

Shaking off the stragglers

*LPs can benefit from offloading tail-end stakes early instead of holding them to maturity, writes **Hannah Zhang***

Though received wisdom holds that private equity investors can expect to benefit from holding assets for longer, that dynamic doesn't necessarily apply to tail-end portfolios.

According to data from investment advisory firm Upwelling Capital Group, which analysed return multiples from nearly 1,200 US buyout funds over a 20-year period, LPs would have been better off selling tail-end funds earlier rather than holding them to maturity.

Upwelling drew this conclusion after examining the total value to paid-in capital ratio for each fund in the study across every year of its life. The funds, spanning vintage years from 2004 to 2024, were grouped into performance quartiles and compared based on their TVPI levels and annual changes in return multiple. The firm then modelled the outcomes of holding a fourth-quartile fund into years 11-20 versus selling it and immediately reinvesting the proceeds into a first-quartile or median-performing fund.

Assuming a 20 percent discount on the sale, an LP that reinvests the proceeds into a first-quartile fund would

see their portfolio outperform the value of holding the tail-end asset by year two, according to the research. Even at a 40 percent discount, the LP can expect to surpass the value of a holding decision by year four.

"Typically, investors justify holding these [tail-end] funds to maturity due to factors such as lack of liquidity needs, long-term investment horizon, reluctance to sell below NAV or underallocation to a given asset class," the paper said. "However, those rationales are increasingly difficult to defend as liquidity pressure builds while invested capital in growing tail-end portfolios has become a bigger drag on overall performance."

Problem spotting

Identifying the lagging performers isn't difficult as they tend to reach a return plateau earlier than stronger funds, according to the research. Over the past 20 years, top-quartile funds have reached a TVPI peak of 2.2x by year 10, while median and fourth-quartile performers plateaued around 1.8x and 1.5x, respectively, by year nine. Bottom-decile funds hit their maximum

TVPI much earlier – around 1.1x by year six.

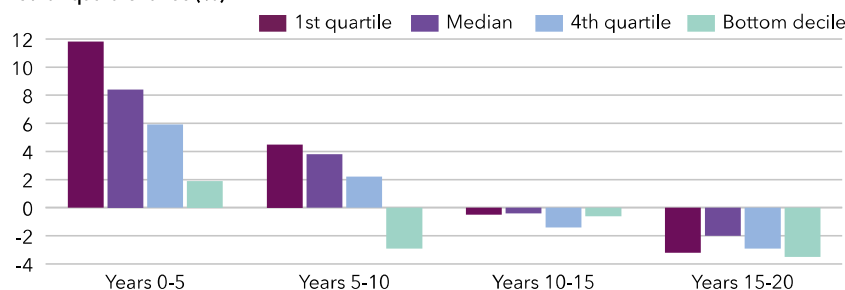
Upwelling partner Eric Green told *Private Equity International* that investors should start evaluating the trajectory of bottom-quartile funds within the first five years rather than waiting a decade, since younger funds are more likely to fetch better pricing.

An effective way to spot "problem funds" is by tracking the annual percentage change in their TVPI, according to the paper. During the first five years, the average annual increase in TVPI for first-quartile funds is 11.8 percent – twice that of fourth-quartile funds, which average 5.9 percent. The gap is even more pronounced when compared to bottom-decile funds, which show an average annual increase of just 1.9 percent.

"The greatest opportunity cost relates to smaller funds, which isn't surprising given the likely predominance of first-time funds within this market segmentation," the paper said. It also found that smaller funds have higher outperformance for those in the first quartile and worse underperformance for those in the fourth quartile.

LPs "do all the front-end work" and will benefit from "a more technical approach to measuring performance early on", said Upwelling founder Joncarlo Mark, comparing it to how GPs address underperforming portfolio companies before they experience significant value erosion. "Generally speaking, you hear that the return profile is coming down in the private markets relative to the returns of public markets." ■

During years 0-5 the TVPI increase for first-quartile funds is twice as high as that of fourth-quartile funds (%)



Source: Upwelling Capital Group