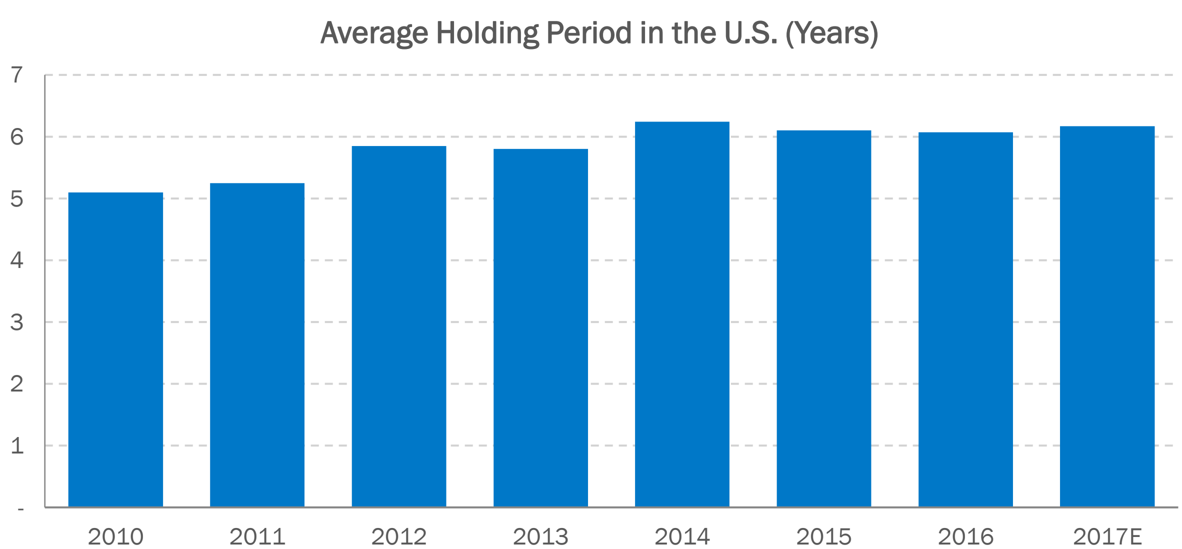
Valitas Insights: Private Equity Holding Period and Value Creation

Your typical source of finance literature would tell you that the standard holding period for a private equity investment is between three and five years. However, this theory has been contested lately, most notably by a PitchBook article positing that the 2017 year-to-date average holding period in the U.S. is 6.17 years[1].

In this week's article, we aim to discuss whether prolonged holding periods have become the "new normal" and examine whether there has been a fundamental shift in the private equity landscape. We also interviewed Michael O'Neill, Director at Stone Arch Capital, who offered some of his insights from the perspective of an industry practitioner.

The "New Normal"

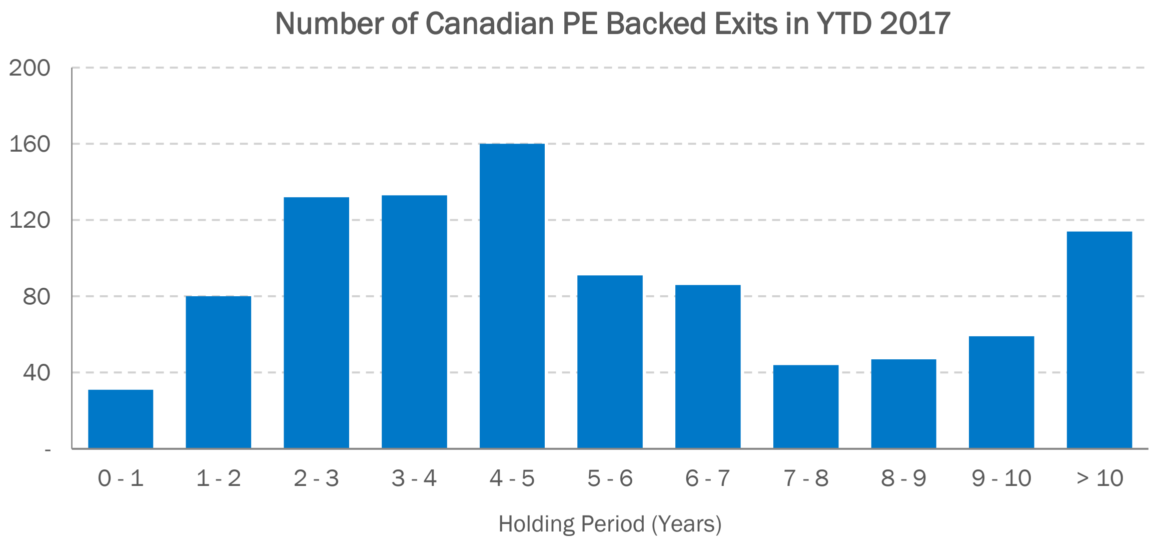
According to the PitchBook article, private equity holding periods have lengthened to 6.17 years for U.S.-based portfolio companies. Notwithstanding any drastic changes in December[2], 2017 will finish with the highest average holding periods since 2014.



Source: PitchBook

Our own research tells us that this trend also pervades the Canadian market, where the average holding period for PE-backed investments this year is 5.59 years with 45% of investments being held for longer than 5 years. While there appears to be a fundamental shift towards extended holding periods, it's worth noting that many Canadian firms still employ a shorter holding period strategy, as approximately 43.5% of PE investments have holding periods between two and five years.

[1] The PitchBook article was written based on the information as of November 14, 2017.
[2] This article was written in early December.



Source: Capital IQ

A few other sources, including Bain's 2017 Global Private Equity report, have observed similar trends occurring globally. For his part, Mr. O'Neill commented that "broadly speaking, five years is in line with what we observe in the market." Mr. O'Neill asserts though that the holding period has more to do with the situation at hand than anything else. For instance, when larger funds acquire large-cap portfolio companies, it is relatively more difficult and time consuming to bring "transformative change" to the large company than it would be to a similar, smaller company.

Underlying Factors Contributing to the Increased Holding Period Trend

While this trend is likely a result of several factors working together, we find the following factors to be particularly relevant:

1. **Challenges in the Recent Deal Making Environment**

   According to Firmex's latest M&A Valuation report, positive momentum continues pushing M&A valuations upwards, with the median exit multiple sitting at 10.8x in North America. As a result, private equity firms are often finding themselves entering into deals with higher multiples on average in today's market. In order to achieve investment returns consistent with prior time periods and justify the initial valuations, PE firms must strive to unlock additional value in portfolio companies after the initial investment, which can lead to longer holding periods as the PE firm implements various value creation mechanisms.

2. **Lagging Effects from the Financial Crisis**

   In the wake of the 2008 financial crisis, private equity firms experienced difficulties both in making new investments and in successfully turning prior investments. This collapse had far-reaching consequences even until recently, since investments made prior to the crisis experienced value deterioration as the market plummeted and required extended holding periods following the crisis in order to recoup and generate value. Based on findings in the Bain report, today's pipeline of PE investments mainly consists of deals made following the market collapse.

3. **Exit Strategy**

There are three main avenues through which investments in platform companies are realized: strategic buyers, sponsor-to-sponsor sales, and IPOs. IPO exits, in particular, have suffered the most from lengthened holding periods in 2017, according to the PitchBook article.

Sponsor-to-sponsor exits have also gained traction in recent years, thanks in part to the proliferation of PE firms. On the surface, the idea of one PE firm selling to another may be perplexing. Why would one PE firm sell a company to another PE firm if there is still value to unlock in the business? One hypothesis to an extended average holding period is that because the second private equity investor would be harder pressed to create value in the portfolio company, these firms need to hold the investments for longer in order to realize their targeted return.

Mr. O'Neill was quick to address this potential misconception, pointing out that "there are different tiers of firms in the private equity industry, and these firms employ different models to unlock value. A small to medium-sized fund, for instance, may focus on institutionalization improvements such as implementing accounting best practices, utilization of KPIs, tracking and understanding margin by customer/SKU/service, setting up key areas of management such as a sales manager, amongst others." Subsequently, a second (and larger) PE sponsor with greater resources may seek to create additional value in an area of their own expertise, such as significantly scaling the company's manufacturing operations while optimizing operating costs.

Achieving Targeted Returns in a Challenging Deal Making Environment

With the aforementioned factors in mind, the current deal making environment challenges PE firms to be more diligent in the way they manage portfolio companies. For instance, add-on acquisitions have prevailed as a viable strategy to achieve favorable returns. The ability to add multiple smaller, synergistic companies to an existing platform at relatively discounted multiples before packaging the consolidated firm at a higher multiple is key to this practice.

Amidst the recent trends of increased M&A valuations and the prevalence of sponsor-to-sponsor exits, PE firms are employing strategies that work regardless of market sentiment. The key, according to Mr. O'Neill, is finding a unique value creation angle. Stone Arch, for example, positions themselves as providing "transition capital" and working more closely with management than a typical PE firm to ensure the preservation of a company's legacy and culture while supporting organic and acquisitive growth initiatives. Regardless of the strategy, driving growth in portfolio companies is the ultimate goal of any private equity investor.