

# LIFTING THE CURTAIN ON PRIVATE EQUITY

A GUIDE FOR INSTITUTIONAL INVESTORS AND POLICYMAKERS



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The **American Federation of Teachers** is a union of professionals that champions fairness; democracy; economic opportunity; and high-quality public education, healthcare and public services for our students, their families and our communities. We are committed to advancing these principles through community engagement, organizing, collective bargaining and political activism, and especially through the work our members do.

# Lifting the Curtain on Private Equity:

## A Guide for Institutional Investors and Policymakers<sup>1</sup>

### *Executive Summary:*

In just a dozen years, the global investment landscape has experienced two of the most severe shocks in modern history: the 2008 financial crisis and the COVID-19 pandemic. These successive crises, and the local and state budgetary pressures they induced, have placed acute stress on institutional investors like pension funds. With interest rates kept near zero, and local and state government contributions constrained by fiscal challenges, public pension funds and other institutional investors have been forced into a “search for yield.” In this context, investment in private equity buyout funds promising higher returns than traditional asset classes has surged.

Through a comprehensive review of the most current scholarship on private equity, this report examines whether the industry’s promises have been met. In turn, it considers 1) the empirical evidence on private equity performance; 2) the material risks associated with private equity investment; 3) the systemic impacts produced by externalities resulting from the private equity business model; and 4) policy measures that fiduciaries and public officials can take to safeguard their investments.

**This report makes clear that private equity performance as a whole has hardly been as impressive as the industry has claimed, and that it has worsened in recent years. Key indicators also suggest that there is a significant risk that overall private equity performance will deteriorate further in coming years. Additionally, this report sheds light on the significant risks associated with achieving even these mediocre returns. These include risks directly related to the investment management relationship as well as indirect risks resulting from private equity business practices and structural trends in the investment landscape.**

First, the report finds that private equity performance has never been particularly impressive and has deteriorated over time. From the launch of the first private equity buyout funds in the mid-1980s through the years just before the Great Recession, the average private equity fund roughly matched the performance of

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<sup>1</sup> The author would like to thank Jim Kane of the National Education Association for his invaluable comments and insights that have improved this report.

comparable public equities. Since the mid-2000s, however, the average private equity fund has underperformed such public equities.

The growth of the industry has resulted in an increasing number of market entrants and a ballooning amount of assets under management. Over the past 20 years, AUM has increased significantly, and the private equity industry as a whole now possesses roughly \$1 trillion in “dry powder,” or uninvested capital. Historically, the quantity of capital committed has shown a negative correlation with performance. With greater sums of capital pursuing a finite number of investment opportunities, acquisition prices have steadily been bid upward. These increasing acquisition prices have systematically resulted in lower returns upon sales. With the amount of AUM expected to increase in coming years, this trend is likely to worsen.

The report also analyzes the significant material risks associated with private equity investment. These can generally be classified as direct risks stemming from the investment management relationship and indirect risks resulting from the private equity business model and the structural dynamics surrounding the industry. The direct risks include extremely high fees, discrimination toward smaller investors, illiquidity and the waiving of fiduciary duty by investment managers. Indirect risks include reputational and headline risks associated with destructive private equity business practices as well as structural risks resulting from the maturation of the industry.

Externalities associated with the private equity business model have also been shown to have systemic impacts that affect the viability of institutional investors, especially public pension funds. These include the industry’s role in the privatization of public assets, the impact of its tax avoidance practices on the fiscal condition of local and state governments, and adverse macroeconomic consequences of economic inequality to which it has contributed.

The report concludes by outlining measures that fiduciaries and elected officials can take to increase transparency in private equity practices and performance and to mitigate the risks associated with investment in this asset class.

The Americans for Financial Reform Education Fund is a nonpartisan, nonprofit coalition of more than 200 civil rights, community-based, consumer, labor, small business, and other groups. Formed in the wake of the 2008 financial crisis, AFREF is working to lay the foundation for a strong, stable and ethical financial system—one that serves the economy and the nation as a whole and contributes to shared prosperity for all families and communities. The American Federation of Teachers is a union of professionals that champions fairness; democracy; economic opportunity; and high-quality public education, healthcare and public services for students, their

families and communities. AFT members participate in public pension plans with assets under management totaling an estimated \$3 trillion. AFREF and AFT are jointly releasing this report to shine a light on the significant risks associated with the private equity industry, in order to mitigate harm to investors, workers, and other stakeholders.

# 1. Introduction

In just a dozen years, the global investment landscape has experienced two of the most severe shocks in modern history. First, the 2008 financial crisis convulsed the economy and ushered in the worst downturn since the Great Depression. The recovery that followed was sluggish, even if it did gain steam a decade after the trough. Then came COVID-19, the complete structural consequences of which remain to be seen—but we do know that the impact of the pandemic on labor markets, fiscal conditions and investor sensibilities will likely be felt for some time to come.

These successive crises have placed acute stress on institutional investors like pension funds. In 2007, state pension plans had a median funded level of 92 percent.<sup>2</sup> That figure fell during the financial crisis, and related local and state budget crunches contributed to further revenue losses,<sup>3</sup> with some employers failing to make their required contributions, thus exacerbating funds' reliance on market performance. The effect of COVID-19 on this already difficult situation will depend on a number of factors, above all the pace of the post-vaccine economic recovery. But at a minimum, it is clear that the pandemic will make it even more challenging to close the gap.

The economic policy response to the crises has complicated the situation further. One legacy of the Great Recession—a legacy that seems bound to continue due to the pandemic—has been a commitment by the Federal Reserve, along with central banks around the world, to maintain a monetary policy of low interest rates. In the absence of a sustained fiscal spending program designed to shore up a slack labor market, this monetary policy has played a crucial role in encouraging investment. At the same time, these near-zero rates, together with the adverse effects on contributions of local and state budgetary challenges, have pushed institutional investors into what observers have called a “search for yield.” Safer asset classes like fixed income could not deliver the returns needed to begin inching those battered funded statuses upward, a pressure that led public pension funds and others to seek new investment outlets.

## ***Alternative Investments and Private Equity:***

Within this context, alternative investments have surged, especially since the early 2000s. Technically, anything other than a stock or bond is an “alternative investment,” but the term most commonly refers to private equity, hedge funds, real estate, private debt and venture capital. Promising stronger returns and greater diversification than traditional asset classes, the alternatives industry secured ever larger capital commitments in the years after the financial crisis. By 2012, McKinsey & Company was commenting on the “mainstreaming” of this previously obscure type of investment, and the empirical data has confirmed that observation.<sup>4</sup> In 2008, the total AUM classified as alternative investments was \$3.1 trillion. By 2017, that figure had climbed to \$8.8 trillion, and analysts expect it to reach \$14 trillion by 2023.<sup>5</sup> In the decade following the financial crisis, pension funds' allocations to these asset classes doubled.<sup>6</sup>

This report focuses on private equity buyout funds, one of the largest and most high-profile categories of alternative investments. Central to the private equity business model is the leveraged buyout, through which a general partner, or private equity manager, utilizes a substantial amount of debt—or “leverage”—together with investors' capital to purchase a company. GPs conduct these acquisitions through funds into which limited partners, or institutional investors, have made commitments of capital. After a period of time, during which the

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<sup>2</sup> Karen Pierog and Daniel Bases, “Battered by Great Recession, Underfunded Public Pensions to Persist,” *Reuters*, March 26, 2018.

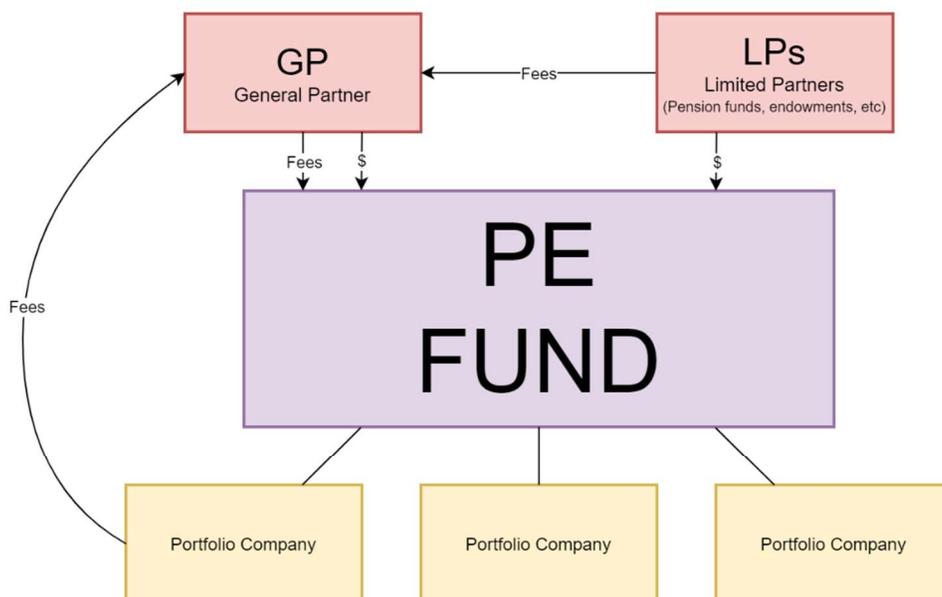
<sup>3</sup> Edward Whitehouse, “Pensions During the Crisis: Impact on Retirement Income Systems and Policy Responses,” *The Geneva Papers on Risk and Insurance – Issues and Practice* 34 (2009): 536-547.

<sup>4</sup> McKinsey & Company, “The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management,” June 2012.

<sup>5</sup> Prequin, “The Future of Alternatives,” October 2018.

<sup>6</sup> Victoria Ivashina and Josh Lerner, “Looking for Alternatives: Pension Investments around the World, 2008-2017,” August 2018.

new management team has organizationally and/or financially restructured the portfolio company, the GP exits the investment by selling all or a part of the fund's stake. In exchange for their services, the GP charges the LP management fees (on average 2 percent of the total capital commitment) and incentive fees, or "carried interest," ordinarily amounting to 20 percent of the profits over a hurdle rate, typically 8 percent. There are sometimes other additional fees or charges. The remainder is returned to the LPs in proportion to their original contribution to the fund. This fee structure is often referred to as "2 and 20." Though variations on this model exist, these are the general outlines of the LBO.

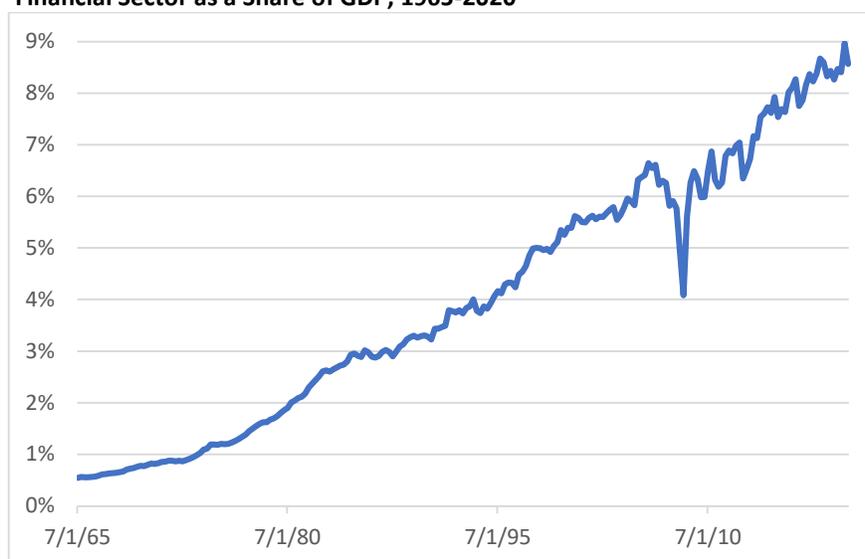


First appearing in the 1980s, LBOs became more frequent in the 1990s, and the number of such transactions began to soar in the years prior to the financial crisis.<sup>7</sup> There are specific historical reasons why this happened when it did. In the mid-1970s, policymakers began to dismantle the financial regulatory regime that had prevailed since the New Deal, a process that accelerated in the following decades. Legislative, juridical and regulatory changes allowed for the emergence of a market in so-called junk bonds, which made it easier to finance highly leveraged acquisitions; the assumption of greater levels of risk by institutional investors under pressure from reduced contributions by plan sponsors; and the liberalization and increasing concentration of corporate and financial institutions. Accompanying these developments was the rise of shareholder primacy, a body of economic and legal theory that reconceptualized the corporation as an abstraction of shareholders rather than a goods- and services-producing business—in other words, that the primary purpose of a corporation was to create value for shareholders, even if that was at odds with the long-term interests of the company. This policy and intellectual

<sup>7</sup> Steven N. Kaplan and Per Strömberg, "Leveraged Buyouts and Private Equity," *Journal of Economic Perspectives* 23, no. 1 (2009): 121-146.

climate fostered the spectacular growth of the financial sector, of which private equity became an important feature.<sup>8</sup>

**Financial Sector as a Share of GDP, 1965-2020**



Source: U.S. Bureau of Economic Analysis, Gross Value Added of Financial Corporate Business [A454RC1Q027SBEA] and Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis.

If this new political and economic environment created the conditions within which private equity could thrive, the industry took off because some funds showed evidence of delivering strong returns for investors. Between 1986 and 2008, the average private equity fund beat the S&P 500 by approximately 3 percent annually. However, recent scholarship has pointed out that the premium largely disappears if performance is compared with risk-adjusted benchmarks, and, as we will see, performance has declined further in recent years.<sup>9</sup>

There have, however, been significant downsides. From the first LBOs onward, various stakeholders have raised concerns about different aspects of the private equity business model.<sup>10</sup> Worker rights organizations have drawn attention to the ways in which private equity firms have contributed to and profited off bankruptcies that have had devastating impacts on workers and retirees.<sup>11</sup> Advocates for consumers, tenants, the environment and other issues have pointed to the deleterious downstream consequences produced by private equity negligence.<sup>12</sup> Investors themselves have noted that fees and opaque investment costs have compressed or even eliminated the premium that private equity promised to achieve. Policymakers have called for greater regulation of this industry that emerged, in large part, because it was exempt from regulation.

## **Structure of Report**

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<sup>8</sup> For a thorough overview of the emergence of private equity, see Eileen Appelbaum and Rosemary Batt, *Private Equity at Work: When Wall Street Manages Main Street* (New York: Russell Sage, 2014), 15-40.

<sup>9</sup> Robert S. Harris, Tim Jenkinson, and Steven N. Kaplan, "Private Equity Performance: What Do We Know?" *Journal of Finance* 69, no. 5 (2014): 1851-1882.

<sup>10</sup> For an early critique of the private equity business model, see Bryan Burrough and John Helyar, *Barbarians at the Gate* (New York: HarperCollins, 1993).

<sup>11</sup> The most thorough treatment of the impacts of private equity on employees is Appelbaum and Batt, *Private Equity at Work*.

<sup>12</sup> The Private Equity Stakeholder Project documents issues resulting from private equity investment for different groups: [www.pestakeholder.org](http://www.pestakeholder.org).

With the arrival of the Biden administration, and with the end of the pandemic possibly in sight, institutional investors are determining their investment strategies for the years to come. This report is intended to inform that process by providing an overview of where the private equity industry stands today. More than a decade has passed since the financial crisis, and a substantial amount of data and a growing academic literature on various aspects of private equity now exists. This report is not a work of original scholarship. Rather, its purpose is to synthesize the findings that researchers and industry analysts have published in recent years in a single document.

**The report offers two substantive points: First, it demonstrates that private equity performance as a whole has hardly been as impressive as the industry has claimed, and that it has worsened in recent years. Moreover, key indicators suggest that private equity performance overall is likely to deteriorate further in coming years. Second, the report sheds light on the significant risks associated with achieving even these mediocre returns. These include risks directly related to the investment management relationship as well as indirect risks resulting from private equity business practices and structural trends in the investment landscape.**

The report is divided into four substantive sections:

- A review of the evidence on private equity returns. A substantial literature has developed on this topic in recent years, drawing on the data now available on the performance of funds raised during and after the financial crisis.
- An analysis of the risks that are particular to private equity investment. Any rigorous consideration of private equity performance must also evaluate the risks associated with those returns.
- An assessment of the systemic impact private equity has had on the macroeconomy, public finances and the political climate, and on the ways in which the resultant externalities bear on investors.
- A set of recommended steps that public pension funds and other institutional investors can take to ensure a maximal alignment of financial interest.

## 2. Returns

In the years since the financial crisis, a number of studies analyzing private equity returns have been published.<sup>13</sup> Their findings raise important questions about private equity performance that should be considered by institutional investors as they determine their asset allocations for the years to come.

First, there has been growing debate over the most appropriate methodology for measuring private equity returns. An increasing number of scholars now support use of the public market equivalent rather than the industry-preferred internal rate of return as the best indicator of private equity performance. Additionally, researchers agree that proper measurements of returns must account for the fees charged to LPs. Such net-of-fees PME-based analyses, using the S&P 500 as a benchmark, showed strong private equity performance between the mid-1980s and the mid-2000s. However, more recent scholarship has shown that much of the premium achieved over public markets is eliminated when these returns are compared with custom, risk-adjusted benchmarks. Moreover, since the mid-2000s, even nominal private equity returns have not beat the S&P 500, and they have been lower than those achieved by custom, risk-adjusted benchmarks.<sup>14</sup>

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<sup>13</sup> For thorough reviews of the literature on private equity performance, see Brad Case, “Has Private Equity Performed for Investors? An Annotated Bibliography,” *Journal of Investing* 30, no. 1 (2020): 123-143; Eileen Appelbaum and Rosemary Batt, “Are Lower Private Equity Returns the New Normal,” in *The Routledge Companion to Management Buyouts*, ed. Mike Wright et al. (New York: Routledge, 2020), Ch. 14.

<sup>14</sup> Jean-Francois L’Her et al., “A Bottom-Up Approach to the Risk-Adjusted Performance of the Buyout Fund Market,” *Financial Analysts Journal* 72, no. 4 (2016): 36-48. For a perspective contending that buyout fund outperformance of the public markets has persisted, see Gregory W. Brown and Steven N. Kaplan, “Have Private Equity Returns Really Declined?” (Frank Hawkins

Scholars have offered a structural explanation for this declining performance over time, which focuses on the maturation of the industry. Specifically, they have argued that the quantity of capital committed to private equity buyout funds has grown at a more rapid rate than the number of investment outlets. In other words, there are now simply too many dollars chasing too few opportunities, and this intensified competition has served to eliminate the private equity premium. This dynamic applies to the private equity industry as a whole—those that purport to be top performers as well as less-celebrated funds will be susceptible to the downward pressures on returns resulting from heightened competition.

### ***Measuring Private Equity Returns***

Any analysis of returns must first settle on a methodology for measuring them. The private equity industry and many institutional investors rely on the internal rate of return to evaluate performance. The IRR originated in corporate finance as a means by which managers could evaluate different investment opportunities. In short, the IRR calculates the net present value of a given quantity of capital put to a use that is expected to yield a predictable annual return over a specified time period. It is an effective tool for firms considering large fixed capital investments, for instance, by enabling a comparison between the benefits of making such an investment and the returns offered by bonds at the prevailing rate of interest.

The IRR is not as useful for investments in which the pace and scale of returns are less stable. By its nature, private equity is such an investment type. The capital committed by LPs is not all called at once but rather is deployed as the GP identifies promising investment outlets. The distributions, likewise, come back only as dividends are issued or portfolio companies are sold, or the companies are taken public. Moreover, there is a wide range in the size of investment targeted by different private equity funds—some are smaller, some are larger, others are in between. All of this makes it challenging both to precisely measure IRRs and to draw comparisons between the IRRs achieved by different funds.<sup>15</sup>

What's more, the IRR is susceptible to manipulation by certain private equity practices. Take, for instance, subscription credit lines, which allow GPs to borrow against LP commitments to a fund. Such facilities have clear benefits, like allowing GPs to act quickly on investment opportunities and to make capital calls more predictable. However, in recent years, GPs have extended the length of use of subscription credit lines, a practice that has been shown to boost IRR by enabling them to delay capital calls and to make distributions prior to exits. In short, IRR can be artificially inflated through timed use of subscription credit lines.<sup>16</sup>

For all these reasons, scholars have increasingly relied on the public market equivalent to assess private equity returns. The PME, which was first introduced in an influential 2005 study, is as straightforward as its name would suggest: It presents a ratio that compares private equity performance to that of an equivalent public market. A PME above 1.0 indicates outperformance of the public market, and a figure below that threshold signals the opposite. From the perspective of an investor, such a ratio provides a clearer picture of relative performance of these different asset classes.<sup>17</sup>

It is important to note, however, that caution is required with use of the PME, as well. Specifically, the term *equivalent* is critical. Most private equity buyout funds invest in firms with smaller market capitalizations, different sectoral compositions and higher rates of leverage than those blue-chip companies included in the S&P 500. That

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Kenan Institute of Private Enterprise, April 2019). Using a different methodology than L'Her et al. and others, Brown and Kaplan find that the PME has remained above one for the entire period. However, they too note that "excess returns and PMEs have declined post-2005," and conclude that going forward it will be "more difficult for buyout funds to continue that performance."

<sup>15</sup> See Appelbaum and Batt, *Private Equity at Work*, 166-176; and Mitchell A. Bollinger, "IRR: Snake Oil by Another Name," *Journal of Investing* 30, no. 1 (2020): 109-122.

<sup>16</sup> Andrea Auerbach, "Should You Avoid Commitment (Facilities)?" (Cambridge Associates, June 2018).

<sup>17</sup> Kaplan and Schoar, "Private Equity Performance."

index, therefore, may not always be the most appropriate benchmark against which to evaluate private equity performance, and scholars have developed custom benchmarks composed of comparable public equities.<sup>18</sup>

To illustrate this point, take the example of a 2013 investigation into six private equity funds in which the Florida State Board of Administration was invested. Between 1988 and 2011, the Florida SBA invested \$836.4 million and received distributions of \$1.2 billion, for a net gain of \$351.5 million. However, the Florida SBA had set as its private equity benchmark the Russell 3000 index—which is more representative of private equity acquisition targets than the S&P 500—plus a 3 percent risk and illiquidity premium. Over the same time horizon, that benchmark would have yielded \$1.38 billion, or nearly \$1 billion more than the private equity funds returned.<sup>19</sup>

### ***How Has Private Equity Performed?***

Relative to public equities, private equity returns in the industry's early years appeared to be very strong. One study found that between 1986 and 2008, the average private equity fund beat the S&P 500 by 3 percent annually. This would imply that top-performing funds exceeded the public markets by even larger margins. Moreover, given that the data showed strong persistence in performance among these early funds, it stands to reason that institutional investors would have been especially attracted to funds managed by GPs with a proven track record.<sup>20</sup>

Recent studies, however, have begun to seriously complicate these findings. First, scholars have called for reliance on an “appropriate risk-adjusted benchmark for measuring the opportunity cost of an investment in buyout funds” and warned that the S&P 500 may not be such an index.<sup>21</sup> They have observed that the kinds of companies that private equity funds invest in are quite different from those included in the S&P 500. Specifically, buyout funds have, on average, invested in companies with smaller market capitalizations and higher rates of leverage than public companies in the same sector. Such investments carry higher risks, as well as the potential for higher returns, than are associated with the large-cap S&P 500.<sup>22</sup>

An influential risk-adjusted-PME study, which constructed a custom benchmark that reflected private equity investment characteristics, found that much of the outperformance demonstrated by private equity funds between 1986 and 2008 was eliminated when investment size, sector and debt load were incorporated into the analysis. Over the two-decade period in question, the risk-adjusted PME was not significantly different than 1.0.<sup>23</sup> In short, when analyzed at a granular level, the returns achieved by private equity funds between the mid-1980s and the mid-2000s do not appear as impressive as initially presented.

Since the mid-2000s, the data are even less favorable. Between 2006 and 2014, average private equity returns net-of-fees simply matched the performance of the S&P 500, which, again, has a lower risk profile than the typical buyout fund. During this period, buyout funds underperformed the custom benchmark, showing a risk-adjusted PME of below 1.0.<sup>24</sup> A study extending the analysis through the end of 2019 found that the trend has largely continued, with net-of-fees private equity fund performance just matching that of public equity markets.<sup>25</sup>

Another study, seeking to evaluate the impact of institutional funds' increasing exposure to alternative investments generally, found that public pension plans underperformed passive investment by 1 percent per year

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<sup>18</sup> L'Her et al., “A Bottom-Up Approach.”

<sup>19</sup> Appelbaum and Batt, *Private Equity at Work*, 175; Gina Edwards, “Opting for Risky and Secretive Private Equity Investments Cost Florida Pension Fund an Estimated \$1 Billion on Six Deals,” *Watchdog City*, April 2, 2013.

<sup>20</sup> Harris, Jenkinson, and Kaplan, “Private Equity Performance”; Kaplan and Schoar, “Private Equity Performance.”

<sup>21</sup> L'Her et al., “A Bottom-Up Approach,” 36.

<sup>22</sup> L'Her et al., “A Bottom-Up Approach”; Antti Ilmanen, Swati Chandra, and Nicholas McQuinn, “Practical Applications of Demystifying Illiquid Assets: Expected Returns for Private Equity,” *Journal of Alternative Investments* 22, no. 2 (2020): 1-6; Ludovic Phalippou, “Performance of Buyout Funds Revisited?” *Review of Finance* 18, no. 1 (2014): 189-218.

<sup>23</sup> L'Her et al., “A Bottom-Up Approach.”

<sup>24</sup> L'Her et al., “A Bottom-Up Approach.”

<sup>25</sup> Ludovic Phalippou, “An Inconvenient Fact: Private Equity Returns and the Buyout Factory,” *Journal of Investing* 30, no. 1 (2020): 11-39.

between 2008 and 2018.<sup>26</sup> Most recently, the Canadian-based consultancy CEM Benchmarking published a robust study demonstrating that, between 1996 and 2020, average private equity returns underperformed a composite of U.S., European and global small-cap equity indices.<sup>27</sup>

Lack of transparency to investors with respect to fees collected by PE firms further complicates these findings. As the CEM Benchmarking paper notes, a 2020 SEC investigation concluded that investors may be paying more in fees on their private equity investments than they expected. Because private equity fees may be higher than studies suggest, the underperformance noted may, in fact, be even more pronounced.

**Taken together, this new body of scholarship suggests that, after risk adjustment, private equity returns net-of-fees has not significantly outperformed comparable public equities and, in recent years, may have underperformed them.**

### ***What Is the Outlook for the Future?***

There are structural reasons why private equity performance is expected to continue to decline. Most generally, the trend is an expression of the industry's maturation. Early in the era of private equity, fewer firms and smaller quantities of capital were involved, allowing for targeted investments into assets with strong growth potential. As the amount of capital committed and the volume of transactions has grown, however, competition over investments has intensified and asset prices have been bid upward. In 2000, the private equity industry had approximately \$700 billion in AUM. Twenty years later, that figure now sits at \$4.4 trillion. This includes at least \$1 trillion in "dry powder," or committed yet uninvested capital.<sup>28</sup>

On a macro level, the quantity of invested capital has historically shown a negative correlation with returns. That is, as more capital is committed, returns tend to track downward.<sup>29</sup> This can be explained by the simple observation that with more money chasing a limited number of investment opportunities, deals become costlier and overall returns diminish. In 2003, for instance, more than 80 percent of buyout deals had an EV/EBITDA (enterprise value divided by earnings before interest, taxes, depreciation and amortization) purchase price multiple of 9 times or less, and very few had a multiple of greater than 11 times. In 2019, 80 percent of buyout deals had an EV/EBITDA purchase price multiple of greater than 9 times, and more than half had a multiple of greater than 11 times.<sup>30</sup> In other words, the acquisition price as a factor of a company's fundamentals has been steadily climbing. Related to this has been the rate of growth of private equity investment valuations. Between 2002 and 2017, the net asset value of private equity investments rose more than twice as fast as public equity market capitalizations.<sup>31</sup>

The challenges associated with acquisition price inflation also manifest when GPs attempt to exit investments. The increase in the frequency and size of secondary buyouts—where a portfolio company is sold from one buyout fund to another—has been one expression of this dynamic. Between 2015 and 2019, the median size of such sales

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<sup>26</sup> Richard Ennis, "Institutional Investment Strategy and Manager Choice: A Critique," *Journal of Portfolio Management* 46, no. 5 (2020): 104-117.

<sup>27</sup> Alexander Beath and Christopher Flynn, "Benchmarking the Performance of Private Equity Portfolios of the World's Largest Institutional Investors: A View from CEM Benchmarking," *Journal of Investing* 30, no. 1 (2020): 67-87. It is important to note as well that institutional investors' public equity portfolios tend to be internationally diversified, including a substantial share in emerging market equities. Their private equity portfolios, in contrast, largely include U.S.-based firms that have shown higher returns than global and emerging market equities. Direct comparisons between private and public equity portfolios obscure this difference and may overstate the performance of the private equity asset class. See, for example, Ludovic Phalippou, "An Inconvenient Fact: Private Equity Returns and the Buyout Factory," *Journal of Investing* 30, no. 1 (2020): 11-39.

<sup>28</sup> Preqin, "The Future of Alternatives."

<sup>29</sup> Raymond Chan et al., "Private Equity: Manager Selection, Portfolio Construction, and Outperformance," *Alternative Investment Analyst Review* 6, no. 4 (2017): 19-26.

<sup>30</sup> Bain & Company, "Global Private Equity Report 2020."

<sup>31</sup> McKinsey & Company, "Private Markets Come of Age: McKinsey Global Private Markets Review 2019."

nearly doubled, and by 2017 nearly half of all private equity exits were secondary buyouts.<sup>32</sup> Given the finite number of institutional investors committing capital to buyout funds of such scale, it is not implausible that LPs may find themselves on both sides of such transactions.

In summary, after adjusting private equity returns for the relevant risks incurred, the industry's performance between the mid-1980s and the mid-2000s has not significantly exceeded that achieved by comparable public equities. What's more, since the mid-2000s, buyout funds have underperformed these custom benchmarks. One key reason for this change is that as the industry has matured, competition has intensified among buyout funds over limited investment opportunities. The result has been rising asset prices, which has made acquisitions more expensive and exits more difficult.

### 3. Risks

A complete analysis of private equity performance must evaluate the range of risks required to achieve a given rate of return. The architects of the custom benchmark described in the previous section have addressed one dimension of this challenge by striving to conduct apples-to-apples comparisons between private equity portfolio companies and relevant public firms. There are, however, additional risks associated with the private equity industry, in general, and the buyout model, in particular, that are important for LPs to consider.

These risks can be classified in two groups: 1) direct risks stemming from the investment management relationship; and 2) indirect risks resulting from the private equity business model, including structural risks. Indirect risks include aspects of the buyout strategy that can come to affect LPs, while structural risks include issues that are endemic to the industry itself at this stage in its life cycle.

#### ***Direct Risks: Investment Management Relationship***

The most direct costs borne by LPs are the management and incentive fees charged by GPs. Typically, GPs charge management fees of 2 percent of the total sum committed to a given fund, as well as incentive fees of 20 percent of the profits earned, although some charge more. Ordinarily, the GP is only able to collect the incentive fee if they have surpassed a specified IRR, also known as a "hurdle rate." The hurdle rate is commonly set at 8 percent. In theory, the fees represent the cost of obtaining talented investment management and encouraging performance by linking the GP payout to the profitability of the fund. In practice, however, these charges can balloon to enormous sums, and the fee structure itself can be opaque to fiduciaries at the time that they make investment decisions.<sup>33</sup>

Regulators attempting to study private equity fees have encountered similar challenges to those faced by investors themselves: The opacity of the data on fees has made comprehensive analyses difficult. In June 2020, the SEC completed an investigation into "deficiencies" across the private equity industry that "may have caused investors in private funds to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest."<sup>34</sup> Given that the fees charged by private equity and other alternative investment managers are the highest of any borne by institutional investors, this lack of transparency represents a significant risk factor.

After completing a comprehensive audit of such costs, CalPERS determined that it had paid fees of an astounding 7 percent per year for its private equity program. This figure is multiple times the investment charges associated

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<sup>32</sup> Alex Lykken, "The Median Size of US Secondary Buyouts Has Nearly Doubled Since 2015," *PitchBook*, April 12, 2019; PitchBook Blog, "Want to Better Execute Secondary Buyouts? Start with the Right Data," *PitchBook*, Aug. 23, 2018.

<sup>33</sup> Note that this section deals only with fees borne by LPs. Monitoring and transaction fees and other charges imposed on portfolio companies are not considered here.

<sup>34</sup> SEC Office of Compliance Inspections and Examinations, "Observations from Examinations of Investment Advisers Managing Private Funds," June 23, 2020.

with public equities. Moreover, it is likely that certain investors pay even more than this amount. One recent study of 230 U.S. pension funds between 1990 and 2018 found significant disparities in the fees charged to different investors *within* given buyout funds. Indeed, the researchers found that the pension funds included in the sample would have earned \$45 billion more—or an additional 8.5 percent—had they each received the fee terms offered to the most privileged investor.<sup>35</sup> In other words, those pension funds less able to negotiate favorable terms are being charged significantly more than their peer investors.

The lack of transparency around and manipulability of the calculation of the IRR may also render the hurdle rate ineffective and allow for easier GP collection of incentive fees. Due to asymmetries in information around the quality of given investments at specific points in time, GPs may be able to issue distributions or conduct exits at optimal moments for them. These practices may not always align with the interests of LPs.<sup>36</sup>

Another concern directly resulting from the investment management relationship is the shedding of responsibility by GPs. In recent years, GPs have demonstrated a trend of waiving their fiduciary duty to funds they manage. Indeed, between 2019 and 2020, more than 70 percent of LPs have reported having such fiduciary duties contractually modified or eliminated in at least half of the funds in which they had invested. Such changes have the potential to result in significant misalignment of interests between GPs and LPs.<sup>37</sup>

Beyond fees, opacity and the degradation of fiduciary responsibility, LPs also face risks resulting from the illiquidity of private equity investments. Investments in illiquid assets, or things that cannot be easily traded, carry inherent opportunity costs that exist for the duration of the investment term. Put simply, such capital is tied up and cannot be directed to other uses, including attractive potential investments that may arise. Scholars have calculated that illiquid investments ought to offer a premium of approximately 3 percent annually to compensate for this opportunity cost.<sup>38</sup>

Related to this is the substantial cyclical performance in private equity. Studies have shown that buyout funds raised when the economy is in periods of strong growth on average generate lower returns than those raised when growth is slack. During boom times, asset prices climb and acquisitions become more expensive. Conversely, during downturns, cheaper assets with strong growth potential are easier to obtain. However, institutional investors may find it more difficult to make large illiquid capital commitments when economic conditions are poor, even though that is when they would likely see the best returns. Without the guarantee of a liquidity premium during such times, it is possible that certain investors may find it more difficult than others to access the most desirable funds.<sup>39</sup>

In summary, the risks directly resulting from the investment management relationship include a costly fee structure, a lack of transparency over investment charges, GP attempts to distance themselves from fiduciary responsibility, and the opportunity costs associated with illiquidity. As the disparities in fees charged to different investors suggest, the intensity of these risks may vary among LPs. Given that even major pension funds have faced fees of 7 percent per year for private equity services, it is likely that the direct risks faced by smaller funds are significant indeed, and that these funds may not benefit from private equity investment at all because of the fee structures.

### ***Indirect Risks: Private Equity Business Model***

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<sup>35</sup> Juliane Begenau and Emil Siriwardane, “How Do Private Equity Fees Vary Across Public Pensions?” SSRN Working Paper (July 2020).

<sup>36</sup> David Robinson and Berk Sensoy, “Cyclical Performance Measurement, and Cash Flow Liquidity in Private Equity,” *Journal of Financial Economics*, 122, no. 3 (2016): 521-543.

<sup>37</sup> Chris Witkowsky, “LPs Fear an ‘Erosion’ of Fiduciary Duty in Fund Contracts: ILPA Survey,” *Buyouts*, July 13, 2020.

<sup>38</sup> Francesco Franzoni, Eric Nowak, and Ludovic Phalippou, “Private Equity Performance and Liquidity Risk,” *Journal of Finance* 67, no. 6 (2012): 2341-2373.

<sup>39</sup> Robinson and Sensoy, “Cyclical Performance Measurement, and Cash Flow Liquidity.”

Outside of the immediate investment management relationship, institutional investors may also face indirect risks associated with the traditional private equity business model. The leverage relied upon by buyout funds carry the potential to amplify returns, but it also comes with downside risk. Additionally, leveraged buyouts have been shown at times to have adverse consequences for certain stakeholders—including employees, consumers, community residents harmed by adverse environmental impacts and others—in ways that can create reputational risks for investors.

Debt is central to the private equity business model, making the entire industry sensitive to larger credit conditions. Although the Federal Reserve and other central banks are likely to maintain a policy of low interest rates for some time due to the economic damage wrought by the COVID-19 pandemic, any change in monetary policy would bear significantly on private equity. At the same time, as long as credit is so easily available, ever higher rates of leverage and the proliferation of lower-grade debt are made possible. Institutional investors should be aware of the variety of related risks that may emerge in such a debt-laden environment.

Typically, however, the debt incurred by buyout funds is transferred onto the portfolio companies they acquire. This is one of the features of the private equity business model that has been shown, in many cases, to result in bankruptcies and other forms of financial distress that negatively affect employees and other stakeholders. Compounding these debt loads, GPs may charge portfolio companies monitoring and other fees, and extract additional value through dividend recapitalizations and other practices. A number of high-profile cases have appeared in the national press in recent years about retailers, healthcare facilities and other workplaces shuttering under the weight of private equity accumulated debt and fees. Workers and retirees who have lost jobs and pensions have drawn attention to the financial engineering behind these episodes in ways that have exposed LPs to reputational or headline risk.

In other cases, LPs have encountered reputational risks simply as a result of investment decisions over which they had no awareness or control. GPs that have deployed buyout fund capital to firearms manufacturers, private detention and incarceration services, predatory financial institutions, and fossil fuel interests have drawn scrutiny from lawmakers and their constituents in ways that have implicated LPs. Among certain investments, additional regulatory risks may exist. As just one example, the value of assets held in the oil and gas sector may be vulnerable to changes in environmental regulation under a new administration. While this is also true for public companies in the fossil fuel industry, investors in public companies can exit these companies at the time of their choosing, whereas private equity investments typically have lock-up periods of at least five years.

Beyond the investment management relationship and the private equity business model, LPs face structural risks endemic to the industry at this stage in its life cycle. As explained in the previous section, the industry has entered a mature stage in which consistently strong returns are less likely to be achieved. This is owing, above all, to the increasingly competitive environment, in which too much capital is being committed to too many investment managers who find limited outlets for it. With acquisitions becoming more and more expensive, the space for new value generation is compressed. While there may be some cyclical to this dynamic—for instance, prices for certain assets may decline due to the pandemic—the evidence suggests that this is a secular development.

The following are examples of private equity practices in healthcare, retail and private prison services and the risks posed to investors:

- **Private Equity and Healthcare: Leonard Green & Partners and Prospect Medical Holdings**  
Private equity firm Leonard Green & Partners owns Prospect Medical Holdings, a safety net hospital company that owns 17 hospitals in five states.<sup>40</sup> Some of the hospitals operated by Prospect Medical Holdings are safety net hospitals, meaning they serve a disproportionate share of low-income and uninsured patients, and 80

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<sup>40</sup> Prospect Medical Holdings, <https://pmh.com>.

percent of Prospect’s revenues come from Medicaid and Medicare reimbursements.<sup>41</sup> Since purchasing Prospect Medical Holdings for \$205 million in 2010,<sup>42</sup> Leonard Green has extracted more than \$570 million in fees and dividends from the company,<sup>43</sup> despite its hospitals facing operating challenges and regulatory scrutiny both before and during the coronavirus pandemic. All but one of Prospect hospitals rank below average on annual federal quality of care assessments, and together they rank in the bottom 17 percent of U.S. hospitals.<sup>44</sup> In June of 2020, members of Congress sent a letter to Leonard Green executives, stating “Leonard Green’s blatant disregard for its commitments to these safety net hospitals cannot continue” and demanding that Leonard Green return the fees and dividends it collected from Prospect and put the funds toward providing patient care.<sup>45</sup> In August of 2020, Rhode Island Treasurer Seth Magaziner said he was “deeply disappointed by the fund’s practices” and announced the state’s Employees’ Retirement System would no longer invest with Leonard Green.<sup>46</sup>

- **Private Equity and Retail: Bain Capital, KKR, Vornado Realty Trust and Toys R Us**

In 2005, private equity firms Bain Capital and KKR together with the real estate firm Vornado Realty Trust acquired the retailer Toys R Us. Employees reported significant changes to working conditions in the aftermath, including the reduction of positions, corresponding increases in workload, and increasing irregularity in scheduling. These changes placed particular strain on the companies’ disproportionately female workforce. Between 2005 and 2017, the ownership group saddled Toys R Us with more than \$3 billion of debt. Over this time, the ownership group extracted more than \$470 in fees and interest payments from Toys R Us. The debt service and fee payments placed acute strain on the company, which operated in a retail industry characterized by low profit margins. In September 2017, Toys R Us was forced into bankruptcy, and in the spring of 2018 the ownership group announced its intention to liquidate, closing all stores and laying off all 33,000 employees. After a highly publicized campaign by employees that highlighted the institutional investors involved in the disaster, Bain Capital and KKR committed to contributing \$20 million into severance payments.<sup>47</sup>

- **Private Equity and Private Prison Services: HIG Capital and Wellpath**

HIG Capital is the owner of Wellpath, a private correctional healthcare service provider to local jails, detention centers, state and federal prisons, and state psychiatric hospitals. It is estimated to be the nation’s largest operator in the correctional healthcare sector.<sup>48</sup> A recent investigation found that Wellpath and its predecessors “have faced concerns for years about whether the company provides sufficient and adequately trained healthcare staff at facilities it serves.”<sup>49</sup> These concerns have grown during the coronavirus pandemic. For instance, Wellpath is the healthcare provider at the Cummins Unit prison in Arkansas, the site of the state’s largest COVID-19 outbreak with more than 1,000 cases and at least 11 deaths.<sup>50</sup> Over the summer, a

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<sup>41</sup> Peter Elkind, “Investors Extracted \$400 Million from a Hospital Chain that Sometimes Couldn’t Pay for Medical Supplies or Gas for Ambulances,” *ProPublica*, Sept. 30, 2020.

<sup>42</sup> Elkind, “Investors Extracted \$400 Million.”

<sup>43</sup> Private Equity Stakeholder Project, “Raiding the Safety Net: Leonard Green & Partners Seeks to Walk Away from Prospect Medical Holdings after Collecting \$570 Million in Fees and Dividends,” Jan. 2020.

<sup>44</sup> Elkind, “Investors Extracted \$400 Million.”

<sup>45</sup> Katie Porter, Lloyd Doggett, Mary Gay Scanlon, and Rosa DeLauro, letter to Jonathan Sokoloff, managing partner of Leonard Green & Partners, June 4, 2020.

<sup>46</sup> Private Equity Stakeholder Project, “Leonard Green & Partners Faces Increasing Scrutiny from Regulators and Investors on Prospect Medical Holdings, Nov. 16, 2020.

<sup>47</sup> Private Equity Stakeholder Project, “Toys R Us Employees Call on KKR, Bain Capital, and Vornado to Pay Severance out of \$470 Million in Monitoring Fees, Interest,” May 24, 2018; Mary Childs, “Who Really Ruined Toys R Us? Hedge Funds and Private Equity Are Playing the Blame Game,” *Barron’s*, Nov. 21, 2018.

<sup>48</sup> Marsha McLeod, “The Private Option,” *The Atlantic*, Sept. 12, 2019.

<sup>49</sup> Private Equity Stakeholder Project, “Jails and Prisons Served by H.I.G. Capital-Owned Wellpath Face COVID-19 Outbreaks, Deaths, Concerns regarding Staffing Levels,” July 8, 2020.

<sup>50</sup> Private Equity Stakeholder Project, “Jails and Prisons.”

court-ordered inspection into the Shelby County Jail Men’s Facility in Memphis, Tenn., found that “the Wellpath COVID-19 response plan is inadequate to protect ... vulnerable inmates.”<sup>51</sup> HIG has relied on significant amounts of leverage to finance its Wellpath acquisitions.<sup>52</sup>

In summary, LPs indirectly face a number of risks that result from the private equity business model. The structure of the leveraged buyout itself presents a range of risks for the investor and the portfolio companies alike. Problems with the latter can subsequently translate into reputational risks if other stakeholders are affected. Moreover, the choice of investment target can introduce additional reputational and regulatory risk, even, and perhaps especially, in cases where LPs are unaware of the ends to which their capital has been deployed. Although investors can also be exposed to reputational and other investment risks through their public equity investments, they have much greater control over when to exit these investments, in contrast with private equity investments, which require investors to invest for a period ranging from five to 10 years.

## 4. Externalities and Systemic Impact

As perpetual investors and universal owners, institutional investors like pension funds are exposed to all aspects of the market and must therefore be sensitive to the systemic impact of their investment practices. The externalities resulting from certain private equity practices may indeed be significant enough to generate material risks for LPs themselves. Moreover, public pension fiduciaries in particular are accountable, above all, to the public employees and retirees who are fund beneficiaries. Private equity practices that imperil the public sector as a site of employment and service provision, therefore, must also be seen as material risks. **There are three systemic risks associated with private equity that stand out: privatization, fiscal impact and macroeconomic impact.**

Privatization represents a clear material threat to public employees, who are the beneficiaries of the largest category of institutional investor—public pension funds. The elimination of public sector jobs results in reduced contributions to such funds, a revenue stream that is vital to the maintenance of solvency, especially in a time of such stressed funded statuses. Private equity and other alternative investment managers have actively advanced a privatization agenda and appear poised to accelerate it in the years to come.

For example, infrastructure funds have become one of the fastest-growing investment vehicles, and they have as their stated objective the acquisition and privatization of public assets. Public pension funds committing capital to such funds may be directly contributing to public sector retrenchment that adversely affects their own beneficiaries.

Healthy fiscal conditions are also vital to the long-term well-being of public pension funds. Without a stable and growing tax base, the risk of public sector retrenchment is ever-present. The private equity industry’s orientation toward tax policy is therefore a relevant fiduciary concern. Indeed, virtually every aspect of the private equity business model and investment strategy is designed to exploit loopholes in the tax code:

- Private equity’s reliance on debt allows for extensive use of interest deductions.
- By utilizing a structure of pass-through entities, private equity firms are able to circumvent proper corporate taxation.
- Classifying their incentive fee as investment rather than ordinary income, private equity firms are able to systematically reduce their tax obligation to the lower capital gains rate.

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<sup>51</sup> Jessica Jaglois, “‘Inadequate and Harmful’: Inspection Report Finds Issues with COVID-19 Response in Shelby Co. Jail,” June 30, 2020.

<sup>52</sup> Private Equity Stakeholder Project, “Jails and Prisons.”

This open tax avoidance undeniably starves public coffers of much-needed revenue and contributes to the fiscal challenges that, during economic downturns, can become full-blown crises.

Finally, the extraordinary amount of wealth earned by GPs has contributed to the heightened level of inequality, which has significantly undermined economic growth. In 2006, just three private equity executives ranked as multibillionaires. By 2020, that number had reached 22. Moreover, aspects of the private equity business model that result in adverse employment effects, like the frequency of bankruptcy among portfolio companies, have had destructive impacts on the income and retirement security of workers. GPs' failure to accept responsibility for such disasters contributes still further to worsening inequality.

From a purely macroeconomic perspective, such economic inequality saps aggregate demand and thereby serves as a headwind against economic growth. For perpetual investors and universal owners who depend on strong macroeconomic conditions, therefore, income and wealth inequality are important fiduciary considerations.

## 5. Conclusion: Policy Options

This report has evaluated the state of the private equity industry today and assessed the opportunities and risks it presents for institutional investors. It began by examining the most-recent research on private equity performance and found that returns have never been as impressive as the industry claims, and have been diminishing in recent years. It then catalogued the different kinds of risks that investors face. These include risks directly stemming from the investment management relationship, indirect risks resulting from the leveraged buyout model, and structural risks endemic to the industry at this stage in its life cycle. Finally, it considered some of private equity's systemic impacts that are important for perpetual investors and universal owners like pension funds to consider.

**The report has shown that private equity does not significantly outperform comparable public equities and, indeed, now may be underperforming them. Moreover, there are significant direct, indirect and structural risks associated with achieving even these returns. The structural risks are unlikely to be addressed without changes to fiscal and monetary policy and economic regulation.**

By supporting certain public policy measures and undertaking new initiatives in limited partner agreements, however, investors may begin to mitigate some of the direct and indirect risks associated with investment in private equity. First, institutional investors and elected officials can take steps to increase transparency around the investment management relationship. Doing so would begin to address some of the direct risks faced by LPs. Second, they can implement measures to increase the accountability of GPs to both LPs and portfolio companies. Together, such policies would serve to improve the alignment of interest and best protect investors' fiduciary obligations.

### ***Steps Fiduciaries Can Take***

- Require GPs to report performance using appropriate custom PME benchmarks to ensure clear and accurate reporting of fund performance, and replace IRR hurdle rate with a PME threshold to ensure that incentive fees are only distributed when clearly specified performance targets are met.
- Require GPs to develop consistent valuation methodologies to ensure that all return data is reported in reliable and comparable terms.
- Mandate that GPs consistently report quarterly fee and cost data through a template that, at minimum, meets the standards of the [fee reporting template](#) developed by the Institutional Limited Partners Association and make this data publicly available.
- Require that GPs notify LPs of other investors in funds to allow for communication and clarity about market terms for a given fund.
- As part of the due diligence process for selecting and allocating capital to GPs, require that GPs provide information related to portfolio companies and investment targets to assess any adverse consequences for employees, consumers and other stakeholders that can create reputational risks for investors.

- Adopt investment policies requiring GPs to refrain from eliminating public sector jobs and privatizing public assets as part of their business model, such as the anti-privatization policies adopted by CalPERS, NYCERS and the Ohio Public Employees’ Retirement System, among others.<sup>53</sup> Additionally, adopt Responsible Contractor Policies that mitigate risk and provide for robust labor due diligence through union neutrality, project notification and the exclusion of debarred contractors.
- Consider supporting federal legislation, such as the Stop Wall Street Looting Act, that would mitigate some of the investment risks associated with private equity.

### ***Steps Policymakers Can Take***

Pass legislation that:

- Requires GPs to share responsibility for all liabilities of companies under their control, and ends GP immunity for violations of law by portfolio companies to mitigate potential for reputational risk resulting from negligent or otherwise detrimental management practices.
- Requires GPs to prioritize worker pay and worker retention in the bankruptcy process, and requires GPs to retain risks related to debt arrangement to disincentivize the use of bankruptcy as a strategic exit.
- Bans dividends for two years after a portfolio company is acquired, and limits monitoring and transaction fees to disincentivize asset stripping and encourage value-generating management and investment.

Implement regulations that:

- Require GPs to disclose all fees and returns to provide investors with a comprehensive picture of investment performance, and prevent GPs from waiving their fiduciary duty to funds into which capital is committed.
- Require GPs to disclose results from SEC compliance exams to ensure awareness of any issues flagged by regulators.
- Ensure that GPs are held accountable when they charge pension funds improper or illegal fees and expenses.

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<sup>53</sup> Charles Forelle and Daniel Golden, “Calpers Flexes Muscle Against Privatizing Jobs,” *Wall Street Journal*, Sept. 23, 2003.



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