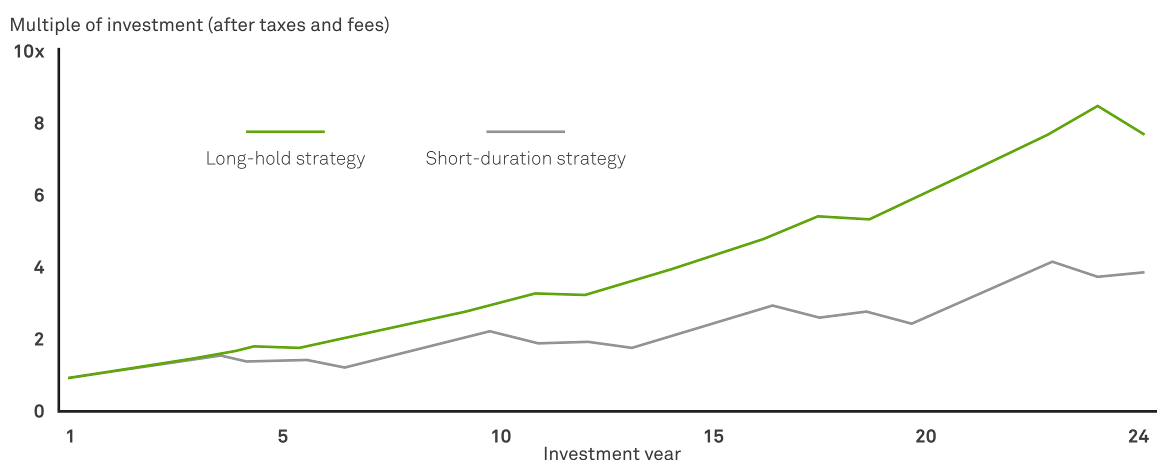
It is estimated that a good proportion (~40%) of private equity exits are to other private equity firms in the form of secondary buyouts.[2] This means that there are private companies that are serially changing hands among investment managers, with some reports estimating that more than 500 companies have been owned by three-or-more private equity firms.[3]

In these circumstances, LPs could have repeated exposure to the same asset and incur transaction costs and new layers of fees (management and carried interest) and taxes each time it is bought and sold.

This fee leakage can have a large impact on returns when repeated over a long time horizon and across several funds.

Modelling conducted by industry experts effectively illustrates the impact of this leakage. The model considered the costs and returns for the same theoretical portfolio company under two scenarios. In the first scenario, the company was held for 24 years

FIGURE 4 LONG-HOLD FUNDS OUTPERFORM OVER THE LONG HAUL



Source: Bain and Company analysis, 2018

[2] Degeorge, Martin, & Phalippou, 2015
[3] Bain Global PE Report, 2018

in a longer-hold fund. This was compared with the second scenario, where the company was sold four times over the same time period by a traditional buyout fund (see Figure 4).

The modellers found that the longer-hold fund outperformed the short-duration fund by almost two times on an after-tax basis – a product of reducing transaction fees, deferring capital gains tax and keeping capital fully invested.[4]

Material co-investment opportunities for LPs

LTPC strategies lend themselves to greater co-investment due to the larger ticket size of these opportunities, allowing LPs to put greater scale dollars to work on investments at a lower level of risk than traditional buyout investments.

Co-investments play a key role in reducing LPs' fees and through LTPC strategies GPs are able to provide more co-investment opportunities than a traditional buyout fund.

Lower gross to net spread

Typically buyout funds target higher gross IRRs than LTPC strategies (e.g. 20%). In order to generate this level of return, GPs will often target riskier investments. However, the fee structure of a typical buyout fund (e.g. 2% management fee and 20% carried interest) means that on a net basis there is a significant proportion of the investment return that is paid away to the GP.

While LTPC strategies typically target a lower risk/return profile than traditional buyout strategies, most GPs of LTPC strategies are charging lower management fees and carried interest to ensure that their products are attractive to LPs on a net-return basis. The long-term nature of LTPC strategies also means that the partnership expenses and transaction costs of buying and selling investments is lower in an LTPC strategy. Further, the scale and size of LTPC opportunities and scope for co-investing can also serve to lower LPs' fees. As a result, LTPC strategies are often comparable to or lower than traditional private equity on a net return basis, and at lower levels of risk.

Addressing ESG opportunities and challenges to drive investment value

The link between the effective management of environmental, social and governance issues and investment value and returns is well understood by investors. Traditional value drivers are enhanced by taking a responsible business approach. However, many of the fundamental shifts required to deliver on ESG objectives – such as, reducing carbon footprints, pivoting workplace practices to achieve inclusion and diversity goals, unpicking and overhauling supply chains, among others – may require a longer time frame to execute, especially in larger, more mature companies or in certain industries. These are not quick fixes but require committed stakeholders focused on the sustainability of the business and its ability to create shared economic and social value over the long term.

One of the advantages of the longer hold period LTPC strategies affords, is creating an opportunity to support businesses to address the ESG issues they are facing. This approach is often aligned with investors' own in-house ESG objectives such as promoting portfolio net zero targets or diversity goals among many others. LTPC strategies allow investors to make meaningful and sustainable changes at the asset level over the long term.

Conclusion

At a time when institutional investors are increasingly turning to their private equity allocations to drive returns, new long-dated ownership such as LTPC strategies are side-stepping some of the structural limitations of traditional buyout private equity approaches.

LTPC strategies offer GPs long-term exposure to high-quality companies with a more aligned ownership model. The long-term nature of these strategies allows returns to compound over a greater time horizon, creates less fee leakage and portfolio churn, and offers better alignment with investor and ESG objectives. Additionally, the more specialised approach offered by long term private capital is signalling a new chapter in private equity investing.

Over time, as LPs become more familiar with LTPC strategies we expect this newer model of private investment to form a core part of a LP's asset allocation. For those stable companies seeking long term ownership and investors seeking long-term investments, LTPC strategies represent a complementary solution for both parties.

[4] Bain Global PE Report, 2018

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