Brookfield

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PRIVATE EQUITY

Long-Term Private Equity: The Power of Compounding Returns

Introduction

Great companies have a lot in common. Chief among them is the ability to consistently produce cash flows that are stable and durable—and to capitalize on secular growth trends over the long term. Yet many great businesses seeking longer-term capital today are not well served by the traditional public and private markets.

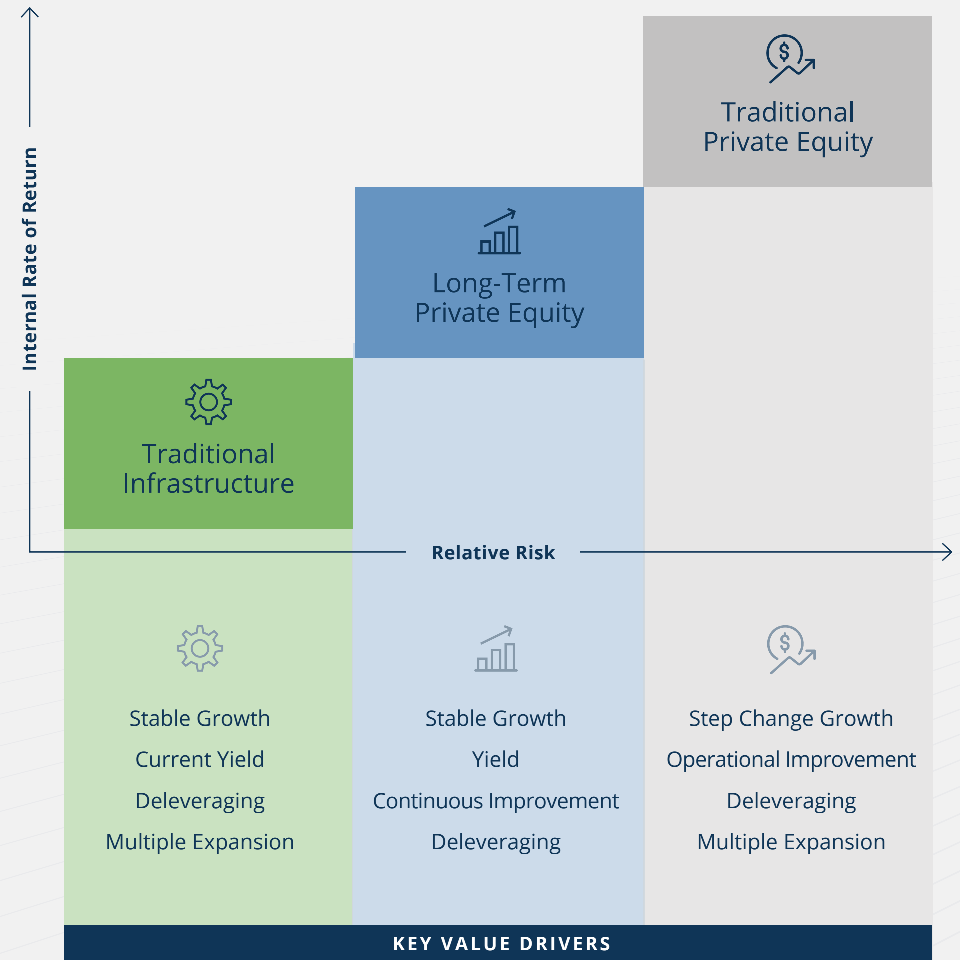
In the public markets, smaller companies tend to miss out on the level of research coverage and trade execution enjoyed by large Fortune 500 companies, resulting in less efficient access to capital. And in the private markets, traditional private equity generally seeks a medium-term time horizon—around three to five years—creating a mismatch for management teams of established, well-run businesses focused on long-term value creation. Such companies would be better served with strategic capital to drive value over a longer horizon.

These dynamics are creating increasing demand for capital from long-term private equity (LTPE) investment strategies. LTPE is an emerging approach focused on acquiring great businesses with lower operating risk profiles. The types of assets well-suited to this style of investing sit between traditional infrastructure and traditional private equity on the risk/return spectrum (see Figure 1).

For investors, holding these assets for 10 to 15 years allows for lower volatility and transaction costs, generating meaningful compounding returns on capital while enabling company management to focus on running their businesses. It also allows for a longer horizon for these businesses to benefit from secular tailwinds, which tend to be more difficult to time correctly within a traditional private equity holding period.

FIGURE 1

An Emerging Asset Class at the Intersection of Private Equity and Infrastructure



A Large and Growing Investible Universe

In the U.S., the number of publicly listed companies has shrunk by nearly 40% since 2000, primarily driven by mergers and take-private transactions (see Figure 2).

As the number of listed companies has declined, the remaining constituents have also skewed larger—the 10 largest companies in the S&P 500 made up over 30% of the index in 2022 relative to 20% a decade earlier.

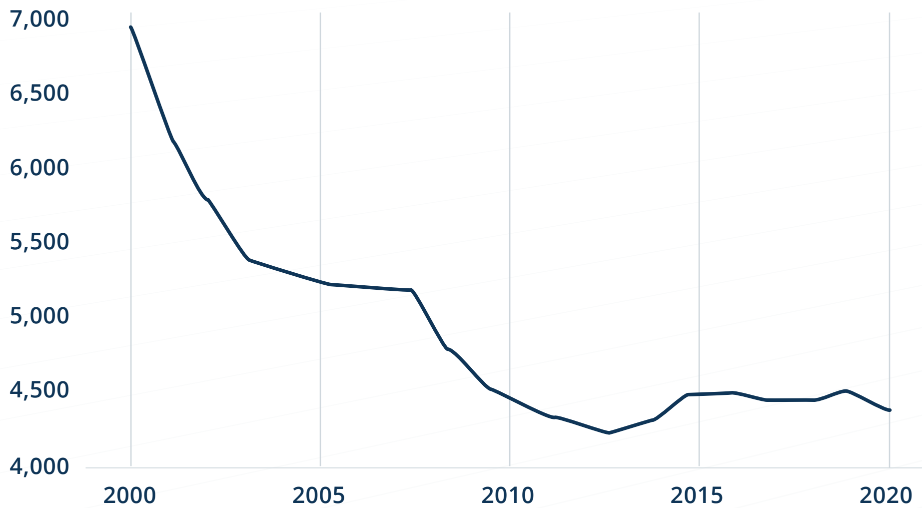
Meanwhile, approximately 55% of the companies listed on the NYSE/Nasdaq are currently, or have previously, been owned by private equity. Public markets have therefore become a smaller part of the investible universe and are getting crowded with large or private-equity-backed companies.

Today, there are over 1,000 private companies across North America, Western Europe and Australia that have been successively owned by at least three private equity owners (see Figure 3). Of those companies, approximately 80% are in the sectors spanning industrials, services, technology and healthcare. For a subset of these companies, an LTPE approach would have led to a longer-term focus, lower friction costs and fewer distractions versus selling from one private equity owner to another.

These trends across both the private and public markets have created a barbell, with a vast and growing expanse of underserved companies seeking long-term and patient capital. An LTPE approach affords these companies access to partners focused beyond quarter-to-quarter results, who are actively involved in driving governance and capital allocation toward achieving longer term goals.

FIGURE 2

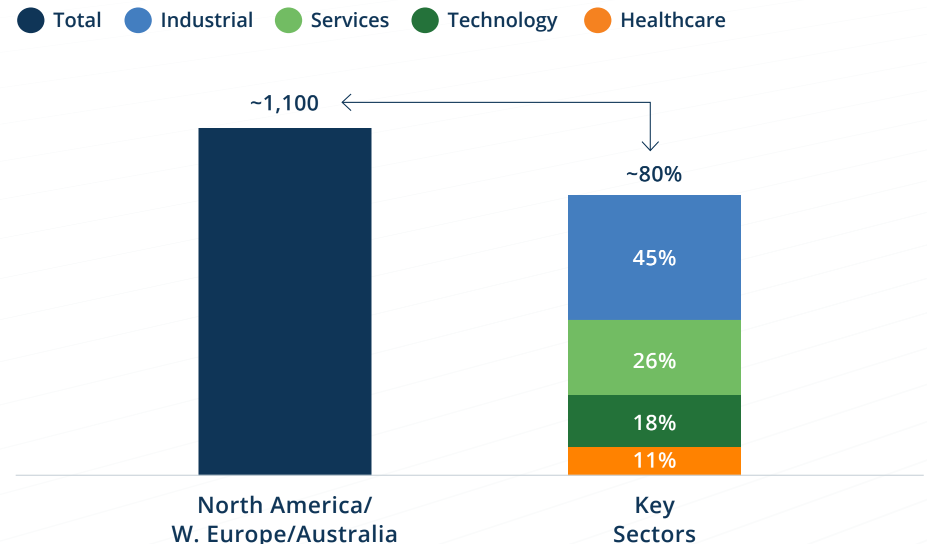
Evolution of the Number of U.S. Public Companies



Source: The World Bank

FIGURE 3

Companies With Three or More Private Equity Owners



Source: Capital IQ

The Need for Long-Term Capital

Companies that are candidates for traditional private equity investing tend to have common attributes centered around a change in performance or a repositioning suited for a shorter investment horizon.

These changes are often key tenets of an investment thesis and can include:

- A significant consolidation or de-consolidation
- A repositioning of the competitive or business model
- A rapidly changing market environment
- Meaningful operational changes
- The creation of a standalone entity from an orphaned division
- A turn-around of a distressed company

While management teams are critical to successfully achieving these goals, changing or augmenting the managerial skill set is an important factor in enabling or accelerating change. Importantly, in this operating environment, all stakeholders typically align on a medium-term outcome with incentives and governance aligned to these objectives, including a planned sale of the company.

FIGURE 4

Differentiating Profiles Between LTPE and Traditional Private Equity

	Long-Term Private Equity	Traditional Private Equity
Cash Flow Profile	Record of consistent and growing cash flow	Varies, usually more cash flow volatility
Growth Profile	Emphasis on sustainable compounding growth	Opportunity for a step change in earnings
Operational	Continuous long-term improvements	Short-term value creation plans
Yield	Reoccurring distributions	Less-stable distributions
Geography	Developed markets	Developed and emerging markets
Holding Period	10–15 years	3–5 years

On the other hand, businesses with attributes suitable for LTPE investing usually do not need to transform or reposition and have demonstrated a track record of durability (see Figure 4). Often, the management teams of these companies are seeking patient and long-term capital to support their continuing efforts to deliver consistent and attractive returns. These companies may prefer not to go public or be sold either to a strategic acquirer or from one private equity firm to another. Importantly, sale processes and changes in ownership can be a significant distraction to highly functioning management teams and can have a meaningful impact on business performance.

Investing in LTPE

An LTPE strategy can be attractive for investors seeking exposure to exceptional and durable businesses. Such businesses have characteristics that minimize volatility from uncontrollable factors. These benefits are further compounded by a longer-term investment horizon, which minimizes friction costs and allows for incremental value capture from secular tailwinds.

PARTNERING WITH EXCEPTIONAL COMPANIES

A cornerstone of LTPE investing is employing extremely high underwriting standards in identifying the attributes of a high-quality business (see Private Equity Investing: Assessing Business Quality). These attributes must align with characteristics that minimize exogenous risks and deliver greater stability to the operations of a company (see Figure 5).

FIGURE 5

Seeking Great Businesses With Low-Risk Profiles

Market-leading businesses that provide essential products and services with stable cash flows and long-term value creation potential are ideal candidates for LTPE. These companies are durable, with defensible market positions and limited risk of substitution or disruption.

In addition, they demonstrate highly consistent profitability and cash flow conversion through market cycles, with strong returns on capital. Finally, these businesses are typically run by exceptional management teams with proven track records of sustainably driving shareholder returns. As a result, they tend to focus on both continuous improvement and reinvesting capital into projects with the potential to generate attractive absolute returns, while providing excess cash that can be responsibly distributed to their investors.

CAPITALIZING ON LONG-TERM SECULAR TAILWINDS

While identifying market themes and trends is an important part of private equity investing broadly, it is often challenging to underwrite long-term secular trends over a shorter hold period. Often, these long-term trends may be viewed as a potential upside or value that accrues to the next investor. A longer-duration strategy enables the benefits of these trends to be more effectively captured—and with greater conviction—than would be possible in a traditional private equity structure.

MITIGATING EXOGENOUS FACTORS

A focus on business quality is especially important during periods of market and interest rate volatility. Exceptional companies see a greater proportion of their long-term value creation potential generated through the realization of stable, compounding growth and free cash flow generation—factors that are more reliant on underlying business attributes.

Therefore, LTPE investments should be much less susceptible to exogenous factors that are difficult to underwrite or are outside of a management team's control (see Figure 6). These include:

- Changes in the exit multiple realized upon a sale
- The availability or cost of debt, which is contingent on the state of the capital markets
- An unforeseen recession

FIGURE 6

Illustrative Impact of Exogenous Factors on Returns

	IRR Impact	
Sensitivity	**15-Year LTPE[1]**	**Five-Year Traditional[2]**
+/- 1.0x Exit Multiple	~50 bps	~410 bps
+/- 10% Debt Available	~70 bps	~180 bps
Recession[3]	~190 bps	~680 bps

1. Illustrative analysis based on impact over 15 year returns of 15% IRR. Assumes 12x EBITDA entry/exit multiples and 6x entry leverage with dividend recaps to 6x EBITDA every 5 years.
2. Illustrative analysis based on impact over 5 year returns of 20% IRR. Assumes 10x EBITDA entry/exit multiples and 6.5x entry leverage with no dividend recaps.
3. Assumes 10% downturn in third year of investment and 10% recovery in fourth year.

MINIMIZING FRICTION COSTS

While the lower risk profile of LTPE leads to lower targeted project-level returns than traditional private equity, an LTPE investment can seek to deliver comparable net returns to investors through the incurrence of less friction costs (see Figure 7). These include:

- **Deal Friction Costs**
  Exceptional businesses seeking to remain in the private markets would traditionally sell from one private equity investor to another every few years. By holding these investments in an LTPE structure, businesses can avoid meaningful friction costs incurred in both the buy-side and sell-side processes, such as M&A advisor fees, committed debt financing fees, due diligence advisory costs and other transaction costs. These businesses can instead pay reoccurring dividends or be responsibly recapitalized periodically to return capital to investors.

- **Investor Fees**
  LTPE strategies can often offer lower management and incentive fees when compared with traditional private equity. Also, since identifying opportunities with attributes suitable for LTPE tends to be more episodic, fees are typically incurred on invested rather than committed capital.

Importantly, the longer horizon of LTPE allows investors to benefit from their capital remaining invested and compounding on a pre-tax/pre-fee basis. And they don't need to take reinvestment risk or sit on cash until a suitable alternative investment can be found.

FIGURE 7

Illustrative IRR Leakage Over a 15-Year Investment Horizon

	Long-Term Private Equity[1]	Traditional Private Equity (Three Owners)[2]
Deal Friction Costs[3]	~160 bps	~300 bps
Management Fees/ Carried Interest	~190 bps	~500 bps
Total Fee Leakage	**~350 bps**	**~800 bps**

1. Assumes recapitalization to initial leverage levels in years 5 and 10. Investor fees consist of 1.0% management fee on invested capital and 10% carried interest.
2. Assumes business is sold every five years to a new private equity owner. Investor fees consist of 1.8% management fee on committed capital (assumes 2.5 years to deployment), 1.5% management fee on invested capital and 20% carried interest.
3. Assumes the incurrence of sell-side M&A fees, financing fees, and transaction fees on every sale transaction. Assumes refinancing fees incurred in LTPE scenario.

The Virtue of Patience

Exceptional companies are increasingly seeking long-term private equity capital because it provides them with a more attractive, more suitable solution for their capital needs. And investors are increasingly allocating to LTPE to gain exposure to higher quality, lower risk companies that are well equipped to capitalize on long-term secular tailwinds.

The bottom line: Combining a long-term focus with truly exceptional companies that have lower operating risk profiles has the potential to unlock the power of compounding returns.

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