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The People vs. Private Equity

By Jonathan Keehner and Jason Kelly November 23, 2011

It's almost 10 p.m. on an October Tuesday at Brasserie 8½, a French restaurant on 57th Street in Manhattan, and the Texan in the back corner is just warming up. Steven LeBlanc, former real estate executive and senior managing director of a $110 billion pension fund, is holding forth at the lone occupied table. The restaurant takes its name from the iconic concave tower above it known as 9 West. The building has breathtaking views of Central Park and houses some of the world's largest hedge funds and private equity firms.

A senior executive from private equity firm KKR (KKR), arguably 9 West's most powerful tenant, has just left LeBlanc's table, where he had been auditioning for more of LeBlanc's business. Apollo Global Management (APO), another huge buyout shop with offices upstairs, will have LeBlanc to breakfast the following day to make its case. LeBlanc is shopping for money managers; a few weeks later his office will announce an unprecedented $6 billion investment with the two firms on terms that reduce fees to the benefit of LeBlanc's fund, the Teacher Retirement System of Texas.

LeBlanc, 54, is responsible for allocating $35 billion in private investments for the pension fund, which has 1.3 million members. The way the private equity bigwigs have been courting the likes of LeBlanc for his investment dollars is a major reversal from how things used to be, when pension funds were practically begging private equity funds to take their money, at whatever terms the funds were offering.

LeBlanc has another appointment waiting at the bar, the head of a Connecticut investment firm. First, though, he wants to talk about "The Texas Way," a manifesto of sorts he's put together in PowerPoint format. It's sitting on the table, detailing how he and his staff are pressing private equity to deliver better profits to their investors, with fewer of the lavish fees that have made private equity managers some of the best compensated—and most criticized—individuals on Wall Street. Under the Texas Way, buyout firms such as KKR and Apollo must vie for a place on LeBlanc's "premier list," a group of top-performing managers that's reevaluated every six months. The best of this group may gain access to even more of his pension dollars, while the bottom tier faces expulsion. It's the opposite of the old days, when everyone, it seemed, got an investment.

The private equity business is one of the most lucrative in finance, and one of the most controversial. Investment funds buy out companies, often instituting layoffs, piling on debt, and extracting rich payouts for themselves in the process, with the ultimate goal of selling the companies for a profit. Less appreciated is that the biggest sources of private equity funds are the pension funds of working-class Americans—teachers, firefighters, and other public employees.

For years private equity has set the terms—and fees—of the arrangement. But as returns diminished after the boom and suspicion of Wall Street grew, pension fund managers began to reassert themselves. LeBlanc is among those leading the charge. He is calling for more money to be allocated to fewer managers, and for more data from those managers to be shared with investors. He's intent on making sure everyone has the right motivation. With the recent KKR deal, management fees are lower, while better performance earns higher payouts. "He has certainly made managers think about what they're doing and what they ought to be doing," says Thomas C. Franco, a partner at Clayton, Dubilier & Rice, one of the oldest private equity firms. "He asks a lot of questions."

It's a crucial time for pension funds. Britt Harris, LeBlanc's boss and the chief investment officer for the Texas teachers' fund, told his state legislature in April that the fund had a return of 14.7 percent in 2010 but an annualized return of 4.8 percent for the decade ended Dec. 31. That's barely half the fund's assumed 8 percent annual return. To maintain a level of funding to cover its liabilities (what it owes retirees), the Texas teachers' fund would need an annual return of 21 percent for the current fiscal year, Texas officials told the lawmakers. There is not much chance of that happening, and the Texas fund isn't the only one in such a bind. Public pensions nationwide are grappling with about $3.6 trillion in unfunded liabilities, according to a 2010 study by Joshua Rauh of Northwestern University and Robert Novy-Marx of the University of Rochester.

Private equity managers like to argue that they're one of the few investment alternatives that can bridge that gap—and the pension funds don't necessarily disagree. Nevertheless, fund managers have started talking about an "alignment of interests," a polite way of saying they don't want the private equity managers to win just by getting their money. They insist that profits come from successful investments, not fees levied just for doing deals or, in some cases, keeping an eye on the companies they already own, a practice known as a monitoring fee. "All of us are pushing harder than we ever have on terms," says Gary Bruebaker, chief investment officer of the Washington State Investment Board, among the first public plans to invest in private equity back in the early 1980s. "We've put them under a microscope."

The increased scrutiny comes as private equity's profile is rising. Regulators and politicians in Washington are demanding more information from buyout firms, noting their growing influence on the public through their ownership of everything from Dunkin' Donuts to the largest power generator in Texas. A long-debated increase in the tax rate for private equity profits was revived earlier this year as part of President Barack Obama's plan to reduce the deficit. Then there's the 2012 Presidential election, which may for the first time feature a former private equity chieftain, Mitt Romney, as a major-party nominee.

While private equity firms brag about their ability to fix broken companies, high-profile deals gone bad highlight the dangers of the business model, especially for workers, many of whom have retirement funds of their own. In one example, Wasserstein & Co. took over the Medford (Ore.) mail-order fruit basket company Harry & David in 2004 for $253 million, about two-thirds of which was borrowed money. The buyout firm proceeded to load more debt on the company, ultimately paying itself dividends that gave it a 23 percent return. Harry & David filed for bankruptcy in March 2011.

In private equity a manager pools investment dollars from limited partners—pensions, endowments, or wealthy families, also known as LPs—that pay 1.5 percent to 2 percent of their commitment annually as a management fee as well as 20 percent of the profits from successful investments to the managers, known as general partners (GPs). This compensation structure is abbreviated to “2 and 20,” and similar structures are used for hedge funds, real estate funds, and other so-called alternative assets.

The arrangement dates to the earliest investments made by the pension funds of Washington and Oregon state workers to KKR in the early 1980s, when Henry R. Kravis and George Roberts created small pools of capital for leveraged buyout deals. KKR bought the likes of Safeway (SWY) and Duracell, using money borrowed against the companies it was taking over, an era defined in the public imagination by the book *Barbarians at the Gate*, a chronicle of the RJR Nabisco takeover. Those early investments delivered huge returns for the pensions—more than 10 times their initial investment, in some cases—and set the founders of the private equity firms on their way to becoming billionaires.

The fees were accepted by the investors when the returns seemed to justify the costs. The management fee is intended to fund an office and salaries for the private equity partners and their staff. The real payday is supposed to come from the 20 percent of profits, also known as the carried interest, or carry. “What I want is for them to be able to pay for their administrative costs, their house, and a nice vacation with the management fee,” says Bruebaker. “For that second and third home and that yacht, I want them to pay for that out of carry. I hope every one of our GPs gets rich, but after my members make money.”

Over time the fees and payouts to the general partners ballooned. Then the boom ended. Pension managers watched the funds’ performance fall, in the worst case to a one-year loss of 30 percent across the industry in March 2009, according to researcher Preqin. LeBlanc’s state was home to the biggest LBO ever, the $43.2 billion takeover of what was then known as power producer TXU by KKR and TPG Capital in 2007. The owners have struggled with the company, now known as Energy Future Holdings. KKR values its investment in the company at 10¢ on the dollar.

Firms such as KKR found themselves trapped during the credit crisis, unable to sell the positions they’d bought into and unable to do new deals without debt financing. Many funds were also sitting on huge piles of cash. Pension funds were paying all kinds of management fees for money that wasn’t getting spent, they weren’t able to get their cut of any profits because the companies weren’t getting sold, and their broader portfolios, from hedge funds to treasuries, were getting crushed. But the pensions weren’t organized enough to do much about it.

After working his way through college as a real estate broker, LeBlanc served as an executive at several property companies. He joined Charlotte-based real estate investment trust Summit Properties in 1998, where he would go on to become chief executive officer and earn shareholders a 144 percent return while at the company. After selling Summit to Camden Property Trust (CPT) in 2005, he took a job teaching courses in real estate at his alma mater, the University of Texas at Austin. When Harris called in 2008 looking for someone to manage private equity assets for the Texas teachers’ fund, LeBlanc said yes and was given wide latitude in remaking combined private equity and real estate assets. “Helping teachers and bus drivers was very attractive to me,” says LeBlanc, whose mother raised three children by herself on a teacher’s aide’s salary.

He approached the task with an edge that many pension managers, whose ranks are staffed largely by career public servants, didn't have. "I'm probably a bit more aggressive than the average limited partner," adds LeBlanc. "I've been a GP my whole career. That helps."

On a cold January morning in 2009, about a dozen public pension managers from the U.S. and Canada met in a windowless conference room in the Denver airport. Together, the assembled crew represented almost $1 trillion in assets. In large part, they were there because of LeBlanc, who had helped organize the meeting. Although they managed hundreds of billions in retirement plans, they were mostly government employees with tight budgets made tighter by the crisis that had eviscerated their portfolios.

Over the course of several hours, snacking on peanuts and not much more, the gathering of what became known informally as the Denver Group discussed the concessions they wanted to extract from buyout managers in the wake of the financial crisis. The Denver Group decided that the best approach to getting their voice heard was to create a set of principles that spelled out what they expected from private equity fund managers. They all wanted increased transparency, a return to a pay structure that emphasized paying for performance instead of just management, and tighter governance. The problem was, they were a dozen voices, and while they commanded a huge part of the market, they needed to speak with a single voice.

LeBlanc found that others beyond his group in Denver were thinking along similar lines. The Institutional Limited Partners Assn. (ILPA), an industry group based in Toronto, had been talking about the same issues at its annual meeting that spring. The association released a set of principles in October 2009. The message was clear. Pension fund investors were, if not mad as hell, at least not going to take it anymore. "ILPA has been a game changer," says Joncarlo Mark, a former senior portfolio manager at CalPERS and chairman of ILPA from 2007 to 2010. "Having people like LeBlanc and TRS support the principles … has been critical."

In early 2011, KKR endorsed the principles. KKR for the first time has said it must meet a minimum return for investors before it takes any profits for itself. Blackstone Group (BX), the biggest buyout company, and TPG, the architect of buyouts from Continental Airlines (UAL) to J. Crew, followed KKR's endorsement. "Like other folks in our industry, we may not support every provision, but Blackstone has largely complied with these principles for many years—long before the existence of ILPA—and we will continue to do so," Blackstone President Tony James says. In 2010, Blackstone won its first-ever investment, of $200 million, from Oregon's public employee pension plan after the firm announced that commitments of more than $1 billion would lower the annual management fee to 1 percent from 1.5 percent.

There is a sense among private equity managers that the changes in reporting are permanent, but the fee question may be more complicated. The best managers may at some point be able to dictate their own terms again, and potentially charge higher fees. "It's a market, and every fund is a negotiation," says Steven N. Kaplan, a professor at the University of Chicago Booth School of Business who follows the industry closely. For now, the pressure is on. ILPA is trying to introduce yet stricter guidelines, and the SEC is weighing whether to extend oversight to about 3,500 advisers and demand they disclose information about investors, employees, assets they manage, and potential conflicts of interest.

"The crisis provided a real opportunity for LPs to stand up and say, 'There are certain things that aren't working for us and aren't fair,'" says Mark

Wiseman, executive vice-president for investments at the Canada Pension Plan. “It was the classic example of when the tide went out there were any number of GPs and organizations that weren’t wearing bathing suits.”

For his part, LeBlanc remains intent on seizing the opportunity to make sure those who were naked learned their lesson. “After the crash, we had a voice,” he says, “and LPs made it clear that we aren’t just going to fold up and go away.”

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