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INVESTMENT MANAGEMENT

Post COVID-19 Crisis, Increasing Duration Could Open Up New Realms for Private Equity Managers

PRIVATE CREDIT & EQUITY | AIP PRIVATE MARKETS TEAM | INVESTMENT INSIGHT | 2020

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In today's world, durations in private equity investments have and will likely continue to extend. Why? The answer lies in the impact of crises in the 21st Century. Crises tend to have a long-lasting effect on holding periods. The median holding period of a private equity portfolio company in 2019 was more than 30% longer than leading into the Global Financial Crisis.[1] As a consequence, the median time it takes for a private equity fund to liquidate fully stands at more than 13 years, while the average term for a PE vehicle remains at 10 years.[2] While funds can be extended, Limited Partners (LPs) have become increasingly frustrated with the frequency at which fund durations exceed a decade. This persistent upward trend in duration and the associated illiquidity is a concern for investors, and partly explains why the average portfolio allocation to private equity is below what is generally considered optimal exposure. The amount of time it will take funds to fully liquidate is expected to only continue to increase in light of the current COVID-19 pandemic which, in turn, can easily

[1] McKinsey Annual Private Markets Review (2019)

[2] Palico Private Equity Marketplace Content

increase this allocation gap. Coming out of the current crisis, the industry will need to allay investors' concerns to drive allocation to the asset class and consider several new types of transactions which can provide some solutions.

This mismatch of duration and capital needs has a variety of root causes. The typical private equity fund structure has not adapted to the growing and maturing private equity market. The ten-year fund life structure, which was perhaps fitting twenty-five years ago, is still the backbone of the vast majority of funds today. As the private equity market has become more competitive and more efficient, General Partners' (GPs) value creation plans often take longer to execute than expected, elongating hold periods. GPs have typically wanted to hold on to their 'winners' in order to maximize their potential value, particularly during a market downturn. These situations frequently create conflict between GPs and LPs and among the LPs themselves—some of whom want to stay on for a longer period of time, while others demand nearer term liquidity to ensure sustained annual distribution activity. Despite these challenges, there are solutions that can combat the duration dilemma while allowing the GP to continue to manage a particular investment.

One solution has been the launch of longer duration or even evergreen private equity funds such as those introduced by well-known firms including Apollo, KKR, and Carlyle. While these funds are a natural solution to this issue, they appear unlikely to penetrate the private equity market on a broad level. Truly, only the largest private firms are able to provide investors with comfort that the governance, talent and focus required will continue to exist over these extended fund lives. This type of solution is well suited for the small group of investors in private equity funds have a structure that allows them to participate in such a long-dated vehicle.

Another answer is the sale of positions held within funds that have surpassed their fund life to another fund of a more recent vintage managed by the same private equity firm. This solution enables the manager to continue owning an asset that it views as attractive. However, a conflict of interest stems from the fact that a GP acts as a seller and a buyer simultaneously. Additionally, a GP may determine not to transfer 100% of the ownership of the asset into the more recent fund, creating misalignment of interests. Since processes for resolving these conflict issues are not typically addressed in fund documents, a number of LPs have struggled with lack of transparency, information asymmetry and limited time and resources to fully diligence such transactions. An independent third party responsible for pricing these transactions can add a lot of value for LPs in this situation.

The private equity secondaries market also provides[3] elegant solutions to addressing LPs' issues with duration. The most common transaction type within this space is the acquisition of a diversified portfolio of limited partnership interests by a dedicated secondaries fund. Moreover, a select number of secondary buyers take this approach a step further, employing a more concentrated approach that enables them to isolate and invest in specific assets. These transactions are known as "single-asset lift outs", "transformational secondaries" or "GP-led secondaries". Secondary buyers in these instances work with GPs to create vehicles that will hold one or more investments that the GP wants to continue to own and/or investments that require more time to achieve their full growth potential. Single-asset lift outs can provide significant benefits to both GPs and LPs. First, they allow GPs to continue to manage certain holdings for a longer period of time to extract additional value and, in some cases, provide them with follow on capital for use opportunistically. Second, they offer existing LPs the option to cash out or to remain invested for a longer duration. GP-led secondaries serve as a specialized solution for GPs that can address the challenges posed by the competing demands of the capital requirements of portfolio companies, limited fund lives and the liquidity needs of LPs.

Given the current environment and strong potential for holding periods to increase even more than where they are today, the industry will need to evolve for its investors. There are already signs that these solutions, particularly from the secondaries market, can address investors' concerns about duration and may be gaining in popularity as a result. In fact, total secondary deal volumes doubled from 2016 to 2019 , an evolution of the market that came as a surprise to many. Innovative approaches, like single-asset lift outs, have the potential to address the ongoing duration concerns that may have been preventing asset allocators from dedicating a greater proportion of their assets to private equity.

[3] Greenhill Global Secondary Market Trends and Outlook (January 2020)

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CRC 3214986 Exp. 08/25/2021 9890972_KC_0820
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