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New horizons for private equity

Why long-term investors and strong businesses need a longer-term approach

Summary

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- Most institutional investors use equity exposure as their core driver of returns, typically employing a mix of publicly traded equities and leveraged buyout-style private equity.
- Because a growing number of companies don't find either of these forms of ownership attractive, a large population of productive businesses has become difficult for investors to access. To invest in these companies, a new private ownership model is needed.
- This need reflects a bifurcation of the market for corporate ownership over the past several decades. Public equity markets have contracted, changed their composition and grown increasingly efficient. At the other end of the spectrum, the traditional buyout model has proliferated and matured.
- While traditional buyout funds have performed well for institutional investors, their structure is at odds with the goal of maintaining long-term exposures and has led to a misalignment of interests between managers and limited partners. This has spurred consideration of new approaches that build on the lessons of buyouts but create better alignment of interests.
- Long-term funds can potentially overcome challenges buyout investors face (such as friction costs resulting from portfolio turnover, and associated reinvestment risks) while also benefitting from effective private governance of portfolio companies.
- We expect long-term vehicles to take their place beside—but not to replace—listed equities and traditional buyouts. We see public markets as the home for most companies of scale and buyouts continuing to reward managers and investors who can consistently improve and resell companies in a highly levered context.
- At the same time, more and more of the profitable and growing companies that don't fit in either the public market or the buyout category are likely to be owned by long-term private vehicles, to the benefit of both investors and the companies themselves.

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The need for a bigger toolkit

After a decade of low interest rates, institutional investors are more reliant than ever on equity exposure as their core driver of returns. Most get this exposure with a mix of publicly traded equities and leveraged buyout-style private equity. Today, however, there's a large population of productive businesses that can't be accessed through either type of investment, for the simple reason that a growing number of companies don't find either form of ownership attractive.

This situation is the result of a significant reordering of the market for corporate ownership over the past several decades. Public equity markets have changed their composition and contracted dramatically. In the U.S., for example, public listings have declined nearly 40% since 1988, while the number of private companies with 500 or more employees has grown more than 50%. Private equity, meanwhile, has burgeoned, rising to $3.3 trillion in global assets under management (including both deployed and undeployed capital), helping to reduce the population of public companies and transform a wide swath of the corporate landscape. See the charts below.

As the potential of PE buyouts first became evident, some observers saw an ownership model destined to eclipse public markets, largely because it was better at aligning the interests of business owners and managers.[1]

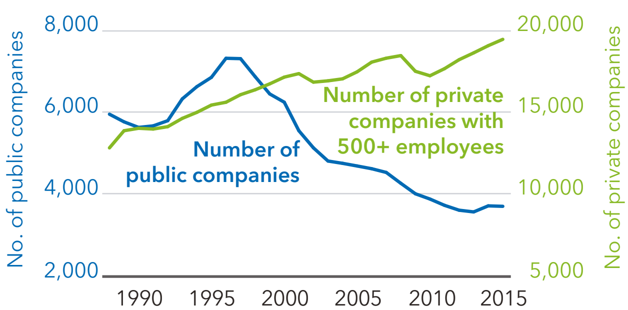
The reality has turned out to be more complex. Effective governance has indeed helped buyouts drive great change in how companies are owned. But rather than dominating the entire landscape, buyout funds command the part of it where their playbook of leverage, operational improvements and resale after a few years is most effective. From a company standpoint, buyouts make sense for businesses with room for significant operational improvement and rapid earnings expansion. From an investor standpoint, buyouts belong in the higher-risk, higher-potential-return quadrant of the portfolio.

Public markets still occupy a major portion of today's corporate ownership map, but it is a much smaller segment than it was thirty years ago. From a company standpoint, the increased regulatory burdens of a public listing and the prospect of pressure from activist shareholders have led many to prefer private ownership.

From an investor standpoint, today's public equity markets contain not just fewer companies, but companies that have a larger average size, are older, and have more of their shares held by institutions.[2] Stock repurchases are further shrinking the market: Buybacks by S&P 500 companies totaled $583 billion in the first three quarters of 2018, according to S&P Dow Jones Indices. The large-cap world is increasingly concentrated in a few sectors, with a

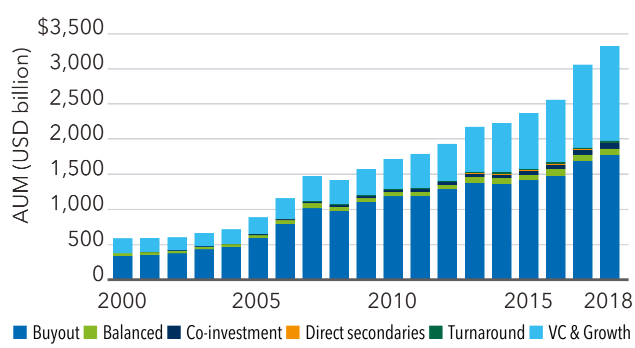
The changing landscape of corporate ownership

Population of U.S. public and private companies



Sources: BlackRock Investment Institute, with data from U.S. Census Bureau-Statistics of U.S. Businesses; Droidge, Karolyi, and Stulz (1988-2012); Wilshire Associates (2013-2014).

Private equity assets under management



Source: Preqin, 2018. Includes undeployed capital. Balanced strategies invest in all stages of development. YTD total as of March 31, 2018.

1 Most notably, Michael Jensen in his 1989 article Harvard Business Review article, "The Eclipse of the Public Corporation."
2 For details, see "Is the U.S. Public Corporation in Trouble?" published in 2017 by Kathleen M. Kahle and René M. Stulz in the Journal of Economic Perspectives.

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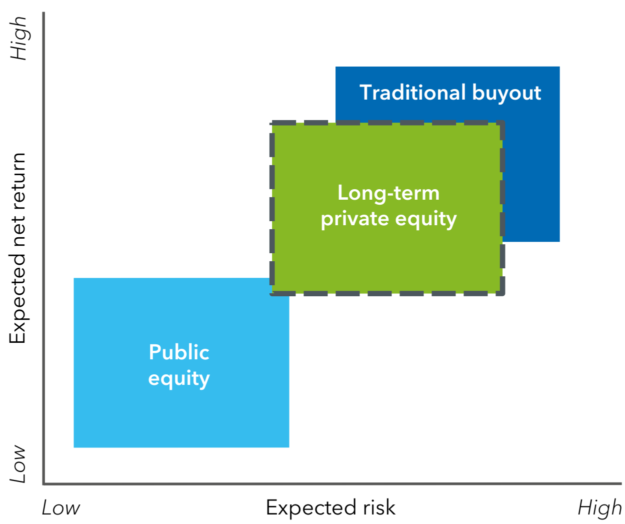
third of the S&P 500 consisting of technology and financial companies. The transparency and efficiency of the public market has grown, data has proliferated, and systematic tools are increasingly important in the pursuit of alpha.

This bifurcated landscape has created a need—among both investors and companies—for a new ownership model. Successful companies need patient capital and governance that emphasizes long-term growth, rather than the quarterly performance prized by the public markets or the leverage-influenced, fix-and-sell priorities of a buyout fund.

Filling a gap

Characteristics of different types of equity exposure



	Public equity	Long-term ownership	Buyout fund ownership
Liquidity	High	Dependent on private market	
Transparency	High	Company information available to GPs and LPs	
Governance	Broadly distributed	Concentrated	
Risk/return	Lower/ medium	Medium/ high	High/high
Sources of risk/return	Economic growth, sector, idiosyncratic	Economic growth, sector, idiosyncratic, liquidity, operational adjustments	Economic growth, sector, idiosyncratic, liquidity, deep operational improvements, leverage

Source: BlackRock, December 2018.

Investors with long-dated liabilities need a model that applies some of the key insights of the buyout funds—the private-market premiums available through tighter governance and acceptance of lower liquidity—in a structure better aligned with their objectives. See the chart below.

A look at the contours of this new landscape suggests that a large number of businesses aren't well suited to either of the two predominant models when they need new ownership or additional capital. Public markets show no signs of reclaiming their previous broader role. As for buyouts, undeployed capital stood at a record $663 billion as of October 2018, according to Preqin, challenging buyout funds to maintain purchase discipline as they seek to sustain historic deployment ratios. Yet the global universe of companies is still vast.

In the U.S. alone, there are nearly 20,000 private companies with more than 500 employees, according to the U.S. Census Bureau. Global corporate divestitures numbered more than 6,400 in 2017, valued at more than $592 billion, according to S&P Capital IQ. Private equity firms themselves are adding to the supply of companies for sale, with more than 8,000 potential exits from portfolio companies anticipated in coming years, according to Preqin. As we detail in the next section, these sizable pools contain significant subsets of businesses that are well managed and consistently profitable—attractive investments, given the right vehicle.

For institutional investors, the need for a new company ownership model comes at a time when they are both increasingly reliant on their private equity allocations to generate returns and increasingly aware of the buyout model's structural constraints. Fees have barely evolved since the PE industry's inception, a marked contrast to other investment products. Maintaining allocations at desired levels requires dynamic asset allocation, which becomes especially challenging when the assets are shares in private funds with different vintages and strategies. Short fund lives and an ongoing cycle of irregular cash flows combined with reinvestment risk are signs of a model that does not easily align with long-term investment objectives.

With strong companies seeking stable, long-term capital, and investors seeking long-term exposure to high-quality companies, the stage is set for a new, more efficient approach to private equity investing.

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The case for patient capital

The short-term focus of public equity markets, and the resulting pressures on public corporations, have been criticized by both investors and corporate management teams. Some institutional shareholders—including BlackRock—are working to focus public companies on the long term, but change is slow and uneven.

Traditional private equity buyouts grew up partly in response to the short-term focus of the public markets. PE funds remove their companies from the pressures of public reporting, at least temporarily, giving them a chance to make improvements and, hopefully, become better businesses. If all goes well, in three to five years these companies can be returned to the public markets in an IPO, sold to a strategic acquirer, or, increasingly, sold to another PE firm.

Buyout strategies have grown more sophisticated and specialized over the years, to include roll-ups in sectors ripe for consolidation, repositioning companies in adjacent sectors and turnarounds of distressed businesses. Buyout firms have specialized by geography and industry sector and helped make PE a major industry in its own right, accounting for more than 1,000 of the nearly 8,000 PE firms in the world, according to figures from Preqin. Despite the growth, however, most buyout strategies remain variations on the same relatively short-term theme, with governance, fee structures and incentives all geared toward exits.

As shown in the table below, the companies best suited to pass through this type of ownership usually share some key traits. Ideally, they will have some under-exploited opportunities for deep operational improvements and/or strategic repositioning, with scope for a significant (and usually one-time) step-up in EBITDA, or earnings before interest, taxes, depreciation and amortization. Strong management is a plus but not a must, since many PE firms consider hiring and incentivizing management a core skill. The balance sheet and business model will typically need to support considerable leverage to amplify returns.[3] With the maturation of the buyout industry, however, deep and high-risk operational enhancements, and sometimes break-ups and restructurings, have become the paramount sources of value creation.

Last and perhaps most important, the company's major stakeholders (such as management, partial owners or key employees) must embrace the overarching objective: a sale to new owners within a few years.

One model doesn't fit all companies

Attributes of companies suited to two different ownership models

Company attributes	Traditional buyouts	Long-term private equity
Growth profile	Opportunity for a step-change in EBITDA	Emphasis on sustainable growth
Operational strength at the time of purchase	Medium, with scope for a revamp	High, with a focus on continuous improvement
Management team	Varies—management change can be seen as a core way to add value	High-quality management an essential part of investment thesis
Governance horizon	Focus on 3-7 year exit timeframe	Focus on long-term ownership and compounding returns

Source: BlackRock, December 2018.

3 For example, leverage accounted for 31% of company-level returns in a global analysis of 2,029 buyouts between 1987 and 2013. See "Essays on Value Creation and its Determinants in Private Equity," published in 2016 by Benjamin Puche of the Technical University of Munich.

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Talented managers are often enthusiastic about buyouts and their potential rewards, and thousands of companies have thrived under PE ownership. Yet many strong businesses simply don't fit in this template. Consider, then, the hypothetical case of a well-managed company with strong profitability, efficient operations, a firm grasp of its growth opportunities, and led by a team with no interest in being resold in a few years. The company needs new ownership or additional equity capital, but a private equity buyout deal is inappropriate, integration into a strategic acquirer is unappealing and regulatory burdens and public-market pressures make a public listing unattractive. Where should it turn?

A few such companies may look to the world's small population of conglomerates and multi-industry investment companies, a list that includes such names as 3M in the U.S. and Investor AB in Sweden. The best known is probably the U.S.'s Berkshire Hathaway, which under Warren Buffett's leadership has become closely identified with patient capital: the acquisition and long-term ownership of businesses with good franchise value, strong management and consistent profitability. But with Berkshire mainly focused on large public targets and other conglomerates maintaining their own criteria, the great majority of businesses can't go this route. A few of the world's biggest pension and sovereign wealth funds also buy companies and hold them for long periods, but such investments are not widespread. Meanwhile, we believe that the number of businesses in the world needing this type of ownership is very large.

These companies are mainly found within three larger pools: private and closely-held companies; businesses being divested by corporations; and businesses being sold by traditional PE firms.

Private and closely held companies

There's no single authority on the world's private companies, but various groups produce research that maps their economic significance. On the University of St. Gallen's list of the 500 largest family-controlled companies in the world more than half, or 257, are entirely private. These are sizable businesses: for the 144 in EMEA, the average revenue is $10 billion and the average number of employees is 34,000. Other listings point to variety in the mid-size part of the spectrum. The 2017 Forbes ranking of the largest private companies in the U.S. counts 225 firms with revenues above $2 billion.

For many family-controlled companies, there are transitions ahead due to generational change. A 2017 INSEAD business school study of 123 Asian and Middle Eastern family firms reported that 30% face such a change in the next five years. In Germany, a 2017 survey by KfW Banking Group of the country's storied *Mittelstand*—the small and medium-size enterprises that have been central to Germany's economic success—found that more than 840,000 company owners face retirement in the next five years. While many of these firms are small, a significant number are not. A St. Gallen ranking of leading suppliers to various industries identifies nearly 500 "hidden champions" in the ranks of the *Mittelstand*—global leaders often operating in niche markets and playing important roles in industrial markets.

Corporate divestitures

The 2018 edition of EY's Global Corporate Divestment Study (an annual survey of 1,000 global executives) showed a record 87% of responding companies planning to divest in the next two years—more than double the 43% reported in the 2017 study. The volume of transactions is running a bit behind 2017's pace, with S&P Capital IQ counting about $380 billion worth for the first ten months of 2018. But the underlying reasons for corporate restructuring are likely to persist.

The most frequently cited drivers of divestments, EY's survey found, are technological disruption to business models and tax law changes. The march of technology—mainly digital, but also including innovations in fields such as energy and pharmaceuticals—can make it necessary for companies to slim down and reinvest in core businesses. At the same time, policy changes in both the U.S. and Europe are reshaping the tax profiles of businesses.

For sale, soon

Potential forthcoming company sales by traditional PE funds

Region	No. of potential exits	Aggregate deal value at entry (USD bil)
Asia	1,469	$146
Europe	2,653	$320
North America	3,636	$620
Rest of world	750	$56
Total	**8,505**	**$1,140**

Source: Preqin, August 2018. Preqin estimates potential forthcoming exits using a combination of factors, including initial investment date and fund vintage data. Expected exits are those where portfolio company has been reported as entering the sale process or being courted, or the investor reportedly has intentions to exit the company.

Private equity exits

Given that traditional buyout exits are preceded (at least ideally) by significant operational improvements, a subset of these companies represents a natural third pool of candidates for the long-term ownership model. This potential pool is large, thanks to an extensive global pipeline of likely PE exits in the medium term. In August 2018 Preqin estimated the number of potential forthcoming PE exits at more than 8,500 companies, with an aggregate deal value of $1.1 trillion at entry. See the table above.

These companies operate in a wide range of industries, from manufacturing (9.1% of the companies) to financial services (8.7%) to oil and gas (5.3%) to healthcare (4.2%), according to Preqin. If history is a guide, many will likely be bought by strategic acquirers and end up as part of larger companies, which are paying PE firms for their operational work, and, sometimes, their foresight in anticipating growth businesses.

Less logical, in our view, is the sale of many of these businesses to a second (or third) buyout firm. Figures from Preqin show that sponsor-to-sponsor deals accounted for 26% of a total $297 billion worth of buyout-backed exits in 2017, second to strategic acquirers (55%) and well ahead of IPOs (10%). For its *2018 Global Private Equity Report*, Bain also found more than 500 businesses that were owned successively by at least three PE funds over the past two decades.

The problem isn't that sponsor-to-sponsor deals can't reward buyers. A 2015 study by Cambridge Associates looked at the returns (measured as a multiple on invested capital) for 248 such investments between 2004 and 2012 and found that they outperformed the PE industry average.[4] But this begs the question of why the sales are happening in the first place—and leads to the obvious answer that the sellers are motivated by the short time horizon of their funds.

Many long-term investors (and the beneficiaries they serve) see sequential ownership of portfolio companies by buyout firms as evidence that the traditional buyout model is out of sync with their needs. If the investors are limited partners in the funds of both the seller and the buyer—not an unusual occurrence among the largest buyers of PE interests—they may end up owning the same company in two or three different vehicles, with multiple sets of fees and transaction costs acting as a major drag on returns.

For this and other reasons, investor interest in long-term vehicles has increased significantly of late. Shouldn't it be possible to eliminate the churn and own these same companies in a longer-term vehicle that allows limited partners to capture a higher share of the profits and benefit from the potential to compound returns for extended periods of time? The answer, we believe, is yes. As we have indicated, the key is to recognize that the buyout and long-hold models should target two different kinds of companies.

In the next section, we take a more detailed look at the two models.

4 See "Want to own a previously private equity-owned company? Quite possibly yes," a 2015 Research Brief from Cambridge Associates.

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Taking a longer view

The private equity industry is still largely set up to execute on its traditional buyout model. Most funds still have 10 to 12- year lives, with investment periods of about half that. Such a structure makes sense when the strategy calls for quickly improving and reselling companies while accepting the risks and targeting the potential returns that come with this approach. It was never designed or intended, however, for achieving long-term exposures. When the goal is to participate in the sustained growth of strong businesses, we believe a vehicle with a more flexible ownership period and a better-aligned fee structure is called for.

Over the past half-decade, and especially in the past year or so, the PE industry has begun to introduce funds with longer lives, typically in the 15- to 20-year range familiar to infrastructure investors. However, such funds account for only about 4% of buyout or growth capital raised since 2015, according to a recent INSEAD paper[5] that looked at funds larger than $1 billion. If we are right about the mutual need of businesses and institutional investors for a longer-term model, it's fair to ask why this change has been so long in coming. We see several factors at work, including the term structure of buyout partnerships. But the most significant factor, in our view, is simply the historically strong performance of buyout funds, which has made limited partners quite willing to recommit to buyout vehicles.

Given the reorientation required for managers, investors and businesses alike, we don't expect long-hold funds to reach their potential overnight. For investors, they present their own set of challenges including decisions about how to fund, hold, manage and benchmark such assets. We plan to share our views on these questions in a sequel to this paper.

For now, however, it's useful to detail the need for longer-term vehicles, and to specify the investor challenges they should address.

The difficulty of maintaining allocations

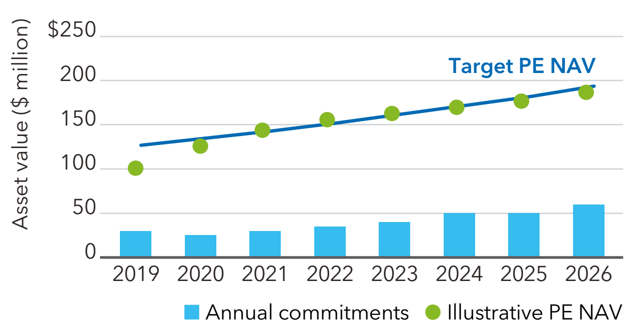
Using short-term vehicles to achieve long-term exposures inevitably presents hurdles. For private equity investors, keeping an allocation steady at a given percent of the portfolio requires dynamic asset allocation—which is to say, continued effort and periodically adjusted capital commitments to multiple funds. Investors must accept distributions from funds as they wind down and then reinvest the capital in funds of successive vintages that may not be readily available—even as growth of the overall portfolio means that the PE allocation must grow in absolute terms to maintain its share.

Experienced investors typically manage this process with pacing models based on historical cash flows of previous funds, which must be periodically rerun. Meanwhile, the risk of multiple capital calls coming at the same time, and the difficulty of maintaining vintage diversification, present additional challenges.

The chart below shows the basic dynamic faced by a hypothetical investor with an existing $100 million (net asset value) private equity portfolio. Assuming the average institutional investor's overall portfolio grows at just over 6% a year, the PE portion needs to grow proportionately. This growth plus the 'runoff' of existing funds distributing capital means that the annual commitment doubles from $30 million to $60 million per year over a seven year period.

The challenge of dynamic allocation

Annual commitments needed to maintain PE allocation at a desired weight within a portfolio growing at 6% p.a.



Source: BlackRock, November 2018. Chart assumes an initial allocation of $100 million, and a goal of holding the allocation constant as a percent of a portfolio growing at 6.2% annually. Growth rate represents projected 2015-2020 AUM CAGR of sovereign wealth funds and public pension funds reported in PWC's 2016 report, "Sovereign Investors 2020: A Growing Force."

5 "The Emergence of Long-Term Capital in Private Equity," June 2018.

The hypothetical investor thus faces a choice of either staying below its desired allocation or increasing its annual outlay, regardless of market cycle. Growing commitments require not just capital, but additional resources for manager due diligence and administration.

Managing undeployed capital

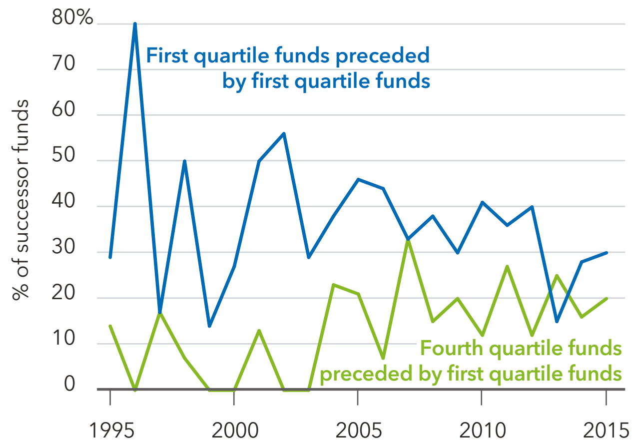
For most investors, a longstanding frustration with private equity has been that the committed capital spends only a portion of the fund life actually invested in portfolio companies. On the front end, investors must keep their capital liquid and ready for capital calls as investment opportunities arise. After investment periods are completed, investors may need an interim home for distributions before committing the capital to the next PE fund. Depending on the investor, this introduces either significant cash drag or public market risk into a PE commitment—drag and reinvestment risk that is not accounted for when a PE fund calculates its performance fees. Moreover, in most cases, private equity managers charge fees on committed but undeployed capital during the investment period, placing an additional economic burden on investors.

Weakening persistence in performance

Investing in successive vintages of PE funds can make for volatile returns. Factors such as market timing, fund size, changes in the competitive landscape and underlying sector evolution inevitably result in varying performance for different vintages. There's evidence that this vintage volatility has increased over the past two decades, with the performance of a given fund becoming less predictive of the performance of a subsequent fund from the same manager. Research by McKinsey & Company in its 2018 *Global Private Markets Review* indicates that in the mid-to-late 1990s, a successor to a fund that performed in the top quartile had on average a 40% chance of repeating the feat. In recent years that number has declined to 30%, and the likelihood of a successor fund finishing in the bottom quartile has quadrupled. See the chart below. While McKinsey cautions that these are "early signs," we see this decline in persistence as further evidence of heightened competition in the buyout arena.

Past performance grows less predictive

Private equity funds' quartile performance relative to immediate predecessors (%)



Past performance is not a reliable indicator of current or future results. Source: McKinsey Global Private Markets Review 2018, using data from Peqin.

Losing exposure to quality businesses

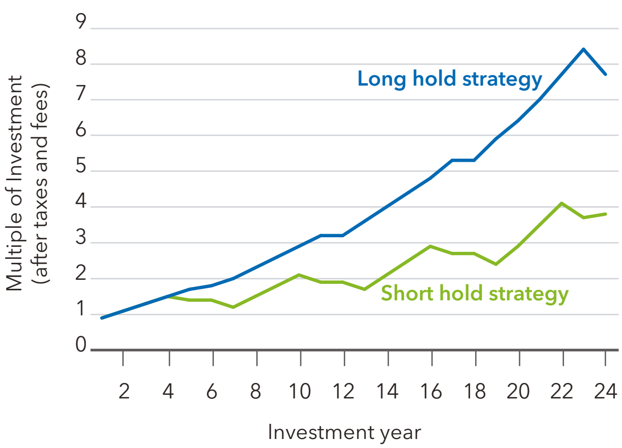
The manager of a private equity fund with a finite term inevitably must liquidate high-quality companies. There is a structural incentive to maximize short-term returns, both in order to get paid and to show returns for the next fundraise.

For long-term investors, this is the clearest sign of a structural mismatch with the traditional buyout model. Losing desired exposure to a quality business purely because of the investment vehicle's structure or a manager's desire to crystallize performance fees makes no sense, especially if the business is simply being sold to another sponsor. Making matters worse, the investor's returns are further eroded by transaction costs incurred in the sale and tax liabilities on the sale proceeds.

The chart below shows the significant toll this portfolio churn takes on long-term performance. In its 2018 *Global Private Equity Report*, Bain modeled the net returns for a theoretical long-hold fund selling an investment after 24 years, comparing it to a typical buyout fund selling four successive companies with identical performance over that period. The analysis shows that 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.

Buy-and-hold outperforms

Modeling the performance of a hypothetical long-hold fund vs. a hypothetical buyout fund



Source: Bain & Co. Global Private Equity report 2018. Chart shows the results of modeling costs and returns for a theoretical long-hold fund selling an investment after 24 years, vs. a typical buyout fund selling four companies over that period. The fund's portfolio company is assumed to perform in an equivalent manner during this period. By eliminating transaction fees, deferring capital gains taxation and keeping capital fully invested, the hypothetical long-hold fund outperforms the short-duration fund by almost two times on an after-tax basis.

Toward a new model

Now more than four decades old, the traditional buyout model has performed well over the years. As usually happens in finance, success has bred plenty of competition, which may be starting to test the limits of the opportunity set for buyouts. Given the maturation of the buyout model and the dramatic shrinkage of public equity markets, institutional investors now need a third way to gain exposure to the corporate activity at the center of economic growth. Thanks to the trail blazed by organizations like Berkshire Hathaway and the handful of pensions and sovereign wealth funds with direct investment capabilities, this new model is now within reach.

We believe the need for an additional model is widely felt among both businesses and investors, and we expect to see multiple versions of it. In general, though, we think the next era of private equity should offer vehicles that are:

- Truly long term, in order to align the investment period with value creation opportunities rather than fund life. This will mitigate the challenges of allocation and portfolio churn, unlock sourcing from companies that want true long-term partners, and ensure that managers only sell companies when doing so is in the best interest of their clients.
- Able to apply the buyout industry's governance insights and incentivize management for long-term performance.
- More efficient and better aligned, allowing for the natural downward evolution in fee levels, and with the economies of scale accruing more to investors than to managers.

Over time, we expect this new model to take its place beside—but not to replace—listed equities and traditional private equity buyouts. Public markets will surely continue to evolve, but will always make sense for most companies of great scale. Buyouts will also remain part of a healthy ecosystem, rewarding managers and investors who can consistently improve and resell companies. But for the many strong, stable companies that don't fit in either of those categories, we expect more and more of them to be owned by long-term vehicles, to the benefit of both the investors and the companies themselves.

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