Private equity titans, time to retire

Immense personal wealth and diversified, publicly-owned businesses give a certain type of private equity manager a free option at his LPs' expense, argues Cyril Demaria

Succession Planning **Commentary**

As every athlete knows, you should retire at the top of your game. Today's 'private equity titans', such as Schwarzman and Perkins, should have followed this adage – they have now reached retirement age, but are arguably an increasing burden, rather than an asset, to their industry.

Consider, first, the image and reputation problem. The old generation started when private equity (PE) was a boutique industry. Communicating was optional, transparency taboo. These executives are ill-prepared to be accountable to all of us who provide their capital through our savings. The extent of this was revealed in the reactions of Blackstone's Steven Schwarzman and Tony Perkins of Kleiner Perkins Caufield & Byers to proposed tax hikes on private equity and its executives, which they notoriously compared to the invasion of Poland by Nazi Germany and the Kristallnacht pogrom, respectively. Both later apologised.

The taxation debate also reminded everyone that this ageing generation of executives had become too rich for the public good, and for genuine alignment of interests between them and us, as investors.

To keep the interests of limited partners (LPs) and general partners (GPs) aligned, fund regulations ensure that GPs have a significant ownership stake in the funds they manage. Any loss in the fund would thus have an impact on the net wealth of the principals.

To be fully effective, this mechanism relies on three assumptions:

- First, that the GP is owned by a significant share (if not all) of its employees, and that all have a common interest to steer the GP in the right direction. The potential losses have to be spread and hurt everyone in a significant way;
- Second, that the GP is concentrated enough to be affected by the losses of a single fund;
- And third, that the commitment of the GP in the fund will represent a significant share of the principals' net worth.

Schwarzman's position will demonstrate that these assumptions no longer hold and that the lack of alignment of interest is born of the accumulated personal wealth of principals – they are simply immune to the pain of losses.

Schwarzman is CEO and chairman of the Blackstone Group, one of the major international managers of LBO funds, of which he owns 23% (worth around $3.2bn (€2.32bn) as of September 2013). This stake does not account for all of Schwarzman's wealth, estimated by Forbes to be $7.7bn as of September 2013 – and increasing every year with his salary (and potential bonuses), carried interest and Blackstone's dividends. Unless Blackstone's share price increases faster than those income streams, that 23% stake in the company will decline as a proportion of Schwarzman's overall wealth.

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Moreover, the fact that he owns 23% of Blackstone shields him from direct personal losses incurred by its funds. Unless he puts his own personal money in each fund managed by the group, the corporation is actually taking risks in lieu of its principals, while the principals enjoy the economics of the corporation (with no say from the funds' LPs).

For its part, Blackstone insists that this 23% stake "represents a large part of [Schwarzman's] personal wealth", that "the success of the firm is his success" and "his interests, the firm's and its employees and our limited partners are all perfectly aligned".

The firm's latest LBO fund, Blackstone Capital Partners VI, raised $16bn. Blackstone generated revenues of $3.1bn and a net income of $219m in 2012. Schwarzman's salary was of $350,000. According to Blackstone's website, 69 senior officers were active in the private equity division of the Group.

Assuming Schwarzman has put his personal wealth at stake in BCP VI, how much would Blackstone have to put in so that, for example, a 10% loss would be felt by Schwarzman?

Let us assume that Schwarzman is putting in 1/70th of Blackstone's commitment, and that his pain threshold is the $3m he reportedly spent on his 60th birthday celebrations. That translates to a $30m personal commitment to the fund, and a $2.1bn commitment from all 70 senior executives – or 13.1% of the total ($16bn) in the fund. But $30m would still only represent 0.4% of Schwarzman's total fortune. The alignment of interest is thus rather tenuous.

Turning to the firm as a whole, if Blackstone put in 10% of the total raised for BCP VI ($1.6bn), this would represent half of its yearly turnover. A 10% loss on this investment ($160m) would represent 73% of its 2012 net income. However, the management fees generated by the fund (1.5% per year over 10 years) would represent roughly $2.4bn. Hence a 10% loss on the 10% stake of BCP VI owned by Blackstone would represent no more than 6.7% of the management fees collected over the life of the fund.

Would this be significant enough to align the interests of Blackstone and its LPs, knowing that Blackstone manages not only other LBO funds, but credit funds (GSO Capital), fund of funds, real estate funds, and other income generating businesses? No. Schwarzman's personal wealth is too great to be affected by such a loss.

Moreover, the wealth of his business partners might not be up to the challenge. The $30m that is a drop in the ocean for Schwarzman would be a significant commitment from his partners (even before taking into account similar commitments to other funds). Thus, within a team, and in the context of generational change, discrepancies of personal wealth create other difficulties: the less wealthy are 'simple employees' and do not invest in funds the way a GP should, while the very wealthy are so rich that before they feel any real pain their LPs would have lost all their money and their companies would have gone bust.

The traditional fund performance model is failing because the old titans are simply too rich for private equity's 'pyramid of pain' to affect them proportionately. A fund is supposedly 99% owned by LPs and 1% by the GP (fully owned by the principals) – the pain for principals is the loss of that 1% of the fund (supposedly a significant part of their wealth) and the inability to raise further funds.

Under the 'Blackstone model', not only are multiple funds owned by LPs at 99% and Blackstone at 1%, but Blackstone itself is largely owned by public shareholders – Schwarzman owns just 23%. His pain is limited to a loss of value at Blackstone. This means that another step is necessary to re-align the interests between Blackstone (as well as Carlyle, KKR and others) and LPs: to trim down and re-focus their activities. Their management fee income stream is too high compared with the sanction of losses, and this distorts the GP's incentive to perform.

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072-IPE-MAY2014.indd 79 15/04/2014 13:48