The fee you see ain't always what you get

Institutional investors are beginning to demand fee reductions from their private equity managers, which go beyond a simple trimming of the headline management expense ratio (MER). MICHAEL BAILEY reports.

Catherine Mountjoy ... *ilpa.org is putting limited partners on the same page*

John Pearce ... *charge active fees on uncalled capital and you shouldn't be in business*

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The tables have turned in the ongoing war over private equity fees, with potential investors now advancing fast on their weakened positions of 2006-07.

A key battleground, according to Brad Young from private equity consultancy and fund-of-funds manager Altius Associates, are the 'work fees' charged to the underlying company involved in a private equity transaction.

"These work fees might be director's fees, if the [private equity] general partner takes a couple of board seats. Or the manager might convince a company to which it's providing growth capital that it needs a strategic review, and by the way here are a couple of guys that can do that for you – for a fee of course," Young says.

Some limited partners are unaware their private equity manager is being paid in this way, and don't ask that any of this remuneration be credited back to the net asset value of the fund.

Savvier limited partners have, in the past, received a 50 :50 split of the proceeds, however Young says that in the buyer's market of private equity today, he has managed to negotiate up to an 80 per cent split of the work fees on behalf of Altius' advisory clients.

"We only want our managers getting paid when we get paid," he says. "It's harder to get alignment of interests in a private equity transaction today, where the pool of assets has grown larger to the point where it has itself become a revenue generator."

Even an 80:20 split in the investors' favour falls short of the aspirational goal set out by the global body representing their interests, the Institutional Limited Partners Association (ILPA).

The ILPA Private Equity Principles, released only months ago, state that: "All transaction, monitoring, directory, advisory, and exit fees charged by the general partner should

accrue 100 per cent to the benefit of the fund."

Another Altius partner, Catherine Mountjoy, said the ILPA website – www.ilpa.org – was becoming a tool to help "limited partners all get on the same page with each other", and even begin to create a "true secondary market" for their private equity fund interests.

She said the network was helping expose the "window dressing" of published management expense ratios, and bringing transparency and even standardisation of carry terms, commitment fees and ensuring incentives generally aligned with the long-term interests of limited partners.

Based in Virginia, Altius has been a presence in Australia since 2007, when it became the advisor to the international private equity portfolio of the Australian Reward Investment Alliance (ARIA). It also picked up UniSuper as a client, although that relationship has recently become more a matter of monitoring existing managers than sourcing new ones.

The chief investment officer of the $25 billion industry fund, John Pearce, confirmed last month he was sticking by his decision to make no new private equity investments for the time being, in preference for the "better opportunities" in property and infrastructure.

UniSuper has even sold some of its large number of private equity closed-end fund interests on the secondary market, crystallising losses in some cases.

Pearce acknowledges that institutional investors were now driving fairer splits on work fees, but says that is a moot point for UniSuper given its withdrawal from new investment. A far bigger problem is that the fund continues to pay a full active fee on the undrawn capital in many of its private equity investments.

"The managers justify that by saying they've got fixed costs and what have you, but if you ask me, if they need to charge that to survive then they are in the wrong business," Pearce says.

The chief investment officer also has no time for that other great justification of charging active fees on uncommitted capital – that it prevents managers from recklessly pursuing any deal that comes their way.

"The managers all have a lot of their own money tied up in their funds, so the incentive not to do deals for the sake of a higher fee is already there." Pearce is not alone in his reservations towards private equity. The 'barbarians' of a few years ago have experienced lacklustre responses to their recent approaches to investors.

Altius' Young observes that Blackstone, for instance, just closed a fund "having raised a lot less than they have in the past", while a Madison Dearborn offering was also undersubscribed.

Where the consultant is seeing demand outstrip supply is at the smaller end of the market, where managers are seeking $4-500 million to deploy much-needed capital to middle-tier businesses. ■