Roundtable Summary

Towards a Better Aligned Private Equity World: Perspectives of Limited and General Partners

Over the past several years, issues around alignment of general and limited partners have taken center stage. These concerns have manifested themselves in a variety of different ways, from concerns about poorly disclosed fees, the desire on the part of LPs to explore separate accounts, co-investments, and other special relationships with GPs, and the increasing tendency for large institutions to "go it alone" with their own investment teams.

On May 4th, 2016, the Institutional Limited Partners Association (ILPA) and the Private Capital Research Institute (PCRI) brought together a group of industry thought leaders—comprised of prominent limited partners, general partners and academics—at Harvard Business School to have a candid discussion. This workshop, part of an ongoing series of seminars organized by the PCRI, sought to explore the important and dynamic issues associated with creating better alignment in the private capital industry. Each of these sessions provoked lively discussion between panelists and audience members.

This document summarizes the three panel discussions. Due to the sensitivity of the topics, we did not attribute the remarks to individual panelists or workshop participants, with the exception of the discussion of the publicly available academic research.

Panel Discussion 1: Creative approaches to alignment from the LP's perspective

Moderator: Mike Mazzola, *Director of Alternative Investments*, MetLife
Panelists: Tim Recker, *Managing Director*, Private Equity and Real Assets at University of California Regents
Brad Thawley, *Senior Investment Manager* of Teachers Retirement System of Texas

The panel began with a discussion on the ways in which the relationship between LPs and GPs has evolved over the years. The participants observed that overall there is currently a trend towards more flexibility and transparency, which is generally leading to better alignment. The extent of alignment for buyouts has increased over the years. However, for venture capital, the results are more mixed.

The participants noted that co-investments, which provide more control and better economics to the LPs, are now becoming a large part of the private equity investment model across the industry. In addition, the participants touted the benefits of more concentration and deeper engagement with GP partners. They stated that the ability to focus on a limited number of funds allows for more influence, better collaboration, strengthened relationships, and a reduction in the extensive negotiations undertaken with the launch of each new fund.

At the same time, it was highlighted that the move to separate accounts and co-investments had a darker side. In particular, these steps had the potential to introduce misalignment across the LPs, where each did not know the economic arrangement that the other had. Some LPs expressed that the concern that one of their peers with a particularly favorable arrangement with a GP might be more willing to countenance problematic behavior by them, and thus undermine efforts of other LPs to address a troubled situation.

Next, the conversation turned to a discussion about fees. The participants agreed that currently there is a more open dialogue around fees, citing the importance of the release of the ILPA fee reporting template. There is a trend towards more transparency about how managers are creating value and incentive-based compensation. Increasingly, the participants noted that fee structures are moving towards lower management fees and possibly higher carry.

Furthermore, one-for-one offsets of transaction and other fees through reductions of management fees are now more prevalent. Now, almost two-thirds of the funds have 100% offsets, as compared to years ago when there were very few. (Instead, 50% and 80% offsets were prevalent.)

That being said, there are still remaining issues. One issue that is also very important to LPs is how compensation (carry in particular) is distributed within a GP, particularly in the not-uncommon situations where younger partners are doing the bulk of the "heavy lifting" in the partnership. The benefits of higher level of transparency around carry splits within GP firms was also noted. Partner succession plans are another major issue with a view that the ownership of a GP should naturally pass to the next generation rather than providing liquidity to retiring partners by ascribing a multiple to their ownership interests.

Overall, the participants believe that the GP-LP relationship is a delicate balance. LPs may not want to negotiate every last dollar. In fact, it was mentioned that some studies even seems to indicate that some of the best performing managers are not necessarily the best-aligned ones. An LP that negotiates too hard may risk being left out of a "hot" fund. A good relationship and respect are also important pieces of the equation. That said, the panelists felt that there will be more alignment going forward. Critical to all this transparency is more and better data.

Panel Discussion 2: Academic perspectives on GP-LP alignment

Moderator: Josh Lerner, Harvard Business School and Private Capital Research Institute
Panelists: Victoria Ivashina, Harvard Business School
Berk Sensoy, Ohio State University
Antoinette Schoar, MIT

Antoinette Schoar began by sharing her insights on LP investment decisions. Schoar, along with Steven Kalan, found that there has historically been large persistence of performance in buyouts and venture capital.[1] This is true not only in the top tercile of funds, but also the bottom tercile of funds. See Table 1. This stands in sharp contrast to the patterns among mutual funds, where there the results do not support superior stock-picking skills, as the persistence in performance is completely explained by common factors and investment expenses.[2]

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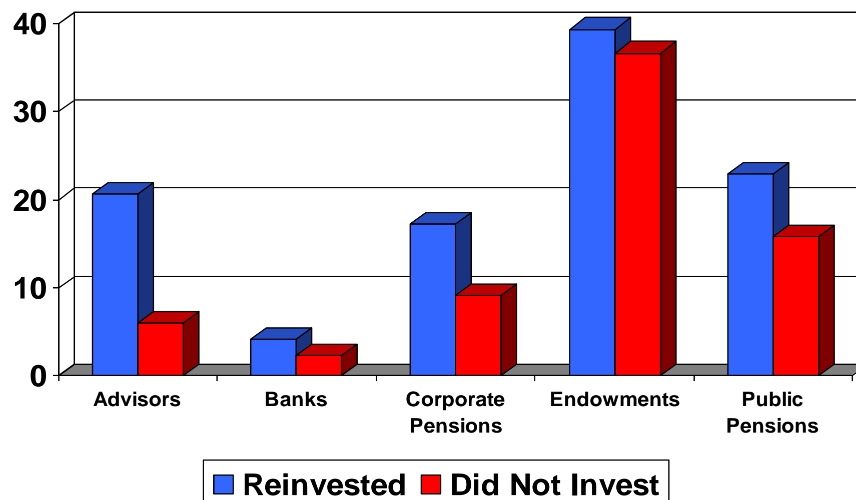
[1] Kaplan, Steven and Antoinette Schoar, "Private Equity Performance: Returns, Persistence, and Capital Flows," *Journal of Finance* 2005
[2] Carhart, Mark M., "On Persistence in Mutual Fund Performance," *Journal of Finance*, March 1997

Table 1
Persistence of Performance
(Kaplan and Schoar, *Journal of Finance*, 2005)

	Bottom	Medium	Top
Bottom Tercile	61%	22%	17%
Medium Tercile	25%	45%	30%
Top Tercile	27%	24%	48%

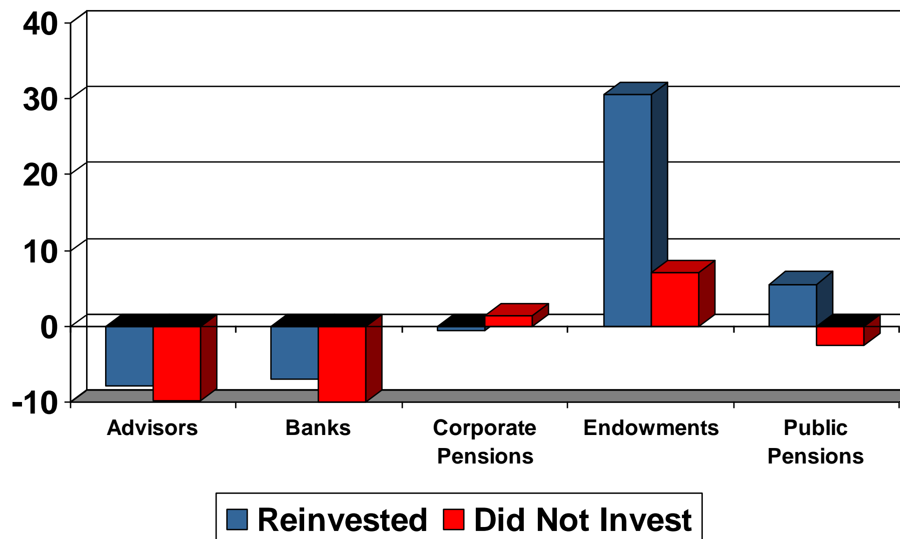
Puzzled that bottom tercile funds continue to receive funding, she (along with Josh Lerner and Wan Wongsunwai) examined the question of how LPs make investment decisions.[3] They find that there is much heterogeneity in the investment behavior amongst the LPs. Some LPs were not sensitive to past performance, meaning they stood ready to reinvest no matter how poorly past funds performed. Other funds, in particular endowments, were less likely to reinvest in poorly performing funds. The researchers also found the funds in which endowments chose to reinvest continued to have returns outperformed their peers. See Charts 1 and 2. From a governance standpoint, the researchers questioned LPs decisions to reinvest in poorly performing funds. The researchers concluded that LPs themselves must have poorly aligned incentives, whereby they are not incentivized by performance, but instead incentivized to make allocations. It was noted that the differing investment success between endowments and other investors appears to have narrowed substantially in recent years, but it was unclear whether this was due to the lagging returns of venture capital funds—which drive much of the endowments' success--during the first decade of the 2000s (and thus might be expected to resume as venture returns have climbed in recent years), or whether this represented a permanent shift.

Chart 1
IRR of Previous Fund
(Lerner, Schoar, Wong, *Journal of Finance*, 2007)



[3] Josh Lerner, Antoinette Schoar, and Wan Wongsunwai, "Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle," Journal of Finance, April 2007

Chart 2
IRR of Next Fund
(Lerner, Schoar, Wong, *Journal of Finance*, 2007)



Next, Professor Berk Sensoy from Ohio State discussed his research with his colleague David Robinson on the relationship between fees and performance.[4] He began by explaining that fees (i.e., contracts) are only one mechanism for helping with alignment of interests. Other levers for alignment include things like reputation (ability to fundraise), ability to exit, voice – the ability to lobby for change --and separate arrangements. In particular, the researchers examined the relationship between net performance of funds and three aspects: management fees, carried interest, and GP ownership. The researchers find that GPs with the highest fees did not have the worst net performance, in fact, tended to slightly outperform. Low fee GPs, perhaps with lower returns and needing to incentive LPs or struggling to fundraise, did not perform as well on a gross basis, but net of fees, the differences were modest. In addition, there was no evidence that low GP investments into the fund, i.e., the "GP commit", results in underperformance.

So, how should one think about rationalization of fees? Sensoy stated that this does not mean LPs should not negotiate hard. All things being equal, it is best to get the lowest fee possible.

Lastly, Professor Victoria Ivashina summarized her study that examined how fund economics are distributed within a GP.[5] Ivashina, along with Josh Lerner, find that the economics of funds are not equally distributed amongst the partners within a GP. Senior partners receive a greater share of the carried interest and, at the same time, there is a concentration of ownership of the management company at the senior level. See Chart 3.

The researchers went on to explore what drives these patterns. They find that there is no relationship between allocation of fund economics and past performance as an investor. Thus, the pay-for-performance tie may be weaker than expected. Perhaps, junior partners are willing to accept a lower share of fees and carry with the hopes of getting promoted. They find that what is important is status as a founder. See Chart 4. However, the

[4] David Robinson and Berk Sensoy, "Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance," Working Paper July 2013
[5] Victoria Ivashina and Josh Lerner, "Pay Now or Pay Later?: The Economics within the Private Equity Partnership," Working Paper, March 2016

inequality of carried interest and ownership tends to lead to the departure of senior partners, which appears to have a negative effect on the ability of funds to raise additional capital. The paper raised the concern that while much work had been done to address alignment issues between LPs and GPs, there were important issues with the GPs themselves.

Chart 3
Distribution of partners' share of carried interest and ownership
(Ivashina, V. and J. Lerner, "Pay Now or Pay Later?: The Economics within the Private Equity Partnership," *Working Paper* 2016)

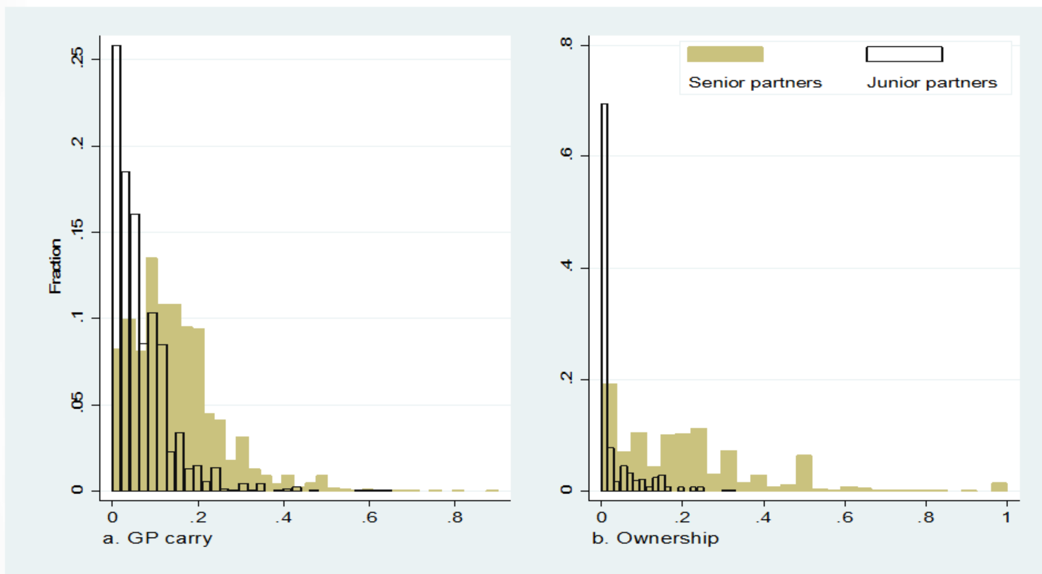
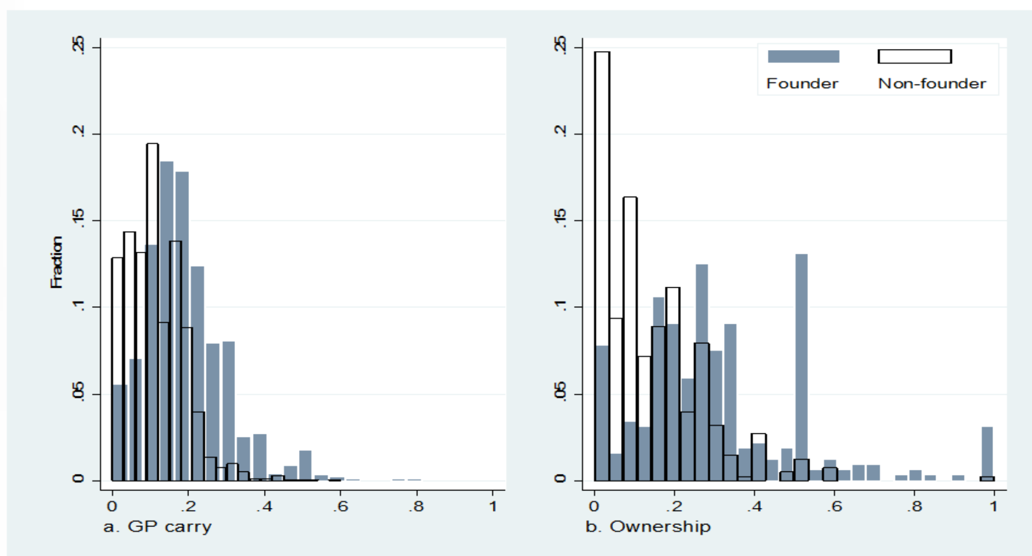


Chart 4
Founder effect
(Ivashina, V. and J. Lerner, "Pay Now or Pay Later?: The Economics within the Private Equity Partnership," *Working Paper* 2016)



Panel Discussion 3: Creative approaches to alignment from the GPs' perspective

Moderator: Scott Kalb, *Executive Director* at Sovereign Investor Institute
Panelists: Perry Golkin, *Co-Founder and Chief Executive Officer* at Public Pension Capital Management; *Adjunct Professor of Law*, University of Pennsylvania Law School
Vincent Mai, *Chairman and CEO*, Cranemere
Steven Pagliuca, *Managing Director*, Bain Capital
David Singer, *Managing Partner*, Maverick Capital Ventures

In this last panel discussion, four prominent GPs discussed their thoughts on current LP-GP alignment issues and their experience in attempting to find solutions, including the development of innovative structures tailored to the needs of the long-term investor. Some participants felt that the private equity world is currently facing declining returns, high fees, problematic incentives, and a lack of governance. In addition, a number of participants felt the current model is too short-term focused, with incentives to monetize investments too early: GPs want to lock in returns before going to raise their next fund. Furthermore, one participant commented that the short-term focus is also driven by metrics such as IRR and performance quartiles, creating perverse incentives where the GPs and LPs alike are willing to exit investments prematurely to satisfy the need for IRR. As a result, GPs sell winners too early at less than maximum exit value and hold on to losers. Another participant added that the model of buying and selling businesses is inefficient with an estimated 7% of enterprise value going to bankers, lawyers and other advisers. Equally important, it was noted that sale processes distract portfolio company management from the job of fundamental value creation.

Finally, the current PE model lacks governance with no mechanism for LPs to address issues and force change if a GP does not do what it says it is going to do.

Next, the participants went on to share some potential solutions from their own experience in attempting to create better alignment with LPs. One participant suggested a reduction in management fees and a 10 percent cap on carry with a pay-for-performance where carry percentages to the GP would be ratcheted against specific hurdles when met. Claw backs were also suggested. To further align incentives, another solution provided was that one-third of capital be required from GP. To encourage long-term investing, two different models were suggested – an evergreen fund or a holding company model akin to Berkshire Hathaway. Such models would also help with governance issues if coupled with the creation of a board of directors to be hold the investors accountable. However, such structures are not without concerns, such as issues related to interim valuations and the potential for adverse incentives resulting in portfolio mark ups and mark downs. Finally, long duration funds might suppress taking a fresh and healthy view of portfolio assets.

For the most part, the LP community have not embraced the new models. Fund raising has proven to be more daunting for the long-dated vehicles than expected. The participants were surprised by the rigidity of the LP community that was not ready to break from the traditional model. That said, it was noted that these longer duration PE models are attractive to family sellers which can generate proprietary, new investment opportunities. The experience of the GP innovators pointed to both the opportunities and the challenges with promoting change in the private equity industry. As the panelists have learned, every solution may also create different issues that need to be addressed.

About the Private Capital Research Institute

The Private Capital Research Institute (PCRI) is a non-profit organization that seeks to further the understanding of private capital and its impact through independent academic studies. PCRI's primary goal is to produce and disseminate high quality academic research, based in large part on the comprehensive academic databases of private capital activity that the PCRI is building.

About the Institutional Limited Partner Association

The ILPA is the leading global, member-driven organization dedicated to advancing the interests of private equity Limited Partners through industry-leading education programs, independent research, best practices, networking opportunities and global collaborations. The ILPA's membership comprises more than 360 institutional member organizations collectively managing approximately US$1 trillion of private equity assets.