



Spotlight on Long-Hold Funds: Opening Up New Horizons

Longer-term investment vehicles can outperform—but only for the right types of assets.

By Hugh MacArthur

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Buyout firms typically aim to acquire companies and sell them profitably within three to five years. But that relatively short duration generates recurring costs for the funds and the limited partners (LPs) that invest in them, as well as recurring hunts for new assets by general partners (GPs). In recent years, a growing number of investors have decided to put some of their money in longer-term investment vehicles. Such patience presents an opportunity to generate higher returns on committed capital over the long haul, Bain's analysis shows.

Several large PE firms, including CVC, The Carlyle Group and Blackstone, have been launching buyout funds with longer lives. Blackstone raised \$5 billion for a fund with expected holding periods roughly double those of the traditional buyout fund. Two first-time funds, Core Equity and Cove Hill, also raised more than \$1 billion each in short order, with anticipated holding periods of up to 15 years.

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Two main types of long-hold funds have come to market. "Core" buyout funds target portfolio companies with lower risk and lower return (the name is a riff on the so-called core infrastructure funds that cover the lower risk/ lower return end of the infrastructure spectrum). CVC's Strategic Opportunities fund has a 15-year

life span and targets an internal rate of return (IRR) of 12% to 14% while charging lower fees. Its first investment, in UK roadside-assistance operator RAC Group, exemplifies the type of stable, low-growth assets that fit the core buyout fund model.

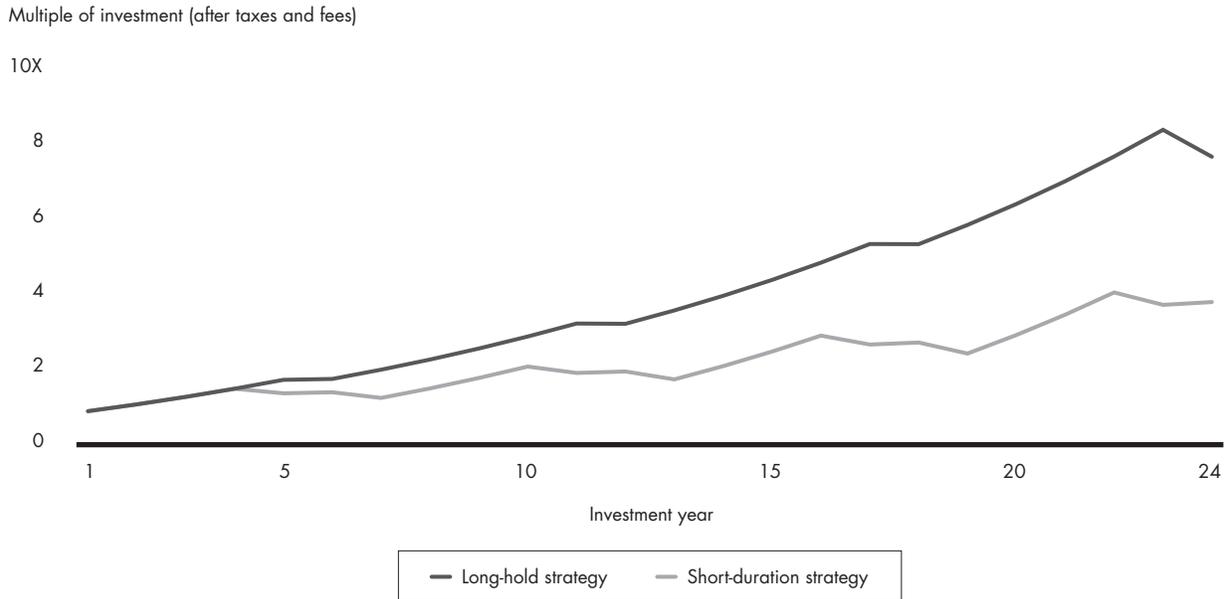
Another type of fund, which we call a long-hold buyout fund, targets risk/return profiles, as well as fees, in line with traditional buyout funds. For this type of fund, investors don't need to sacrifice a measure of returns in exchange for longer duration. In fact, each type of long-hold fund offers several advantages:

- Lower transaction costs, such as taxes and consultant fees, associated with buying and selling businesses
- Fewer distractions for portfolio company management
- Fully invested capital over longer periods and with less time waiting to be reinvested
- Deferred taxation of capital gains, allowing capital to compound over time
- More flexibility on the investment horizon, allowing funds to sell an asset at the optimal time
- Access to companies looking for patient capital, such as founder-led businesses that need capital to grow

Bain recently modeled costs and returns for a theoretical long-hold fund selling an investment after 24 years, vs. a typical buyout fund selling four successive companies over that period. If the fund's portfolio company performs in an equivalent manner during this period, by eliminating transaction fees, deferring capital gains taxation and keeping capital fully invested, the long-hold fund outperforms the short-duration fund by almost two times on an after-tax basis, our analysis shows (*see Figure 1*).

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Figure 1
 Long-hold funds outperform over the long haul



Source: Bain & Company analysis

Not all assets lend themselves to this strategy—distressed properties, turnaround candidates or economic-cycle plays need not apply. To meet their IRR targets over a sustained period, long-hold funds typically seek inherently high-quality companies that are well positioned to compound earnings before interest, taxes, depreciation and amortization over a long time frame, with strong management, strong free cash flow, high relative market share and/or the opportunity to gain share. These businesses might be disrupting an industry and can take market share over an extended period, or have long tailwinds based on customer demographics like an aging population. Company size is less important than that strategic profile. To get a sense of how many companies might fit in a long-hold strategy, we looked for businesses that were owned successively by at least three PE funds. Reviewing

deals globally over the past two decades, we found more than 500 such companies.

How can investors ensure that they calibrate their risk underwriting correctly? Investors seeking to hold assets over a long period need a clear view of the duration risk that exists in most industries, as technology, regulations and competitive threats can change quickly. Re-diligence of portfolio companies on a regular basis, perhaps every three to four years, provides an updated understanding of industry dynamics and the competitive positioning of the asset. Shifting risks or opportunities inform the hold or sell decision. If the duration risk gets too high, pull the rip cord and sell. If the answer is to hold, then adjust the plan in order to keep creating value.

Long-hold funds are becoming compelling to GPs and LPs alike. However, one alternative model outside traditional private equity appears to be maximizing the benefits of long-term investments: professionally managed private capital holding companies. The Cranemere Group, a London-based private holding company founded by a former CEO of AEA Investors, exemplifies this model. Cranemere's primary investors include family offices and sovereign wealth funds, which seek strong returns on their capital, not short-term distributions.

Cranemere designed its structure specifically to allow investors to capture the benefits of a long-term approach. Investors become shareholders, not LPs, in the holding company. Most of Cranemere's management team and board of directors are shareholders as well. Shareholders have controlling governance rights that ensure alignment between investors and management. With no set investment mandate, as with a typical GP/LP relationship, the strategy can evolve over time. If investors want liquidity, they have an option after their capital is fully called: They will be offered an opportunity to sell shares annually within a certain window of time, based on mark-to-market valuations by an independent third party.

Having a permanent capital base means assets can be held indefinitely, with no need or incentive to exit an investment before it makes sense. It also leads to tax efficiency, as Cranemere is not required to distribute capital back to investors. Cash generated by a portfolio company goes first to the Cranemere holding company, not to shareholders, so there is no capital gains tax and the capital can be reinvested. Moreover, management can make attractive long-term investment decisions that would be harder to justify with a holding period of only three to five years.

Given that long-hold funds have just started to emerge in the marketplace, it's too soon to say how much capital they will ultimately attract. But for institutional investors (especially taxable investors) with long investment horizons, steering some capital to long-hold funds makes sense. For one thing, to compete with corporate buyers in M&A, especially for large assets, PE firms

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may need to act more like corporations and extend the duration of their investments. Doing so would give them more time to integrate add-on acquisitions and transform the assets. And for GPs that spend most of their waking hours either raising funds or buying and selling assets, having the flexibility of more years to hold and nurture great assets could be a welcome change. 

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