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The Power of Permanent Capital: Alternative Asset Managers and Family Investment Firms Vie for Deals & Talent

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A next-generation investor is becoming a prominent force in alternative asset investing, and it can go by various names: family office, family investment firm, or permanent capital investor. These firms are increasing their direct investing activity at an astonishing rate with Pitchbook reporting a 300% increase in capital committed directly to deals by family offices between 2011 and 2016. And this trend shows no sign of abating. A recent survey of 109 family offices by the Family Office Exchange found that 30% plan to increase the pace in direct investments.

Friend, Foe, or Both?

For fund managers, these family investment players present a new set of challenges. On one front, they are new competitors for deals and opportunities, often with patience and in-depth knowledge of specific sectors. But these players may also be fund manager clients or co- investors.

That makes it critical for fund managers to understand their model, approach, and capabilities, and to learn how to manage relationships with family offices as both clients and deal rivals.

Many family offices have organized separate investment arms to distinguish their activities from the more mundane administrative tasks of family offices. Among the most successful of these family investment firms, are those that focus their investment strategy on industry verticals that play to their strength or where they have developed an expertise. These firms are competing and winning deals away from private equity firms. And, it's not just deals that are flowing their way. They have been successful too in recruiting senior talent from large alternative asset managers, merchant and investment banks. With permanent capital and an entrepreneurial mindset that aligns well with portfolio company management, they are redefining how value is created.

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Pitchbook Data

What's Old is New Again

Among leading alternative asset managers, the notion of permanent capital has been called the "Holy Grail". According to quarterly reports, Apollo Global Management and Blackstone have led the way in transforming their businesses to focus on permanent capital with 41% of Apollo's AUM in permanent capital vehicles and 15% of Blackstone's fee-earning AUM in permanent capital vehicles as of the end of 2017. Joining the quest are KKR, Fortress, CVC Capital, Carlyle, and hedge fund managers Pershing Square, Third Point, and Brevan Howard. Permanent capital has been raised in a variety of ways including, public-listed companies, special purpose vehicles and insurance company capital reserves and premiums.

What is permanent capital? Simply put, it is capital that can be invested in perpetuity – without a target date when capital must be harvested and returned to LPs. The evergreen nature of these vehicles has allowed managers to play the long-game pushing out the horizon from the closed-end five years of investing, five years of harvesting or "5 and 5" structure to investment horizons of 20 years and longer. It has also changed the focus of investing from acquisition/disposition to generating wealth through recurring fee income.

For private equity and real estate investors, perpetual capital removes the burden of exiting a deal before it has realized its full value - or the need to deploy capital prematurely. For hedge fund managers, permanent capital provides the advantage of riding out market cycles while holding cash that can be used in downturns when opportunities present themselves.

For institutional investors invested in several closed-end funds, the disposition by one fund manager can be the acquisition by another fund manager. According to *Dealogic*, the trend of private-equity firms trading portfolio holdings among themselves is the highest it has been in the last decade, rising to $93.7 billion in 2017. Jerry Albright, CIO of the Teacher Retirement System of Texas has been quoted as saying that, "…in between those flips are fees". Those flips have generated significant fees and the chance of finding yourself on both sides of the deal has increased dramatically.

Not-So-Strange Bedfellows

How can family investment firms beat out major private equity firms that have deep investment team infrastructure and access to capital from institutional investors? They can and have because family wealth understands the importance of permanent capital with its long-term yield-generating approach to investing. The pitch to entrepreneurs looking to sell their businesses or take on a strategic partner is straightforward. Permanent capital allows alignment with management teams, efficient decision-making and flexible transaction structures. Key for business owners is the shift from trying to force value creation into a pre-determined cycle of

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>
> *~CEO of a recently acquired firm*

investing to having a partner who is interested in growing the business for the next 20 years.

Another major advantage for family firms is the pure focus on investing. Their investment teams are unfettered by the care and feeding of LPs or the time required to raise a next fund and can solely focus on portfolio companies. When deals are too big for one family investment firm, they find like-minded family offices to co-invest, no different than what happened two decades ago in private equity and real estate and is happening today in infrastructure.

And, Talent Follows….

These same selling points work when recruiting talent. Executive recruiters have facilitated a steady stream of talent leaving large alternative asset managers or investment banks to join family investment firms. Candidates are attracted by the lean decision-making structure, the breadth of investment opportunities, the flexibility ready capital provides in financial structuring, the longer-term commitment to creating value and the single investor focus.

Once the carried interest issue within an evergreen fund was addressed, the talent began to migrate. While there are several carried interest models, generally, most are based on shares in the overall portfolio using an annual book value of the assets to calculate share value. Unlike carried interest in a fund which is distributed based on the disposition of assets, these plans allow participants to harvest the value of the shares at their discretion, once the shares have vested.

The flow of talent began to make headlines a few years ago with marquee recruitments such as Morgan Stanley Investment Management COO Michael Levy's departure to become the first outside CEO of Crow Holdings and has continued at an increasing rate each year. Family investment firms have attracted senior talent from major private equity outfits such as Madison Dearborn Partners, Palladium Partners, New Mountain Capital, Kleiner Perkins, Battery Ventures, Morgan Creek Capital Management and Quadrangle Group, as well as investment banks including Robert W. Baird & Co., UBS, Goldman Sachs, and JPMorgan, to name but a few.

The benefits of permanent capital may be to the 2020's what real estate was to the 2000's, hedge funds were to the 1990's and LBOs were to the 1980's. Permanent capital investors– and the patient capital they manage - are creating a sea-change in how value is created. As the CEO of a business recently acquired by a family investment firm stated, "Private equity is thinking of where we are going to be in three to five years. Now we can talk about what we want to look like in 2030."