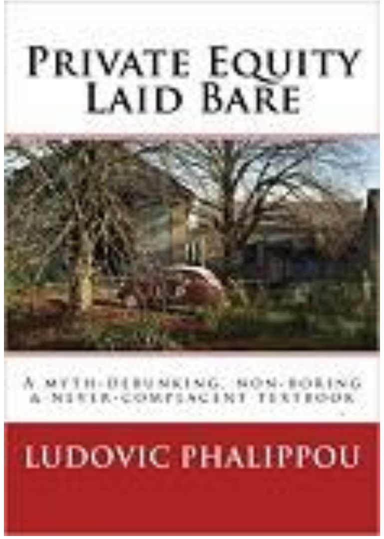
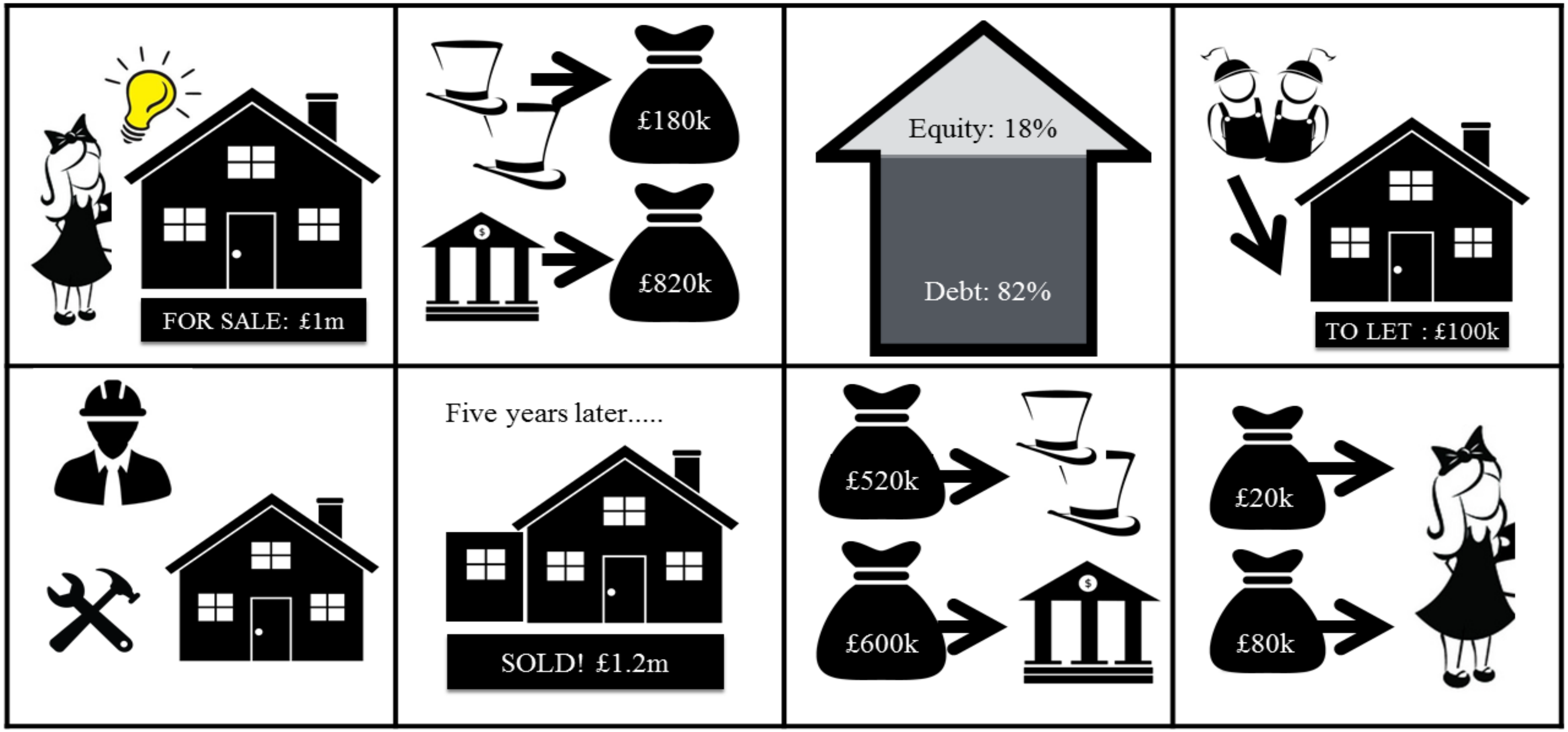
The benefits of transparency in private markets



Ludovic Phalippou

University of Oxford

A private equity transaction



The exact same mechanism is used to purchase shopping malls (real estate), airports (infrastructure), corporations (LBOs/PE), forests …

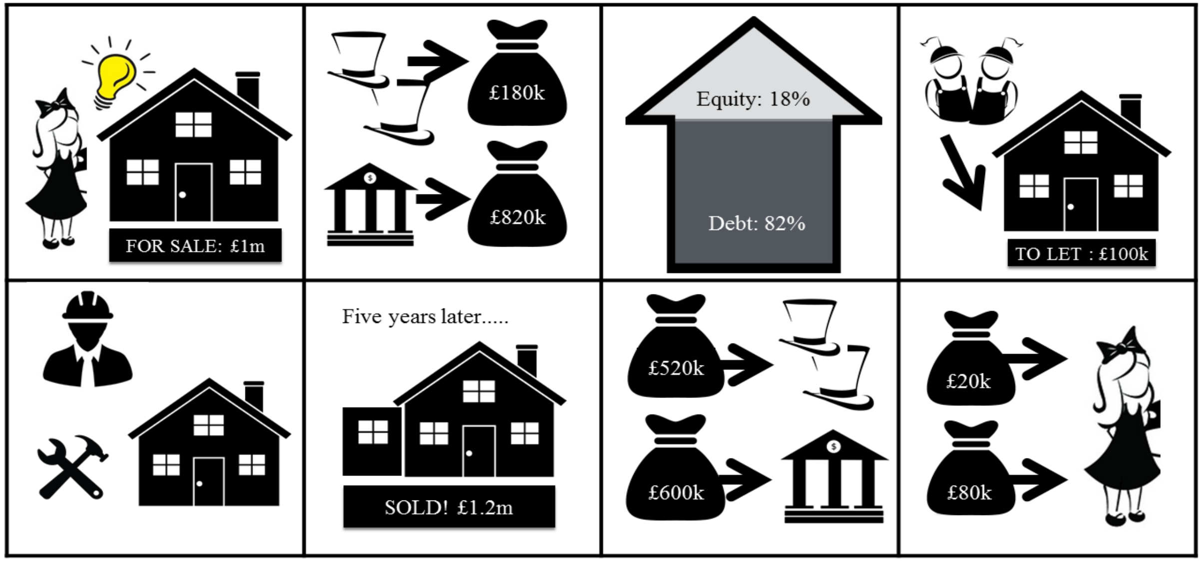
Featuring Alice (GP), Hatters (LPs), House (Portfolio company), Bank (Lender to the portfolio company), “Value Add” (Operating partners, consultants…)

Example of corporations that have been (are) managed by PE firms

Celanese
dfs
DUCATI
Metro Goldwyn Mayer
TRADE MARK
ARS GRATIA ARTIS


Thames Water
HCA
Hospital Corporation of America
selecta
COGNITA
TEACHING EXCELLENCE
PortAventura
LAUREATE
INTERNATIONAL UNIVERSITIES
ECOLES YASSAMINE
مدارس ياسمين
Depuis 1986
DEBENHAMS
BRITAIN'S FAVOURITE DEPARTMENT STORE
TXU energy
Hertz
EMI
Boots
Guitar Center
The Musician's Choice
Mc Graw Hill Education
Hilton
CIRQUE DU SOLEIL
Michaels
Where Creativity Happens
Samsonite
DELL
TOMMY HILFIGER
hotelbeds GROUP
Continental Airlines
ALLIED WASTE INDUSTRIES, INC.
VERSACE
대성산업가스주식회사
DAESUNG INDUSTRIAL GASES CO., LTD.
PETCO.COM
PIZZA PAPA JOHN'S
PRIORY
altice
handspring
Heinz
eircom
EP ENERGY
BURGER KING
VERIVOX
Wir informieren. Sie entscheiden.
TOYS R US
TDC
INTELSAT
Closer, by far
Come closer
YELL
Seagate
58到家
NABISCO
DUPONT
CoatingSolutions

Alignment of interests



- Alice controls the board of the House/Company (she appointed CEO etc.)
- Alice and Hatter certainly both want the house to be worth as much as possible

BUT

- Alice might be tempted to, e.g., use a private jet and stay in a fancy hotel when inspecting the house improvement operations and pay for this using the rental income. She could also hire herself for consulting services. She could give money (kick-backs) to any consultant advising LPs to invest with her …
- This is unregulated. It is down to Alice's goodwill. If LPs do not have full information (or cannot process it), they do not know what she takes.
- *NB: since 2012 the SEC is bringing some discipline… (will it last? be effective?...)*

Who cares?

- Should LPs know how she behaves?
  - Only LPs, or also the pensioners (it's their money)? What about the taxpayer (might be its money soon if the pension fund is underfunded)?

- Typical argument: It is all about net returns
  - If Alice has delivered good returns in the past, there is no need to know the recipe

- Counter argument
  - Potential fairness / ethics / societal concerns
  - Future may differ from the past: what if Alice behaves as in the past but does not perform well anymore? What if expected returns are generally lower?
  - Is it that clear that Alice has delivered good returns?
    - How to measure returns when Alice holds on to losers and values them herself?
    - How to measure risk?, i.e. what is the relevant benchmark?
    - Everyone wants to dress the numbers up to avoid embarrassment / loss of business: consultants, PE team at pension fund, CIO/CEO pension fund, trustees…
    - Note that consultants would earn a lot less if they advised low-cost solutions, and PE/HF are putting together nice conferences and annual investor meetings in 5* hotels …

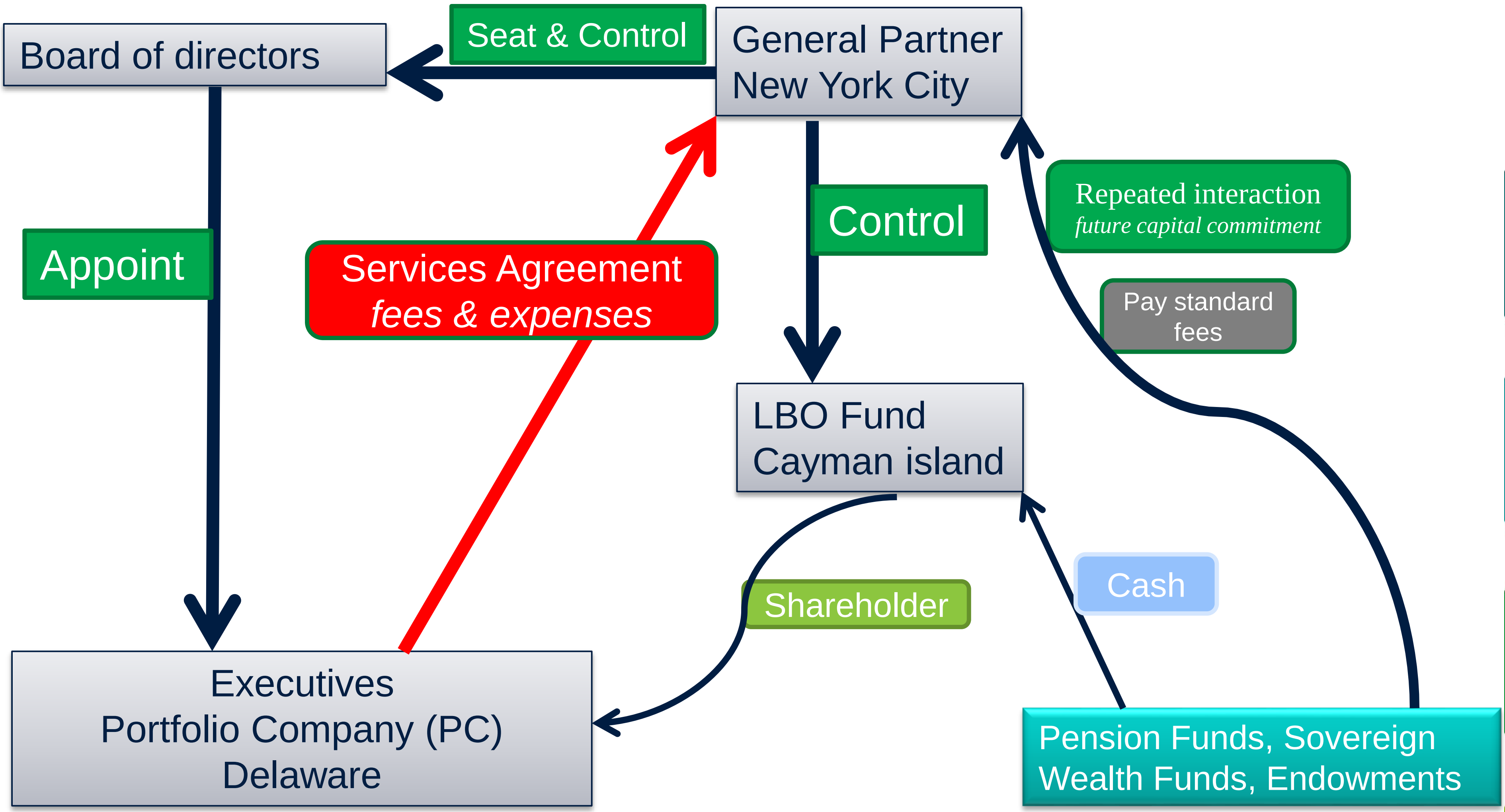
Everyone happy with this?

Table 10.1: CalPERS reported cost and fees for selected buyout funds in 2004 & 2005

	Vintage Year	Capital Committed	Reported annual cost and fees in dollars 2004	2005	% capital committed 2004	2005
Advent IV	2002	25m	258074	338852	1.0%	1.4%
Apollo V	2001	250m	165467	149513	0.1%	0.1%
Blackstone IV	2003	200m	0	31664	0.0%	0.0%
CVC III	2001	200m	2191960	1766954	1.1%	0.9%
KKR European	2001	75m	561145	0	0.7%	0.0%
Madison Dearborn IV	2000	150m	1214183	33384	0.8%	0.0%
TPG IV	2003	200m	338	1974366	0.0%	1.0%

- This is how ALL pension funds, and other asset owners report fees. Total is usually about 1% to 1.5% of NAV
- What is missing?
  - Carried interest: realized and unrealized (about 2-3% p.a.)
  - Fees charged to the asset (about 2-3% p.a.; *see next slides*)
  - Fund expenses, Company expenses (no clue)
  - Other related party transactions (at non arm's length prices), fee waivers...
  - Exact co-investment arrangement

‘Portfolio company fees’ are shown in red below



See *Private Equity Portfolio Company Fees*, by Phalippou, Rauch, and Umber, in *Journal of Financial Economics, 2018*

Example of a transaction

Deal conducted by Apollo and TPG

Announced Sept 2006, Effective Jan 2008

Debt: $22 billion; TEV: $31 billion

What are these transaction and other fees for?

EXECUTION VERSION

SERVICES AGREEMENT

This Services Agreement (the "Agreement") is entered into as of January 28, 2008, by and among Harrah's Entertainment, Inc., a Delaware corporation (the "Company"), Apollo Management VI, L.P., on behalf of affiliated investment funds ("Apollo Management"), Apollo Alternative Assets, L.P. ("Apollo Alternative," and, together with Apollo Management, "Apollo") and TPG Capital, L.P. ("TPG," and, together with Apollo, the "Managers"). (…)

NOW, THEREFORE, in consideration of the mutual covenants contained herein, the parties hereto, intending to be legally bound, hereby agree as follows:

1. Services. Each Manager hereby severally agrees that, during the term of this Agreement (the "Term"), it will provide to the Company (…) from time to time, management, advisory and consulting services in relation to the affairs of the Company (…)

Translation: I may do some work from time to time

What are these transaction and other fees for?

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Translation: I may do some work from time to time

The Managers (…) will devote such time and efforts to the performance of the services contemplated hereby as the Managers deem reasonably necessary or appropriate; provided, however, that no minimum number of hours is required to be devoted by the Managers or the Manager Designees on a weekly, monthly, annual or other basis. (…)

Translation: I'll decide how much I'll work

Potential translation: I won't do anything

What are these transaction and other fees for?

2. Payment of Fees.

(a) As consideration to the Managers for their agreement to render the services in Section 1, on the date hereof, the Company will pay to the Managers (…) an aggregate transaction fee equal to $200,000,000 (two hundred million dollars) (the "Transaction Fee"). (…) In addition to the Transaction Fee, on the date hereof, the Company will pay to the Managers (…) an amount equal to all out-of pocket expenses incurred (…) including, without limitation, (i) the reasonable fees, expenses and disbursements of lawyers, accountants, consultants and other advisors that may have been retained by the Company and/or any Manager or its affiliates and (ii) any fees (including any financing fees) related to the Merger (all such fees and expenses, in the aggregate, the "Covered Costs").

Translation: Yay, I get $200 million

(on top of what it costs to acquire the company?)

Note: GP already receives between 2% and 4% of the equity invested per year from those providing investment capital?

Potential translation: Wow, a $200 million showing-up fee

What are these transaction and other fees for?

(b) During the Term, the Company will pay to the Managers (…) an annual monitoring fee equal to the greater of (x) $30 million and (y) 1.0% (one percent) of the Company's EBITDA (as defined below) (the "Monitoring Fee") as compensation for the services provided by the Managers or the Manager Designees under this Agreement, (…)

Translation:
I'll get at least $30 million a year irrespective of how much I decide to work

Potential translation: Yay, at least $30 million extra per year

What are these transaction and other fees for?

(c) During the Term, in addition to the fees paid pursuant to Section 2(b), the Company will pay to the Managers (...) an aggregate fee (the "Subsequent Fee") in connection with the consummation of any financing or refinancing (equity or debt), dividend, recapitalization, acquisition, disposition, spin-off or split-off transactions involving the Company (...)

Translation: If I do decide to do something, I'll charge extra

What are these transaction and other fees for?

4. Term. This Agreement will continue in full force and effect until the last day of the quarter in which the tenth anniversary of the consummation of the Merger occurs;(…) (x) this Agreement may be terminated at any time upon unanimous consent of the Managers and (y) this Agreement shall terminate automatically immediately prior to the earlier of (i) an Initial Public Offering (…) or (ii) (…) (any such sale transaction, a "Sale"), in each case, unless otherwise agreed by both Managers, (…) Apollo and TPG shall be released from any and all obligations and liabilities with respect to provision of the management, advisory and consulting services pursuant to this Agreement (…) Company shall pay to each Manager (…) a lump-sum amount equal to the net present value of the remaining Transaction Fee, the Monitoring Fee, the Subsequent Fee or any other fees pursuant to this Agreement (…)

Translation: I can stop charging when I want but if I do
I get all the money I was supposed to receive from that point up until 2018

Potential translation: I stop doing nothing when I feel like it

and I get paid for all this work I would not have done

"This isn't like paying a termination fee to your cell phone provider because you don't want to fulfil the term of your two-year agreement. It's like your cell phone provider terminating your service after six months, and then demanding the next 18 months of payment anyway." [Dan Primark, *Fortune*]

Take-away on portfolio company fees

- This company ended up bankrupt and a total of $300 million has been taken out of its cash till by the GPs
- Same thing for Toy’s R’Us ($500 million), Energy Future ($600 million)…
- For a long time, those who knew kept that secret (most LPs were happily ignorant)
- Because of people researching this topic, spreading it in the press …, i.e. pushing transparency,… the industry had to back up a bit
- GPs now often refund most of these fees to the LPs, and responded by saying ‘Ah, yes, these were not very nice practices, but we’ve moved on now’
- Can you still trust these fund managers? There are many other ways for them to help themselves… are we satisfied with transparency achieved so far or do we want more?

Why tranparency can bring a lot more

- Besides ethical considerations, the sure-draining triggered by asymetric fees (see extra slide),...
- If the actual figures are on the table in terms of fees and returns then investors would have more bargaining power and would not accept that:
  - Fund managers take 6-7% p.a., leaving them with returns that are close to those of public equity
  - Most fees are discretionary and unrelated to performance
  - Performance-related fees work only in one direction
  - Fees charged rely on the goodwill of fund managers, especially in bad times
  - Etc.
- Currently, investors try their best to hide all this. Some close their eyes, and some are increasingly investing in private markets all by themselves to avoid all of the above (and because it's a lot more exciting than investing in funds)

Extra slides

The tyranny of asymmetric fee structures

- So far most funds obtained an IRR > 8%, hence nearly all earned a carry, which is expensive but at least returns have been above 8%

- If PE returns are lower going forward, then might end up in the following situation:
  - Allocate $10b to winner funds that return $15b after fees, pay $1b of carried interest to them
  - Allocate $10b to loser funds that return $5b after fees, no carry paid.
  - Total: Paid $20b, received $20b, some fund managers received $1b!
  - By construction if you invest long enough with managers that charge an asymmetric fee, all the money is eventually transferred from pension funds to fund managers
  - Might be why HF and PE are sometimes called: a compensation package dressed up as an asset class

Everyone happy with this?

- All performance figures cited are Internal Rate of Returns.
- These are NOT rates of returns!
- But generates very impressive numbers!
- Who has an incentive to do these computations correctly?

Performance of PE funds – Done properly

- Performance is similar to that of *similar* listed equity

- Most optimistic views would select a major stock benchmark that has low returns (e.g. MSCI world, used to be Russell and S&P 500) – in this case, return is 3-4% above that stock-market index

- Other PE: Bad (Real Estate), Unclear (VC), Good but depends on benchmark (Credit, Infrastructure)