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General Partners' Interests Not Always Aligned With Other Private Equity Stakeholders

Private Equity is an asset class that is tainted by numerous red flags and investors need to be mindful. Though we have written articles that touched on Private Equity none touched on the negative impact of over-capitalization. This article does just that.

Allocation of Too Much Capital as a Means of Propelling Unicorn Events

Looking back, the years of the technology bubble (1995-2000) produced outsize returns. Incredibly, many IPOs would for example be priced at $25 only to run up to some astronomical level on the first day of trading. Investors were greatly rewarded for having invested in the Private Equity fund that sponsored such results. Everyone wanted to invest. Such success, combined with fund management fees of 1-2%, were great incentives for PE Managers.

Fast-forward to today where the IPO market is much quieter, the chase for unicorn events is more difficult. The classic temptation is for GPs to over-allocate capital to funds in the hope of propelling portfolio company growth. What most often transpires to these over-capitalized companies is that founder/executive owners are diluted thereby reducing their "skin in the game" thus reducing their incentives for success.

Desire for Large Size

During the high-flying period of the technology bubble, GPs were significantly rewarded when IPOs were realized as a result of enjoying a handsome percentage of the carried interest. Today with the environment for such high-flying liquidity events non-existent, many GPs are simply satisfied with capturing the management fee on a fund with a much larger pool of capital as compared to the days of the technology bubble. Thus, many GPs are prone to act with much complacency and own too many companies with small positions, none of which have the ability to truly influence the complete portfolio.

To rectify, allocations to companies need to right-sized so that the GPs are significantly rewarded via bigger payoff from their carried interests. Thus, we suggest that investors review smaller focused funds (i.e. with around 10 companies) where the GPs reduce or eliminate management fees in favour of larger carried interests. At 10 companies, the fund then defaults to the sizing required for the strategy. The offset potential for pensions is the need to analyze more deals. Institutions often require that their capital not exceed 10% of fund size, and their minimum investment must be $10M or $25M etc., thereby requiring minimum funds of $100-250 million. This is limiting for some allocators, but GPs should be able to adapt while keeping focused portfolios.

Concluding Remarks

The environment for General Partners to earn returns is below peak levels prompting some to impose Private Equity structures that optimize their returns through to the detriment of portfolio company and Limited Partnership alignment. Understanding General Partner incentives and how they can change depending on the market environment is critical. The risk premiums that are available to long-term Private Equity investors can be attractive. Yet, blind acceptance that goes unchecked embolden General Partners to seek as egregious terms as possible.

Bibliography

Frank Casey, Representative at Race Rock Capital LLC; Whistleblower. fcaseymgt@comcast.net. 2017.