PitchBook

Extended Holding Periods in PE

How GPs can hold promising assets longer outside the original fund structure

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Key takeaways

- **With fewer attractively priced buyout targets, GPs believe that reinvesting in some of their most promising current portfolio companies may be the best way to earn additional fees and carry.** GPs are therefore seeking ways to continue holding these assets with further upside potential.

- **The GP-led secondaries space has been one of the largest winners from the proliferation of extended portfolio company holding periods.** A GP-led secondary transaction—whereby a GP rolls one or more portfolio companies out of the original buyout fund and into a special purpose vehicle (SPV)—allows the GP to retain total control over the portfolio company, extend the holding period past what traditional buyout funds allow and continue to profit from remaining upside potential. However, GP-led restructurings may disadvantage LPs depending on how the transaction is structured, the fees involved, and the pricing. On the plus side, these transactions afford LPs the option to maintain, decrease, liquidate or occasionally increase their existing exposure to the company.

- **Self-sourced funds are a more nascent phenomenon where GPs raise a fund with LP commitments and source investments solely from the GP's own buyout funds—**think sponsor-to-sponsor buyouts but only sourced from a GP's own portfolio. However, from an LP's perspective, these have several potential conflicts of interest. Additionally, funds where the GP retains a minority stake allow the GP to collect performance fees without contributing to the outcome of the portfolio companies.

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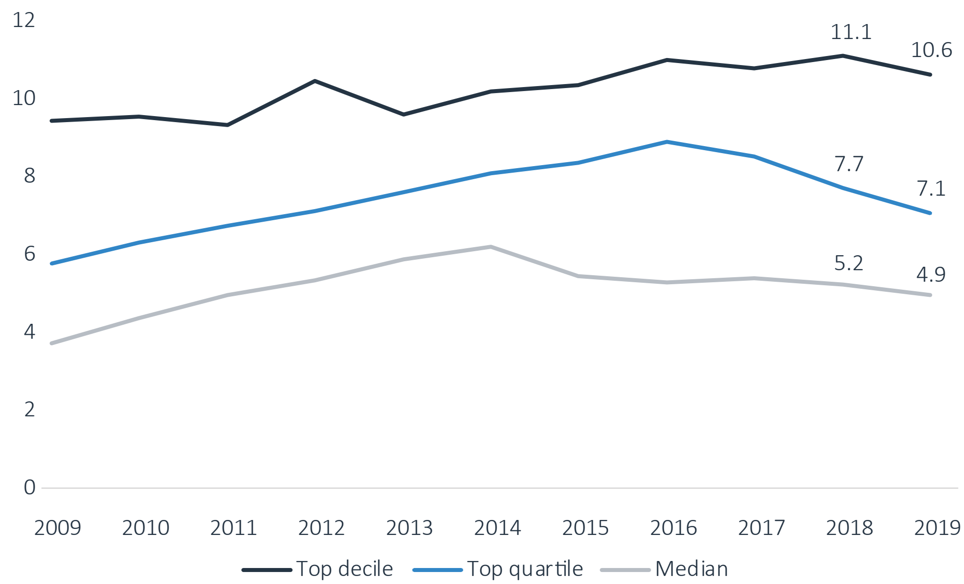
Overview

In its limited partnership agreement (LPA), the typical buyout fund has a lifespan of approximately 10 years.[1] Most LPAs allow the GP to extend this for two one-year periods with enough votes from the LPs at each extension. For the median portfolio company, which has a hold time of 4.9 years, these holding times still fit neatly into the contractual period. However, with the explosive growth in deal counts, a swelling number of PE investments are being held beyond the median timeframe. For context, in 2019, 25% of exited portfolio holdings had been in portfolios for 7.1 or more years; 10% had the same ownership for 10.6 or more years, longer than the typical fund life. While many of these assets are no doubt in "zombie funds" from the financial crisis—funds where the GP is not collecting carry because the assets are performing poorly and little is being done to remedy the situation—this note discusses extended holding times for well-performing assets that GPs are loathe to abandon. We believe structural changes, including the proliferation of long-dated funds and investors with long time horizons, such as family offices and sovereign wealth funds (SWFs), are also pushing out top-decile holding periods. This situation is largely not appreciated by LPs that signed up for 10 years. With hundreds of PE-held companies extending beyond the decade mark, some GPs are pursuing liquidity options that allow them to retain upside.

Distribution of PE holding times (years) by exit year



Source: PitchBook | **Geography:** US

1: Often the 10 years start from the final closing, so the real length is closer to 11 years.

With so many funds holding onto assets longer than LPs anticipated, it is vitally important to understand how GPs are addressing investor discontent with a fund's lack of expected liquidity (i.e. wrapping up the fund within the parameters agreed upon in the LPA). This break from the expected distribution cadence means LPs may have to adjust distribution projections and curtail future fund commitments if cash takes longer to flow back to the portfolio. Some holding options have fewer conflicts of interest than others and some are still not widely understood. Although this note focuses on liquidity options outside the original fund, longer holding times can also pressure GPs to offer liquidity options while keeping portfolio companies inside the original fund structure, which we will discuss in an upcoming note.

GP-led secondaries

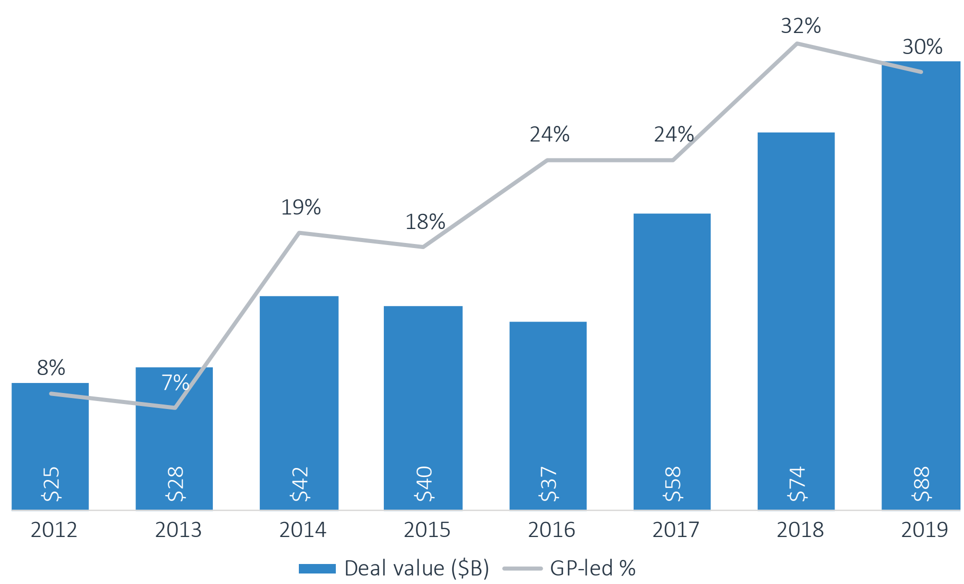
Due to growing LP need for liquidity and a portfolio rebalancing tool, the overall secondaries market—in which LPs sell fund stakes to other LPs or to specific secondaries funds—has matured significantly over the past decade. Under the broader secondaries transaction umbrella, GP-led secondaries have become a budding phenomenon and a larger part of the secondaries market. Although these types of transactions are somewhat infrequent, the GP-led secondaries space has become the industry standard for handling successful assets that can no longer be held within the original fund structure. The types of funds pursuing GP-led deals have shifted dramatically toward successful funds, with the average fund now exhibiting second-quartile performance, up from the fourth quartile in 2016.[2] The GP-led secondaries market fosters heterogeneity, with transactions ranging from simple single-asset deals to multi-asset restructurings with a stapled component. These deals can also demand quick reactions. The Institutional Limited Partners Association (ILPA) deems a 20-business-day turnaround best practice, but the bespoke nature of structuring SPVs, altering GP terms and valuing private assets may not allow enough time for an understaffed LP to go through 1,000+ pages of deal-related documents to reach a well-researched conclusion. The ILPA has put together a helpful resource for investors that explains GP-led secondaries.[3] The report focuses on best practices, some of the more technical aspects of explaining the mechanics, and definitions for GP-led secondaries. This note concentrates on helping investors understand the pros and cons of GP-led secondaries.

A quick primer on GP-led secondaries for those unfamiliar with the space: GPs with funds nearing the end of their contractual lives may choose to transfer some (or all) remaining assets into a new

2: SuperReturn US West 2020 conference, February 11, 2020.
3: "GP-led Secondary Fund Restructurings: Considerations for Limited and General Partners," Institutional Limited Partners Association, April 2019.

fund structure rather than force a liquidity event at an inopportune time. This restructuring entails the creation of a new SPV formed to hold the selected companies, which usually gives the GP another three to five years of runway. This new entity may contain new carry and management fee rates, which can be advantageous to GPs hoping to reset fund economics and realign incentives between the GP and LPs. GP-led secondaries often offer LPs several options: full liquidity,[4] the ability to roll their ownership into the new fund, occasionally the ability to increase their stakes, and sometimes a combination of these. While LPs have long feared that assets will be distributed to them in kind at the end of a fund's life, as is often permitted by the LPA, GPs are becoming more proactive in finding more palatable solutions for LPs that are interested in longer holding periods. The upside for GPs is that they can collect more fees if they are accommodating to the LPs' priorities.

Secondaries deal activity with proportion GP-led secondaries deals ($)

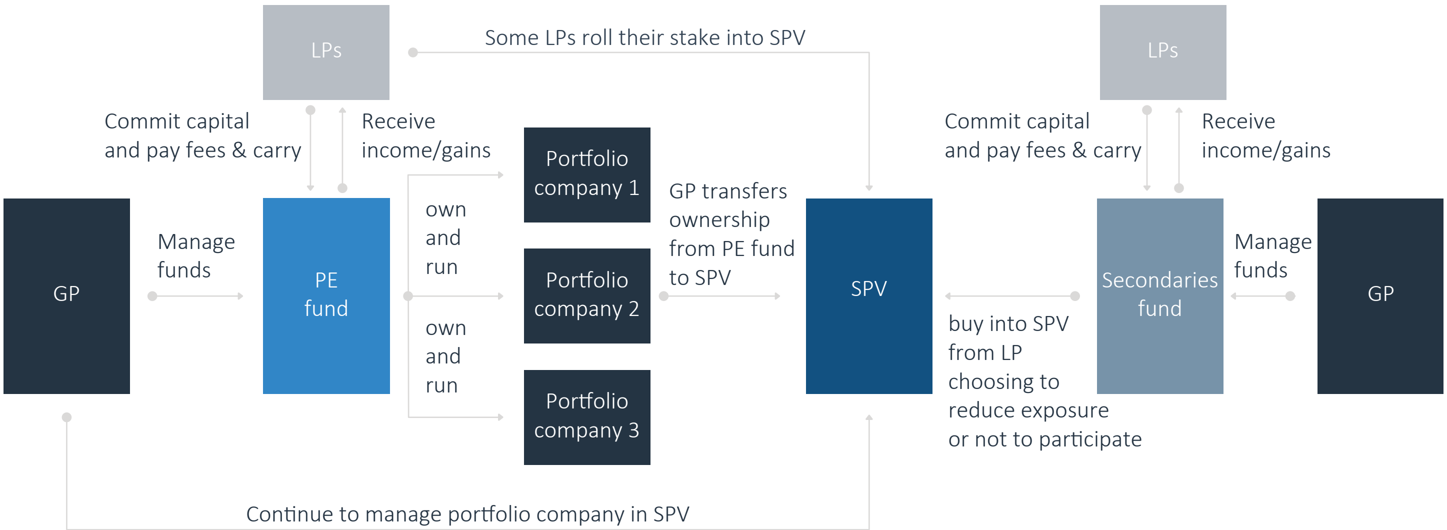


Source: Greenhill | **Geography:** Global

Secondaries activity overall has more than tripled in the past seven years and GP-led restructurings have gone from a relatively unknown option to nearly one-third of the market. There are generally two types of GP-led secondaries transactions: single asset and multi-asset restructurings. GPs may utilize these to reprice one or more underperforming holdings to realign incentives or to avoid selling a portfolio company that has hit its stride as the fund's life is ending. This note focuses on the latter scenario and covers both single-asset and multi-asset restructurings.

4: LPs achieve full or partial liquidity when secondaries funds, such as Lexington or HarbourVest, buy the stakes of LPs choosing to sell rather than participate in the rollover into the new SPV.

Example of a GP-led secondaries restructuring



To better understand GP-led restructurings, let's look at an example. Hellman & Friedman and JMI Equity purchased HR software company Kronos for $1.8 billion in June 2007. After an 11-year holding period that included the addition of some development capital from Blackstone, H&F's Capital Partners VI fund was nearing the end of its life. Despite Kronos holding significant upside potential, H&F had to start looking for liquidity options. They chose to pursue a single-asset GP-led restructuring in 2018 that allowed LPs to roll over their stake or cash out. However, in a rare move, H&F chose not to bring in outside investors, meaning any LP that liquidated sold to existing LPs or to H&F. In February 2020, Hellman & Friedman merged Kronos with Ultimate Software—which H&F, Blackstone and GIC had purchased for $11.0 billion in 2019—at a $22 billion valuation. The 10-year fund life was not long enough for H&F's value-creation efforts to play out. The GP-led restructuring extended the holding time to 13 years (and counting) and provided liquidity to LPs.

Pros

From the LPs' perspective, there are several pros to achieving liquidity through a GP-led secondaries transaction. LPs are given a choice as to how to participate in GP-led deals, which provides LPs a major advantage compared to other liquidity options. If an LP only desires to have exposure to buyout funds—which can vary substantially in risk-and-return profile compared to secondaries investments—they can opt out of participating in the deal and receive full liquidity; or, they can participate in the GP's vision for the asset(s). Additionally, LPs often have the ability to sell some ownership and roll over the rest—or, in some cases, to increase their stakes. The ability to fine tune their exposure provides an attractive opportunity to LPs.

In sticking with the investment, LPs maintain exposure to a proven company that the GP believes still has room to run. LPs may perceive this as a lower-risk investment than taking distributions and committing them to a new fund with unknown portfolio companies. Furthermore, after a decade or longer in their portfolios, LPs theoretically have a solid understanding of the investments and may feel more comfortable choosing the known over the unknown.

Cons

Due to the highly customized nature of GP-led deals, it is difficult to systematically judge the attractiveness of each specific offering. However, each GP-led deal requires LPs to perform thorough due diligence in a truncated timeframe. Additionally, four stakeholders must juggle competing interests as the transaction is negotiated: the GP, LPs wishing to roll over their stakes, LPs seeking liquidity, and any new investors buying into the SPV. Moreover, these investments likely have a lower return profile because the GP has already implemented the value-added programs envisioned at the time of purchase, and may not have the skillset to take the company to a new level that would merit significantly improved performance.

GPs do not typically offer liquidity out of the goodness of their hearts. In some cases, the deal allows GPs to cash in accrued carry on the deals, meaning they realize profits even if the company ends up languishing in the SPV. GPs can also structure an advantageous fee structure in the new SPV, allowing them to collect a management fee on assets that may have no longer been eligible for fees that late in the fund's life. Furthermore, if the new SPV allows for a better carry proposition, GPs could price the transaction on the low end, disadvantaging LPs seeking liquidity.[5] Those on the purchase side of the transaction also desire to pay a lower price—usually quoted as a percentage of net asset value (NAV)—because it gives them more upside potential. While many transactions utilize a third-party valuation company to arrive at what is meant to be a fair value estimate, this is not always an impartial situation, as much of the information the values are based on comes from the GP. In addition, just as credit rating agencies

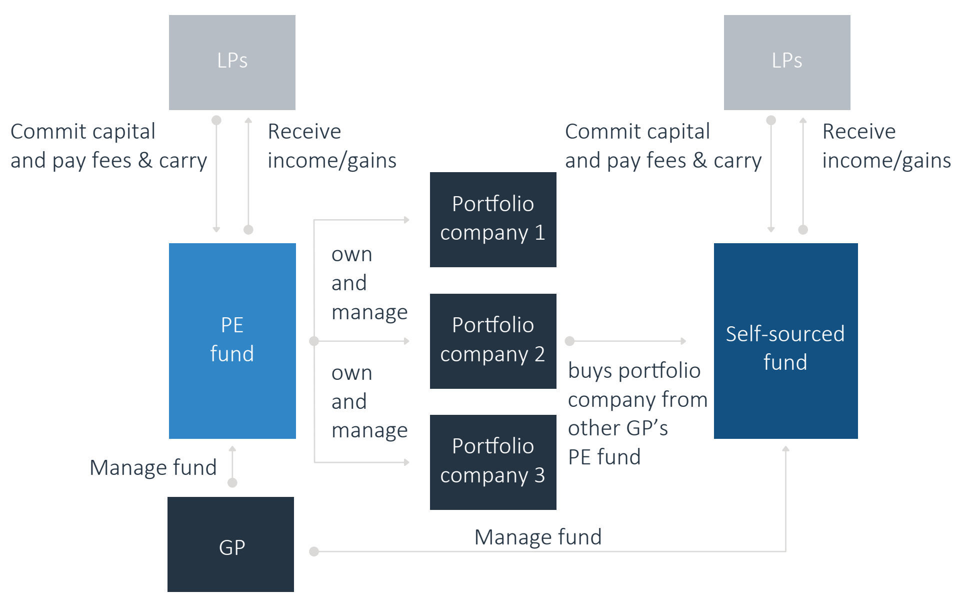
5: However, on the opposite side, GPs that want to raise funds in the future may want to price the transaction on the high end to boost the fund's IRR.

tend to provide generous ratings to secure future business, third-party valuations may be designed to please the party most likely to retain their services in the future.

Self-sourced funds[6]

This nascent and novel strategy is something we have only recently seen. In this scenario, a GP will raise a new fund from both existing and new LPs specifically for the purpose of purchasing companies from funds the GP already manages. These stakes can be majority stakes or minority interests retained after selling companies to other GPs. For example, if a flagship fund has two promising companies to sell, rather than selling to another GP or pursuing a GP-led restructuring, the GP could instead sell to a fund it manages specifically raised for this purpose. This is similar to the situation where GPs sell portfolio companies from one fund it manages to another. In one such example, Bridgepoint sold its stake in Dorna Sports out of its 2008 vintage Europe IV fund into its 2017 vintage Europe VI fund—effectively selling the company to itself.[7] However, a self-sourced fund is raised explicitly to purchase portfolio companies from other funds the same GP manages. To continue using Bridgepoint as an example, a theoretical self-sourced fund from Bridgepoint would only buy portfolio companies being sold from other Bridgepoint funds.

Example of a self-sourced fund structure



One high-profile example of a self-sourced fund comes from TA Associates. In 2019, the manager started raising a $1 billion fund—the Select Opportunities Fund—that will purchase minority stakes

6: Due to the nascence of this phenomenon, we are unaware of any preexisting naming conventions. If you know a more official name for these funds, please reach out to us at reports@pitchbook.com.
7: "Private Equity Firm Bridgepoint Sells MotoGP - to Itself..." Bikesportsnews, Robin Miller, February 15, 2019.

in positions that the GP is exiting but believes still have marked upside. TA realized that with many companies they end up selling, "the new buyer makes a lot of money on it as well," according to a source close to the fund.[8] And while TA's fund only seeks minority stakes, we can just as easily imagine funds that purchase majority stakes from prior funds. This strategy itself seems to be something a lot of GPs managing multiple strategies may pursue depending on the receptiveness of potential LPs. Self-sourced funds are a logical extension of current GP strategies and could provide LPs with a differentiated risk-and-return profile while helping the GP grow AUM.

Pros

If the self-sourced fund retains just a portion of the company being exited—whether minority or majority—this means a third party is involved and validating the purchase price. In these self-sourced funds, the LPs intentionally sign on for an extension of the GP's involvement in the deals. Compared to a GP-led secondaries transaction—in which an extension might blindside the LP—this provides a huge advantage. Self-sourced funds also give LPs the opportunity to project cash flows and allocation changes more accurately rather than scramble for a 20-business day turnaround. The return profile—likely a lower overall return with higher success rates—may also be differentiated enough to attract more risk-averse LPs.

Cons

According to TA Associates' fund documents, "the possibility of generating breakout returns is less likely." This means the fund return profile will likely resemble a PE mega-fund ($5 billion+) or long-dated fund with good but not great performance. Beyond simply lower performance, a single GP owning portfolio companies over multiple standard holding periods may prevent the portfolio companies from reaching their full potential. Many GPs have specific skillsets to add value, such as improving operational efficiencies, cross-selling or global expansion. It is unlikely that the GP will possess all the necessary skillsets to continue or even accelerate the portfolio company's growth trajectory.

LPs also have less control over their exposure in self-sourced funds than they have with GP-led secondaries transactions. The LPs must make the decision to invest in these transactions well before they know what the GP may be interested in selling. Funds such as TA's—which only retains a minority stake—also possess unique cons. TA's fund will not charge a management fee, which makes sense since

8: "TA Closes Unique Double-Down Fund on $1 Bln," Buyouts Insider, Chris Witowsky, January 21, 2020.

they are a passive investor, but can collect carry. This means TA could collect carry on the fund for other GPs' investment results. The fund's structure also means LPs could be paying carry on an investment to two different managers if the LP is invested in both this fund and the fund that purchases the company.

Conclusion

As GPs entertain more liquidity options late in a fund's lifecycle, rolling all or some of the stake into a SPV through a GP-led restructuring has some attractive possibilities for all parties involved, especially if GPs can alleviate the potential drawbacks. These transactions may provide the most attractive end-of-life option for LPs capable of properly assessing proposals to participate in GP-led secondaries in a short amount of time. The optionality that LPs have when determining if they will or won't invest in the transaction holds special appeal. There are certainly conflicts of interest that may arise from these transactions, though there are ways to mitigate them. One best practice may be for GPs to roll their accrued carry forward and not collect until a sale ultimately occurs, something ILPA guidelines support. This will ensure LP and GP interests remain aligned throughout the duration of the extended investment horizon. Moreover, we believe LPs should push for a third-party opinion on the valuation to improve the chances that investors on both sides of the transaction are getting a fair price. However, the third-party should be a group that LPs and the GP can agree upon to prevent favoritism in the final valuation.

Self-sourced funds offer more possibilities for conflicts of interest to arise and disadvantage LPs. For self-sourced funds where the GP remains an operating partner, LP and GP incentives appear more aligned, and we are interested to see how these specific funds play out going forward. However, to provide a truly independent valuation assessment, we believe the GP should sell a piece of the company to management or other outside investors to ensure LPs in the buying and selling funds receive and pay a fair price. Furthermore, transaction costs should be kept to a minimum so LPs in both funds do not have to pay exorbitant fees to continue owning the same company managed by the same GP. In the next note on this subject, we will discuss liquidity options for LPs that involve the company stake remaining in the original fund.