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Longer Hold Periods Become the Norm

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Despite the strong exit environment, research shows that private equity firms are holding on to their portfolio companies longer than ever. According to Bain & Company's 2018 Global Private Equity Report, holding periods are up substantially from a decade ago. In their 2017 report, Bain noted that holding periods for private equity portfolio companies were settling into a new normal of around five years. The five-year median in 2017 only strengthened that conclusion. This is compared to the industry's pre-2007 crisis heyday when the median holding period for portfolio companies was less than four years, and private equity firms were exiting around 40 percent of all their portfolio companies in less than three years. Those "quick flips" have retreated by half, to around 20 percent, according to the Bain report.

The Bain report goes on to suggest that tax reform is playing a role in the longer hold periods. Under the new law, carry generated from investments held for three years or less will be taxed at the higher ordinary income rate rather than the lower capital gains rate. Previously, the threshold was one year.

Pitchbook has also investigated the notion of longer hold periods. It concluded that companies that complete as least one add-on acquisition will take about a year longer to exit, which is part of the reason there are longer hold periods today. Add-ons have been a fundamental component of the private equity strategy for quite some time now, but over the last decade the "buy-and-build" add-on strategy has morphed from a common tactic into a cornerstone of private equity value creation as organic growth became very difficult to achieve in today's macroeconomic environment. Less than 20 percent of private equity-backed companies acquired in the early 2000s undertook an add-on deal, as compared to nearly 30 percent in the mid-to-late 2000s.

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Pitchbook attributes the longer hold period to the additional time it takes to execute on an add-on acquisition and then integrate it into the platform company. Enhancing operations at a single portfolio company is difficult, and combining multiple businesses only complicates the matter. Inking the deal is just the beginning of the process—once the transaction is finalized, work must be done to integrate the companies and realize the benefits of the merger. Historically, it has taken about one year longer to exit a PE-backed company with add-ons compared with a PE-backed company with no add-on acquisitions. Predictably, the average hold time lengthens as a platform company's number of add-ons increases, according to Pitchbook.

Regardless of the reasons, some firms want to be sure they are exiting at the right time with no bias toward holding or selling. To that end, HG Capital formed what it calls a realization committee and is giving the group just as much influence over exit decisions as the firm's investment committee has over investments. The senior partner on the deal appoints the chairperson for the realization committee and the then the chairperson appoints the other committee members. While deal executives once made all the exit decisions, the firm now asks the realization committee to vet and approve exit strategies. The goal is to be more deliberate about preparing a company for exit and more calculating about taking advantage of opportunities as they arise.

The LP

What does this shift mean to limited partners? According to Pitchbook, the community could be divided. "We think that the PE industry in general will benefit from general partners (GPs) spending more time and resources on operational improvements, but LPs need to be cognizant that this shift will impact fund timelines. For their part, many GPs are launching funds with extended lives and adopting a Buffett-like approach to long-term value creation. Many LPs, particularly endowments and SWFs that have indefinite investment horizons, are warming to this idea and are now locking up capital with coveted managers for two decades or more," according to the report.

But still for other LPs, extended fund timelines remain a concern. When committing to closed-end PE funds, many LPs must have a deep understanding of how the GP plans to drive performance. If add-ons are a key component in that strategy—as is increasingly the case—the GP should contemplate potential targets as they conduct due diligence on platform companies and make sure the LP understands that the strategy could impact exit timing, warns the report.