Buying Time – Unrealized Returns – Get Used to Waiting!

I am willing to bet my life savings (consequential to me but inconsequential to some, depending on how much you are winning at life - hahaha) that all staunch private investing proponents have found themselves in a room (probably several times) having to defend the attributes of private equity. Private investing loyalists cannot avoid this conversation - it is almost like a rite of passage. Whether from colleagues and investment managers working in different asset classes, skeptical investment committee members, or academics who have gathered large amounts of data debunking the positive qualities of private equity, all private investing advocates have unavoidably been victims of snide comments, direct belittling, or at the very least, have been recipients of news articles portraying the private investing industry as a no-good posse of capitalist plunderers and looters. I have dealt with this throughout my career and to say it is exhausting is the understatement of the century. One would think that the meteoric rise of the private asset class in size and influence, and its relentless and regenerative tentacles that touch almost every aspect of society, would provide some respite for its supporters – NOPE! We still have to fight for respect, and the best way to do so is through transparency – we must plainly state the obvious problems while also underscoring the observable positives. Long gone are the halcyon days when private equity effortlessly basked in limited competition, lax regulations, easy debt financing, and the infallibility of the entrepreneur. Now, almost everything involves some form of intellectual (or brute lowbrow) barehanded boxing.

When hit with the usual suspect private investing torpedoes that take forms such as "the funds are just hornets' nests of exorbitant fees", "private vehicles are a master class in leverage-fueled financial engineering", "venture capital is legalized high-stakes gambling", "prepare for sleight of hand valuation manipulation", etc., the best advice is to keep one's head on a swivel. Even in my sleep, I can rattle off quick defenses of why private investments are accretive to portfolios – "general higher returns", "relatively lower volatility", "hands-on operational improvement", "broad diversity of investible opportunities", "insulation from unnecessary market noise", etc. However, something that I am having a harder time justifying is how long it takes to get capital back from private assets investing. I fully understand that the illiquidity (long lockups) is a necessary ingredient for hands-on value creation which in turn leads to a higher probability for strong returns, but these days, the wait seems to be getting longer and longer. I explore below some aspects of private funds' return of capital that have been annoyingly ping-ponging and niggling in my mind.

- **Tell me again, when do I get my money back?**: Private funds offer a life expectancy (in years) guidance that follows an initial fund term plus the allowance for a few additional years. It is common to see a fund's expected term portrayed as "10+1+1" or "10+1+1+1", although, in actuality, it is more like "10+1+1+1+forever". Funds never seem to end. There are always some stragglers in the portfolio that keep dragging along for what seems like perpetuity. Justification from GPs comes in some variation of "most of the value has already been redeemed from the portfolio", "the remaining investments still have some good upside potential" or "we are actively looking for ways to liquidate remaining holdings". I am actually not mad at these explanations if there is proof that the juice was/is worth the squeeze. It is just that in more cases than seems appropriate, portfolios are in the ninth or tenth year with limited evidence that "realized" target returns will soon be attained. Marked-up values in the "unrealized" column of a GP's financial report always provide an enticing hook for LPs to stay interested. Additionally, lowered fees on the remaining holdings help to buy more time. The enthusiasm and gusto shown for attaining fund goals (which very much includes efficiently exiting deals and returning capital) during fundraising, wanes quickly as that same fund is getting long in the tooth. This is very frustrating for most LPs.

- **Unrealized returns remain inedible**: Rhetoric around the tangibility of "unrealized returns", "IRR (Inter", "MOIC (Multiple of Invested Capital)" and "TVPI (Total Value to Pain-In Capital)" has been making the rounds for many years now – the common sentiment is that despite how enticing and mouthwatering the these may look, they can never compare with the delectable deep-flavored taste of "DPI (Distributed to Paid-In Capital)". Private investing GPs make it a point to stress the rigor that goes into generating a carrying value for unrealized investments. Some mix of market comps, DCF analysis, fair value accounting, company performance, common sense, and third-party inputs help to generate a "conservative" value that most GPs feel they can defend. Further comfort can be gained from some credible published reports that show that the eventual exit value of private holdings tends to be higher than their prior carrying value. This is all well and good, but it does not change the pressing issue of when these exits will actually appear. Despite a lot of lip service, an LP cannot help but feel that exits are not a priority for many GPs. It is a tough one to dissect because one would think that the attainment of carried interest ("carry" or excess profits accrued to the sponsor) after successful exits is a great aligning mechanism. However, from examining many managers, a concerted selling effort does not seem evident. Does the attainment of a higher carry subconsciously or consciously cause managers to seek (sometimes to the overall fund's detriment) the highest potential price? Does the management fee income on committed/invested capital disincentivize proactive exits? These are curious and juicy questions to delve into at a future date.

- **Get liquidity from secondaries**: GPs are quick to throw out reasons why holdings have not yet been sold – "high cost of leverage", "a sluggish IPO market", "out of favor sectors", "broad economic malaise", "buyer/seller clearing price deltas" – the list goes on. Most reasons are widely known and accepted but it is still common for LPs to suspect that enough creativity is not being applied to generate exits. Some frustrated LPs conclude that "sometimes if you want something done you must do it yourself" and proceed to sell their private holdings on the secondary market (which has grown in efficiency through the years). These LP-led secondaries come with their own unique administrative and valuation (logical discounts) idiosyncrasies, but for the most part, this market is a broadly accommodating method to generate liquidity. Relatedly, some GPs say to nagging LPs "Hey, so you say you want proactivity in liquidity, check this out" and proceed to create GP-led secondaries aka "continuation funds". These vehicles bring in an outside source of capital to give LPs the option to take some capital off the table (usually from the most prized holdings) and/or continue with reset fund terms and a re-incentivized GP. Quite ingenious right? However, I can argue that initially using my capital to fund investments, then getting some of these investments to a desirable state, and then giving me the option to take some capital off the table or continue on, while giving the GP (along with a new outside investor) a second bite of the fee and carry apple, needs a lot more scrutiny.

- **We are fundraising so some capital just came back (or will be back imminently)**: Big things happen or are always around the corner when a GP is in the throes of (or close to) fundraising. It's uncanny how that always happens. Can we please normalize returning capital regardless of proximity to fundraising? Of course, I'm being a little facetious, but I'm still amazed at how GPs become laser-focused on exits in the run-up to fundraising. I just wish this was a thing all the time.

- **Increased admonishment for lethargic exits**: I am very aware that GPs constantly wrestle with the "bird in hand versus the ones in the bush" dilemma. Also, I know many GPs view "selling too early and leaving value on the table" with the same disdain as "incurring flat-out losses". Although I empathize with these realities, I still believe that a focus on fiduciary responsibilities and adhering to the logical weighting of target returns on deals (and consequently the aggregate fund) can help uncomplicate matters. The key point here is that LPs show up for maximized value, but getting to taste these values is what will make them stay for the long run.

Even though it is difficult to get full transparency on exit opportunities that a GP missed or declined, I believe it is incumbent on LPs to maintain an ongoing dialogue with sponsors probing this subject. Additionally, I believe GPs should spend as much time and effort depicting/explaining exit scenarios as they do on markups and previous financing round uplifts.

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