

Notes on Private Equity and Taxes

Jeff Hooke on behalf of Citizens for Tax Justice

As Congress examines the tax loophole for “carried interest” paid to private equity fund managers, it’s important to understand just how different types of investment funds operate, how their managers are compensated, and what these funds have achieved. These fund managers are extremely well compensated for what they do and, on top of this, receive a tax subsidy for their work. Close examination of the industry shows that whatever benefits they provide to their clients or to the broader economy are little different (and often less) than those provided by investment bankers, who do not receive a tax subsidy for their income.

A. Types of Investments by Private Equity Funds

The industry is divided into four business lines: (1) hedge funds; (2) leveraged buyouts; (3) venture capital; and (4) mezzanine and other funds.

Hedge funds principally invest in (i) the securities (or derivatives thereof) of publicly traded companies; or (ii) the securities and currencies of sovereign governments. Because the corporate securities in question are publicly outstanding, most hedge fund investment activity does not directly inject new cash into businesses. This is only done when an established firm issues new loans or new securities, such as in an initial public offering or a secondary public offering.

Leveraged buyout funds acquire profitable established companies, using a combination of (i) their own capital (used as equity) and (ii) substantial borrowings from banks and other lenders. In an LBO, no new cash is injected into the business, although former stockholders have cash available from sale proceeds.

Venture capital funds invest in young, unproven businesses that often are developing new technologies or business concepts.

Mezzanine funds loan money to highly leveraged companies and risky medium sized firms that have advanced beyond the start up phase. The *other funds* definition encompasses a variety of specialized groupings.

B. \$1.85 Trillion Funds Under Management

Publicly available databases and industry sources provide the following \$1.85 trillion breakdown of funds under management by the private equity industry in the United States:

Funds Under Management in the United States

Hedge funds	\$1.1 trillion
Buyout funds	\$ 475 billion
Venture capital	\$ 130 billion
Mezzanine and other	<u>\$140 billion</u>
Total	\$ 1.85 trillion

Sources: Venture Expert (Thomson Financial), Private Equity Analyst, Private Equity Intelligence and Hedgefund.net databases. Institutional Investor, Absolute Return, Financial Times and Dow Jones have published articles on these facts.

The assets controlled by the industry are higher than the \$1.85 trillion of funds under management because of the leverage employed by the industry.

C. Fee Structure

In investing huge sums on behalf of institutions and individuals, most private equity firms charge fees under a structure known as “2 and 20.” Clients pay (i) an annual fee of 2% of committed monies plus (ii) an incentive fee called a “carried interest,” equal to 20% of profits over a fixed rate, such as 8% annually (the hurdle rate). The 2% fee was designed several decades ago, when firms were much smaller, to cover the modest salaries and overhead costs of fund managers. Now, with \$1 billion funds being routine, a handful of executives receive \$20 million annually (2% times \$1 billion), whether or not their clients “beat the market.” Thus, typical fund managers are not entrepreneurs, as depicted by the Carlyle Group’s Bruce Rosenblum in recent Senate testimony, but cautious, well-paid business people. Indeed, one of the primary concerns of sophisticated investors today is that fund managers care more receiving about their annual fees than in maximizing client returns.

D. Carried Interest Tax Rate

The economic attributes of the carried interest closely resemble those of a corporate stock option or year end cash bonus, the benefits of which are taxed as ordinary income at 35%, rather than the 15% capital gains rate provided to the carried interest. With the option, bonus and the carried interest, the beneficiary has little or no money at risk and receives a market-based salary over the holding period, so the cash proceeds from ownership, if any, are gravy.

Like a corporate stock option, the future value of the carried interest is not guaranteed, but the potential gain to the managers is enormous. Due to inflation and the long term trend of rising corporate profits, a carefully selected portfolio of companies should increase in value. With even modest returns such as 12% per year, the math of a 20% carried interest indicates that executives of a \$1 billion fund become very wealthy.

E. Carried Interest is not a Deferred Benefit

Industry lobbyists maintain that the carried interest is a “deferred benefit,” but most funds pay the carried interest to managers on an annual basis, much like a year end bonus. The manager assigns values to the assets of the relevant funds each year, whether or not the assets have been sold. The manager is then allowed to receive a portion of the carried interest based on those estimated values. If the estimates later turn out to be optimistic, the manager returns a portion of the carried interest to the investors. This arrangement is referred to as a “clawback.”

F. Other Fees Charged to Clients

The fund manager fees do not stop at “2 and 20.” The managers, particularly LBO funds, charge their underlying portfolio companies yearly monitoring fees, deal closing fees, financing fees, and deal selling fees, all of which reduce client returns. The firms’ success in squeezing fees out of their clientele is remarkable in light of the modest historical returns.

On an industry wide basis, management and other fees approximate \$50 billion annually. An estimate of the average annual carried interest fee is \$15 billion, or 27% of the total of \$65 billion in fees (i.e., \$50 plus \$15).

The industry suggests that many managers will move their businesses out of the country if the carried interest tax is increased. This seems unlikely since the carried interest is barely a quarter of revenues.

G. Private Equity Does Not Beat the S&P 500

There is a lot of hype surrounding private equity performance, but most clients do not receive out sized returns. Three separate studies by academics at the University of Chicago, INSEAD (France) and University of Amsterdam, respectively, conclude that average returns to private equity investors do not beat a passive strategy of buying an S&P 500 index fund. The high fees are one contributor to this result. Some investors try to avoid this problem by negotiating smaller fees, which are a reflection of supply and demand, rather than the managers’ tax rates. Others concentrate their monies in fund managers that rank in the top quartile in terms of prior performance, which show demonstrably superior returns. However, the research shows that a top quartile fund only

has a 40 percent chance of repeating such performance in a follow-on offering, suggesting a random quality to returns, instead of innate investment skill.

In its website, the Private Equity Council, the industry's lobbying group, emphasizes the high returns generated by the top quarter of funds. This emphasis conveniently disregards the performance of the bottom three quarters. *This is like playing darts and only counting the bull's eyes!*

On balance, America's pension funds would have been better off by never investing in private equity.

H. Future Performance

The investment performance of the current crop of private equity funds remains to be seen. Unlike mutual funds, which are marked to market daily, private equity funds write their own report cards. Managers assign values to portfolio companies with no third party oversight, so investors don't know the true worth of their holdings until the underlying companies or securities are sold.

I. Little Job Creation

Despite the lobbyists' pleas to the contrary, the industry is not a significant source of job creation or innovation. Most private equity investment is devoted to the rapid fire trading of the public securities of established companies (or derivatives thereof) by hedge funds or the acquisition of traditional, low tech businesses by leveraged buyout funds. Neither activity generates employment at the underlying portfolio firms. Backing inventors working on new technologies is relegated to venture capitalists, about 7% of the industry.

The Private Equity Council cites studies by the British and European venture capital associations as to the benefits of industry job creation. These studies can hardly be considered objective, and, in any case, they exclude the US funds' experience. Anecdotally, there are many cases of LBO firms reducing jobs after their acquisition.

Attachments:

About the Author
Chart of LBO Fund Economics

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Jeff Hooke is a former private equity fund manager and the author of four books on finance, including “The Dinosaur Among Us: The World Bank and Its Path to Extinction,” “M&A: A Practical Guide to Doing the Deal,” Security Analysis on Wall Street,” and “The Emerging Markets.” The security analysis book is required reading for the CFA exam and Barron’s called it “a worthwhile successor to Graham and Dodd.”

Mr. Hooke is a former Wall Street investment banker and former executive at Emerging Markets Partnership, a \$5 billion private equity fund group based in Washington, DC. He has written studies for public policy groups such as the Reason Foundation and is working as a volunteer with Citizens for Tax Justice, a DC based advocacy group. He runs a corporate finance advisory practice in McLean, Virginia.

LBO Fund Manager Economics

