PRIVATE EQUITY FEES UNDER SCRUTINY

The explosion in private equity has spawned a torrent of market debate lately about high price multiples and monster debt packages, but the perennial question remains: are managers charging investors too much? **Charlie Corbett** reports.

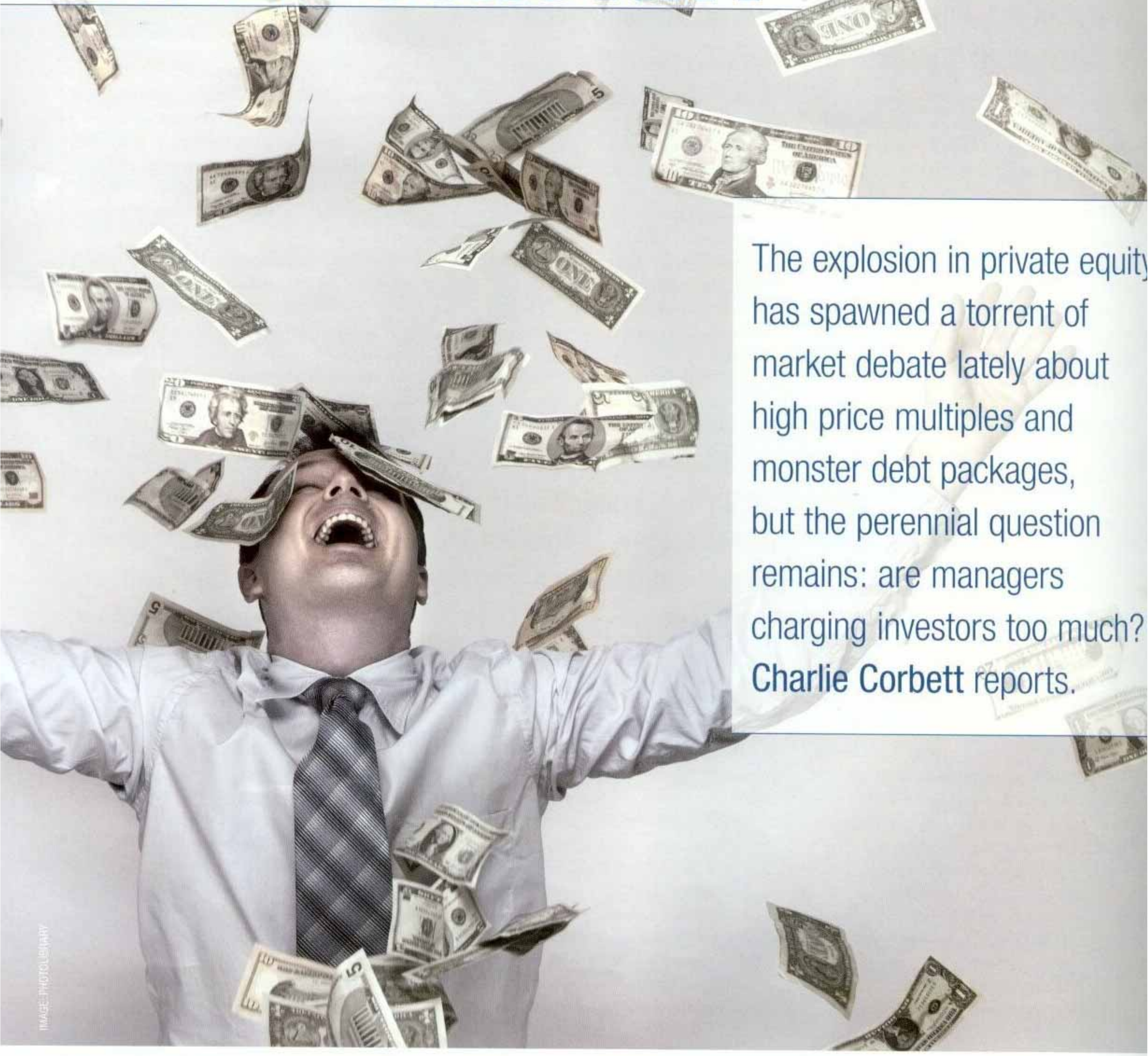
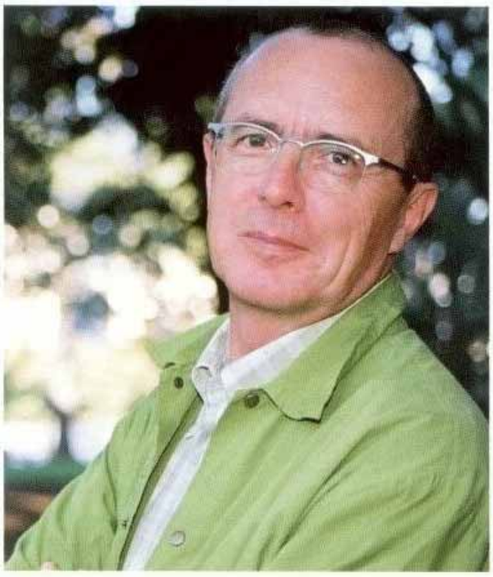


IMAGE: PHOTOLIBRARY



LES FALLICK

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– Les Fallick, Principle Advisory Services

has been breached by the current level of private equity management fees.

"The 2 per cent management fee was established when the average [private equity] fund size was about $300 million. The high fee was a reflection of the hands-on nature of private equity and high cost of running a fund. Investors could audit the accounts of their private equity managers to see that their fee was being spent directly on managing the fund," Fallick says.

"In today's environment, however, when fund sizes are up to $1 billion or $2 billion the connection between the management fee and the cost of running the fund breaks down."

He says that in an environment where individual managers can be earning up to $10 million a year and accumulate up to $40 million over four years, whether the fund is successful or not, the alignment of interests between investors and managers is breached.

"A 2 per cent fee for the larger funds means they can make themselves rich whether they outperform the market or not. This is not good for investors and not good for the industry," he says.

Not everyone agrees, however, that private equity managers earn too much.

Others in the industry argue investors are paying for managers' skill and it is worth every cent.

Australian Private Equity Venture Capital Association chief executive Katherine Woodthorpe agrees that as private equity funds get bigger so the fees go up.

BECAUSE YOU'RE WORTH IT

Woodthorpe argues, however, that this is because there are more mouths to feed. "You need more people to work deals. If you look at Tim Simms at Pacific Equity Partners he has 30 deal makers," she says.

She adds that institutional investors negotiate fees with their managers and would not pay if they did not feel it was worth it.

"It's an even negotiation. The fees are agreed between the investor and the fund manager. Super funds are very sophisticated and have choices about where they put their money. They have the clout to negotiate the fee if they thought it was not fair," she says.

ARIA chief executive Steve Gibbs agrees. "It's true that fees are higher for private equity than any other asset class, and it's an issue that's on our radar, but then you expect that," Gibbs says.

"It's the net result that matters. If we didn't think returns after fees were worth it then we wouldn't invest."

As to the accusation that the alignment of interests between managers and investors has been breached by the big salary packages on offer, Woodthorpe argues that money is not the prime motivator for many managers.

"They love doing what they do. They did not become private equity managers to sit around on big salaries fishing or going on expensive golf trips. If they did that they would have a short shelf life," she says.

"The amount of money in salaries is substantial, but no matter what managers earn, they have to keep proving themselves. They are young guys who want to keep earning good money and are passionate about what they do."

The debate surrounding management fees is a perennial part of global financial services. It's an argument that won't go away in a hurry, but Fallick argues investors can make a difference.

"The challenge for Australian investors is to ensure their gatekeepers, the asset consultants and fund-of-fund managers, are rigorous in monitoring managers' operating budgets and fees," he says.

"Ten years ago the industry funds made a concerted effort to drive down the fees of listed managers and were highly successful. Perhaps it's time in the domestic market for Australian superannuation funds to take a similar approach to private equity base fees." ❇

AUSTRALIA FINANCIAL SPONSOR M&A BUYOUTS[1]

Announced	Deal Value ($m)	No	% M&A Activity
2001	952	22	2.9
2002	548	9	1.7
2003	361	17	0.9
2004	1,543	25	2.2
2005	1,476	47	2.8
2006	19,467	86	18.7
2006 YTD	1,489	14	14.7
2007 YTD	3,399	10	21.8

[1] Acquisitions by private equity firms including add-on transactions

Source: Dealogic