PERMANENT
EQUITY

How Permanent Funds Work

On the surface, money is fungible – a dollar is a dollar. But we (hopefully) all recognize that money comes attached to people. And when it comes to pools of capital for investment, it's defined by its source, the associated expectations of use and return, and how long it is available for investment.

Permanent Equity invests capital from our team, pooled with others, as any committed fund structure does. However, because we wanted to optimize for different behavior, we didn't raise funds under the traditional private equity terms.

Permanent Equity is actively investing out of a $300 million fund (our second) raised in December 2019. Here's why it exists and how it behaves:

How We Got Started

Before we were Permanent Equity, we were the world's smallest family office. Brent, our founder and CEO, started a few businesses in marketing and advertising. The first one went poorly, as most first-time ventures go, resulting in learning what not to do. That led into starting an ad agency, which went better. Then, he got introduced to someone looking to sell a business and assumed that meant he should make an offer to buy it, which he ultimately did with an SBA loan.

The first acquisition combined with the other ventures provided a growing source of cash, allowing for the early repayment of the SBA loan and the ability to seek more investment opportunities. Fast forward five more years and the portfolio had five businesses and a small but growing organization to find, negotiate, diligence, document, and operate smaller companies.

We started as operators and maintained that approach as new investment opportunities presented themselves. The team at the firm scaled mostly to meet the operational support needs of our companies, rather than to bolster our capacity to do deals.

Along the way, we were fortunate to meet some like-minded individuals who were attracted to our patient and operational approach, and who were looking for opportunities to invest in smaller companies. We were asked to take on outside capital in either a fund or holding company structure. Traditional 10-year funds with a 2 and 20 fee structure were not compatible with the way we had been investing and operating businesses. The time horizon created forced buying and forced selling. The fee structure gave us incentives to move "upmarket" and do larger and larger deals to accrue more fees. And, the prevalent use of debt conflicted with our company-centric approach. The holding company structure would have required a contentious process of valuing the current assets,

mechanisms for on-going liquidity, as well as difficulty raising additional money, if needed. We quickly put the idea of outside capital to rest and went back to growing our small family of companies.

And then Brent met Patrick O'Shaughnessy, who wanted his family to invest. He asked a question no one else asked: "What would it take for you all to accept outside capital? You design the structure and terms, and then we'll let you know if we can invest." So we set about rethinking how we might structure a partnership with incentives that would align everyone's interests and encourage a thoughtful long-term approach towards people, organizations, and opportunities.

By this time, we already had a handful of operating companies that were generating sufficient cash flow to help grow Permanent Equity organically. We didn't need fees, but we did want to have more financial capacity to seize opportunities.

We also recognized one surefire way to get backwards with any investment strategy is to deploy it within a structure that might force you to take actions that are inconsistent with that investment strategy. For example, detonation risks for small businesses are enhanced if new ownership feels the need to make lots of near-term changes to the way those businesses operate. But that's precisely what overpaying for assets, a short time horizon, and debt force a traditional 2 and 20 fund to do.

Even the strongest small businesses are messy and more fragile than they may appear; under the intense pressures sparked by the short hold periods and rigid fees of traditional funds, these businesses can crack, losing what makes them great (e.g. people, quality) in the process. So we decided that the only way that we could accept outside capital is if we did it through a vehicle and with partners that allowed us to be disciplined buyers and long-term operators free from the pressure to invest resources immediately, to sell an investment quickly, or to pile on leverage to enhance returns.

How It Works

When it comes to investing other people's money, there are three fundamental terms:

1. How much time do you have to invest it?
2. How long before you have to return it?
3. How much do you charge to do it?

A conventional structure in private equity answers the questions as follows:

1. Three to five years.
2. 10 years.
3. 2% on committed capital and 20% of gains above a hurdle.

In designing our fund model, we wanted significantly more time to do (1) and (2) and a fee structure that wouldn't give any investors heartburn about allowing us that time.

Where we landed was 10 years to invest, 30 years before we have to give the money back, and no fees of any kind unless we are sending out a cash-on-cash return in excess of a hurdle rate.

How It Is Used

Every small business is unique, with its own team, customer, vendor, industry, location, and regulatory dynamics. A formulaic approach doesn't make sense. And so our fund has very few restrictions. Within reason, we can go wherever opportunity takes us, and we have almost unlimited freedom to structure an investment. In our current fund, we could make three investments or 30.

Permanent Equity invests in profitable businesses with durable value propositions and a track record of success. When we are attracted to an opportunity, we work collaboratively with the sellers and operators to build the right terms for the situation.

We rarely use external debt because it increases risk and alters decision-making. We never want to be forced to abandon our approach or values, and so only invest in majority positions (51-100%). And we invest in North American-headquartered operations because that's what we know best culturally and operationally.

Once invested, operations are optimized for sturdy success in terms of quantity and quality of earnings, depth and durability of relationships, and breadth of and access to talent. Depending on the business model, market, capacity, and maturity of the business, that may mean everything from heavy reinvestment to additional acquisitions to healthy distributions on an annual basis. We're always on the lookout for ways to limit downside and increase upside.

How Our Fund Structure Aligns Us with Investors

Let's look at 2020. At the heights of the pandemic, the operating environment was uncertain, and therefore the deal market was strange, to say the least. Owners of good businesses were heads-down, using all their energy to shepherd their companies through the storm. The only businesses that were for sale were distressed, on the brink of disaster, or looking to perfectly "time" a sale.

Permanent Equity made no new investments during that time and felt no pressure to do so. We have always told prospective investors that we solely focus on doing good deals, which might lead us to invest all the fund's capital in one year, or we might struggle to invest much of it over 10 years. Had we been charging our investors the normal fees of 2% on committed capital and had a short window of time to invest, it's likely that we would have felt urgency to "deploy" the capital lest we run out of time or our investors get frustrated by paying good money for us to seemingly do nothing. Instead, we had time to wait and they paid no fees.

While urgency can be healthy in some cases, unaligned pressure is not. Pressure on the buy side creates a pull to settle for lower quality investments, to pay more, and to agree to less favorable terms – anything to close a deal. While that can look smart in the short term, it's long-term stupid. Quick action under pressure with lower standards will hurt returns.

Pressure on the sell side can be even more insidious. Even the best investors don't get the chance to make gold-star investments every day. When that opportunity comes knocking, the key to maximizing returns is to hold that investment and generate compounding returns for as long as possible. If you're operating a 10-year fund, though, "as long as possible" is often five years or less.

Peers regularly acknowledge that the biggest drag on returns is not from making bad investments, but in selling good companies prematurely – before they have had the chance to fulfill their potential.

Again, that is where our fee model aligns us with investors. We have no incentive to do bad deals on the front end. We only get paid when we pay out cash returns to partners in the form of distributions, which we generally aim to do twice per year. If we have no cash to pay out, we take no fees. Said differently, we can't ever make it look like we are doing better than we are with hypothetical asset values or fancy spreadsheets and take fees off of mark to market, or worse, mark to model returns.

On the back end, we're not required to sell for generations. With that kind of time horizon, we collectively enjoy greater prosperity if a company keeps increasing in value and generating free cash flow. That doesn't mean we'll never sell anything, but it gives us the ability to be thoughtful sellers (rather than forced ones) with high opportunity costs.

That's how our terms prop each other up: In order to have a long time to invest and not have to return that money for 30 years, we only get paid when we generate above average cash-on-cash returns. Anything less, we work for free. There's no way for us to make money unless our partners make a lot more. And, unless they can buy beer with it, we don't charge fees on it.

How Our Fund Structure Aligns Us with Operators

We're predominantly investing in the U.S. lower middle market, which we define as being businesses that are generating between $2M and $25M of cash flow. These businesses have been successful by any measure, but for one reason or another have not grown bigger. There are all kinds of reasons why this can be the case, and the nuance should guide how best to hold and reinvest.

Because of a short hold period, most firms have to default to an add-on strategy, rolling up other firms in successive transactions to build up collective EBITDA. Oftentimes the businesses will have disparate operating approaches, customer conflicts, and potentially even disjointed value propositions that don't make a ton of sense mashed together. But all things being equal, more EBITDA is better when flipping the company to the next buyer, regardless of how muddled and messy it can be day-to-day for operators and an organization's legacy.

While we will look for add-on opportunities, we have a broader and more patient view on how to build. One of our favorite questions to ask of a business leader is: What are the things we could invest in now that wouldn't pay off for years, but that could be a gamechanger for the company's trajectory?

With those answers in hand, we can collaborate with leadership to execute. Frequently, the opportunities operators identify are multi-year investments in areas such as marketing, technology, or people. For the businesses we invest in, these would be big, practically impossible aspirations without our investment. And truthfully, if the goal was to optimize EBITDA for the next three to five years, they'd never get off the ground. With 30 years to optimize, we can pursue long-term advancements that add real, sustainable value to the business.

The flip side of this is that if we're opting to make multi-year reinvestments, investors are foregoing cash returns. To ensure that all of our incentives are aligned towards operational excellence, we typically ask the operators at our businesses to be incentivized on distributions as well. That way we are all in the same boat (and the boat isn't lopsided). No one is winning unless we all win together. And while there is plenty of flexibility to work on high impact, long duration projects, even if the feedback loop is going to be long, there's no reason to work on projects that don't have a high probability of paying off.

Why It's Weird and Why Weird Works

We'll come right out and say it: Our funds are weird. It's a weird structure for people who don't mind bucking convention and like uncorrelated returns, and for businesses that appreciate patience, autonomy, and entrepreneurialism, rather than private equity best practices.

It's not for everybody. Many people are happy to ring the short-term cash register rather than let things compound. Fees on committed capital are the epitome of this mindset: if fees are one's main form of compensation, then it makes sense to raise, deploy, raise – as fast as you can.

Also, being patient is hard. We've had partners pass on working with us simply because they don't intend to or can't comprehend what 30 years looks like. To be long-term, you have to commit to showing up for a long time.

Like the old joke about IBM, no allocator at an endowment, family office or institution is going to lose their job for investing with a big private equity firm with average performance and a conventional structure. And no one at a big private equity firm is going to lose their job for generating average performance with the conventional model.

But we've found that there are people – generally with lots of experience where real life and theory collide – dedicated to investing for the long haul in sturdy, durable businesses. And there are many founders and operators who better align with this long-term approach.

Our fund structure allows us to facilitate operational decisions geared towards patient, sturdy growth. Our fund model intentionally promotes alignment between our firm, our portfolio companies, and our investors. Our funds, then, work as a filter, repelling the wrong people and attracting great partners. If you're not genuinely a long-term investor or operator, the fund structure probably sounds, at best, weird.

If you bet on weird and it goes awry, there's fear, real or imagined. People are going to look at you sideways. And you can expect a lot of questions.

Yet we think that's the strength of our model. It's different, long-term, and aligning, even if it's not for everyone.