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Private equity portfolio company fees[☆]

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ABSTRACT

In private equity, general partners (GPs) receive fee payments from companies whose boards they control. Fees amount to $20 billion evenly distributed over time, representing over 6% of equity invested by GPs. They do not vary with business cycles, company characteristics, or GP performance. Fees vary significantly across GPs and are persistent within GPs, even after accounting for fee rebates to limited partners (LPs). GPs charging the least raise more capital postfinancial crisis and are backed by more skilled LPs. GPs increase fees prior to going public. We discuss how these results could be explained by optimal contracting and tax arbitrage.

1. Introduction

Since the 2008 financial crisis, private equity (PE) firms have gone from managing $1 trillion to managing $4.3 trillion. From public filings, we know that over that time period, the private equity divisions of Carlyle, KKR, Blackstone, and Apollo collectively earned (i) $20 billion in carried interest, which is paid if the return exceeds a threshold level; (ii) $13 billion in management fees, which is a fixed fee; and (iii) a minimum of $3 billion in "net monitoring and transaction fees" (Table A.1).

While the former two sources of fees have been extensively studied, e.g., Gompers and Lerner (1999), Metrick and Yasuda (2010), and Robinson and Sensoy (2013), we know little about monitoring and transaction fees besides summary statistics reported in practitioner memos and informal surveys. Moreover, these fees are puzzling because it is not clear for which services they are being earned, and they are being paid by companies whose board members are employed by the PE firm receiving these fees. In fact, these fees recently became a public policy focus, with the Securities and Exchange Commission (SEC)

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fining several PE firms, and state treasurers demanding full disclosure.[1]

Using a comprehensive hand-collected dataset, this paper describes the contracts underlying transaction and monitoring fees, quantifies those fees, and studies their variation across fund managers, business cycles, and company types. In addition, we attempt to reconcile these fee arrangements with relevant optimal contracting theories.

Most private equity funds are organized as limited partnerships, with private equity firms (e.g., Blackstone) serving as general partners (GPs) of the funds, and institutional investors providing most of the capital as limited partners (LPs). Limited partnership agreements (LPAs) are signed at the funds' inception and define the expected payments by LPs to GPs: the management fee and carried interest. The amount of fees charged to portfolio companies (such as transaction and monitoring fees) is not specified in the LPA; they are contracted upon in management services agreements (MSAs), which are signed by GPs and representatives of the company at the time of the transaction, hence ex-post LPA. The LPA, however, states the fraction of each type of portfolio company fees that is rebated against the management fee due by LPs (subject to a number of exceptions).

As limited partnerships last for over ten years, LPAs are necessarily incomplete contracts. It is difficult to write and foresee the numerous contingencies that can arise over such a long period of time. The earliest foundation of transaction cost economics, such as Williamson (1971), argues that incomplete contracts imply the need for ex-post adaptation. The procurement literature, for example, highlights the importance of allowing agents to charge ex-post adaptation costs, as shown in, e.g., Crocker and Reynolds (1993), Bajari and Tadelis (2001), and Bajari et al. (2014). We may need a combination of an ex-ante contract such as the LPA, which is standard and similar across GPs, followed by an ex-post adjustment contract such as the MSA. This would imply that portfolio company fees should be predominantly company- and time-specific, not GP-specific. Companies that are riskier or more difficult to monitor can command higher fees, and fees can increase for all companies when leveraged buyouts (LBOs) are more costly to execute in times of higher credit spreads, lower risk premium, or lower credit supply, as argued by Axelson et al. (2013) and Haddad et al. (2017).

There are several other theoretical arguments to support the view that MSAs are part of an optimal contracting device. We examine four such arguments here. First, as LPs need to learn about GPs' talent and pay GPs accordingly, it can be optimal to start with a standard and low compensation and to let GPs adjust it upward if they are successful (see Berk and Green, 2004; Robinson and Sensoy, 2013). Second, GPs have less financial incentives when their carried interest is out of the money, and MSAs can be used to reset their incentives. Similarly, when a company is in financial distress, equity holders have less incentive to perform since some of the benefits accrue to debtholders, as in Myers (1977). Discretionary adaptation fees could solve this old problem. Third, as fees are subordinated to debt, they can be a commitment device by GPs to repay debt to earn the fees, as argued by Malenko and Malenko (2015). Fourth, following Axelson et al. (2009), MSAs can counteract a GP's incentive to invest in bad projects when they are getting close to their investment period deadline. These arguments imply that certain GP characteristics should relate to fee levels such as the GPs' past and current performance, the GP's reputation with creditors, or the fund age at the time of LBO inception.

Alternatively, these fees can be camouflaged dividends. The idea, building on Polsky (2014), is that GPs transfer cash out of the company and call it a fee rather than a dividend because fees, unlike dividends, are deductible from corporate taxes. GPs then share the tax savings with LPs via a reduction in management fees. Under this tax view, we expect GPs to charge more at times when more taxes are being paid (i.e., in good times) and to companies with larger tax bills. GPs should rebate at least 60% of the portfolio company fees to LPs because the maximum marginal corporate tax rate is 40%. We can also expect LPs to reward GPs who generate larger tax savings.

We manually collect comprehensive information about portfolio company fees; we examine 25,000 pages of relevant SEC filings covering 1044 GP investments in 592 LBO transactions, whose total enterprise values (TEVs), including add-on acquisitions, add up to $1.1 trillion. SEC filers need to disclose (i) material definitive agreements such as credit agreements and MSAs; (ii) previous fiscal year or currently contemplated related party transactions worth more than $120,000; and (iii) financial information for the preceding three years. As a result, SEC filings provide annual information on portfolio company fees. LBOs with SEC filings are essentially those that ended their PE sponsorship via an initial public offering (IPO), and LBOs with publicly traded debt.

We retrieve the underlying contracts (MSAs) and record the time series of the two main portfolio company fees. A transaction fee is charged at the time of LBO inception and when add-on acquisitions are made. The sum of the transaction fees in our sample is $10 billion. Monitoring fees are charged quarterly during the life of the investment; they add up to a similar amount. These two fees thus reach near to $20 billion, or 6% of the equity invested by GPs on behalf of their investors, and are basically constant over time. Importantly, MSAs indicate that transaction fees are paid on top of what it costs to acquire the company, and monitoring fees do not require actual work to be performed to trigger their payment (director fees are separate).

To evaluate optimal contracting theories, we first study how the fees relate to LBO characteristics (industry, earnings volatility, leverage, and GP ownership) and to business- and LBO-industry cycles. However, we find no statistically significant relations. Notably, fees are not higher at times when it is more difficult to execute and

[1] On July 21st, 2015, 13 state and city treasurers wrote to the SEC to ask for private equity firms to reveal the monitoring and transaction fees they charge investors. In August 2015, one of the largest investors in private equity said that it will no longer invest in funds that do not disclose all of their fees. The SEC announced on October 7th, 2015, that it "will continue taking action against advisers that do not adequately disclose their fees and expenses" following a settlement by Blackstone for $39 million over so-called accelerated monitoring fees.