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About those fees

Evan Lorenz writes:

It's a curious fact that investors worry more about $750 billion in collateralized loans than the $2.2 trillion in private equity that sits beneath the loans. Following is a look into CLOs, private equity and the nature of systemic financial risk a decade after Dodd–Frank. As for a relevant ticker, we perform a deep, bearish dive into Partners Group Holding A.G. (PGHN in Switzerland), the biggest p.e. manager you've never heard of.

"Imagine if, in addition to all the uncertainty surrounding the pandemic, you woke up one morning to find that the financial sector had collapsed," Frank Partnoy, a law professor at the University of California, Berkeley, and a former *Grant's* conference speaker, writes in the July/August issue of *The Atlantic*. Partnoy's bugbear—not ours—is CLOs.

By his telling, collateralized loan obligations are the spitting image of collateralized debt obligations (CDOs), which caused havoc in the prior financial crisis. Both CLOs and CDOs buy dicey credits and then securitize bonds with various claims on the resulting cash flows. In 2007, the CDO market footed to $640 billion; today, there are approximately $750 billion's worth of CLOs outstanding. According to a December report by the Financial Stability Board, 30 too-big-to-fail banks have an average CLO and leveraged-loan exposure equal to 60% of their capital.

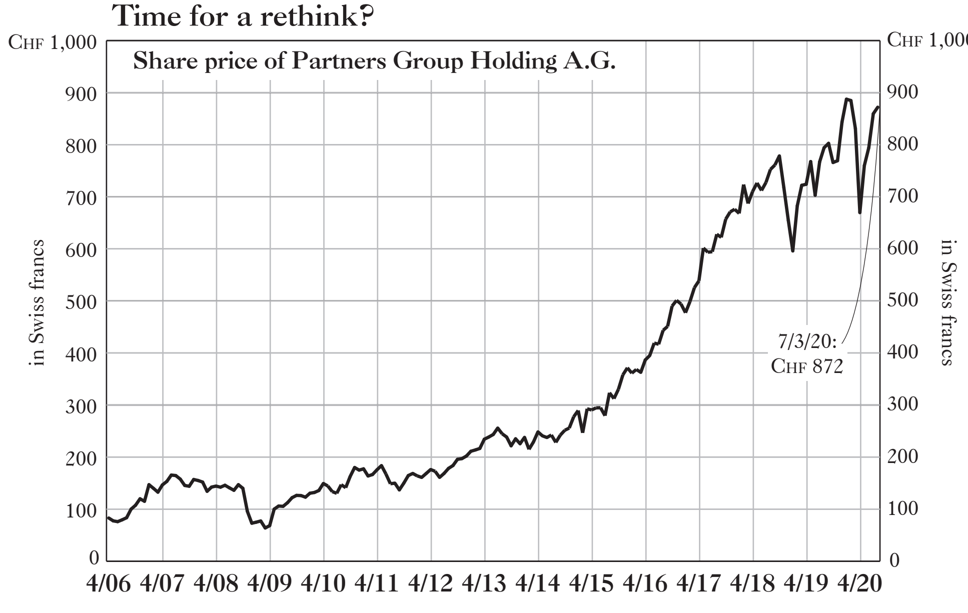
Despite their similar names and structures, CLOs are very different beasts from the CDOs of yesteryear. CLOs buy leveraged loans, i.e., first-lien debt from sub-investment-grade companies, in an industry-diversified fashion. Given their seniority in a borrower's capital structure, defaulted leveraged loans have historically commanded recovery rates in the mid-70s. Even in 2008, such loans recovered an average of 66%, according to Moody's Investors Service.

During the housing boom, CDOs purchased the junior slices of subprime and Alt-A residential mortgage-backed securities. Some bought credit default swaps on residential mortgage-backed securities, betting that poorly underwritten mortgage loans would perform. While CDOs supposedly offered geographic diversification, they were, in effect, a collection of claims tailored to bear the first losses from any housing downturn. And they did.

As of March 31, according to LCD, S&P Global's loan-research unit, American banks held $99 billion's worth of CLOs, a large figure, to be sure, but only 3.9% of the banks' $2.5 trillion of commercial real-estate loans. Altogether, the nonresidential real-estate markets are in a shambles, what with social distancing, working from home and near-record levels of delinquencies on collateralized mortgage-backed securities. In sum, the proper object for bank-themed worry would appear to be the banks' conventional loan books, not their generally well-insulated (with substantial loss-absorbing capital under the senior CLO tranches) double- and triple-A-rated CLO portfolios.

Nevertheless, losses on leveraged loans will certainly inflict pain some-

Time for a rethink?



source: The Bloomberg

Partners Group at a glance
all figures in CHF mns unless otherwise indicated

	2019	2018	2017	2016	2015
revenue	CHF 1,456.9	CHF 1,280.2	CHF 1,214.0	CHF 948.4	CHF 601.9
operating profit	1,007.6	864.8	811.4	589.0	356.8
net income	899.9	769.3	752.3	558.1	395.9
cash	933.0	412.2	852.3	186.0	163.8
debt	798.6	299.4	299.2	0	95.0
total assets	3,949.7	2,949.1	2,932.7	1,928.4	1,501.0
assets under management (in $ bns)	$94.1	$83.3	$74.4	$57.2	$50.0

source: company reports

where. In the Sept. 7, 2018 issue, *Grant's* identified Oxford Lane Capital Corp. and Eagle Point Credit Co., Inc. as canaries in the credit coal mine. Each is a closed-end fund that primarily invests in CLO equity and adds leverage to enhance returns (80% of net assets for Oxford and 34% for Eagle). Since Dec. 31, the firms have suffered drawdowns in book value of 57% and 39%, respectively.

Some clever sleuthing by a trio of Federal Reserve economists (take a bow, Laurie DeMarco, Emily Liu and Tim Schmidt-Eisenlohr) shows that insurers hold $53.5 billion of the $98.6 billion in trackable mezzanine and junior CLO notes. The plunge in interest rates has pressured the insurance industry—on May 10, *The Wall Street Journal* reported that life insurers are turning away new customers due to skimpy portfolio yields—so insurers have taken on greater risks.

In June, the trailing 12-month default rate on leveraged loans rose to 3.7% from 2.02% in March. Wells Fargo & Co. forecasts that such defaults will climb to 12% by the end of 2020, which, if true, would likely cause heartburn for junior CLO tranches even while leaving triple-A tranches unscathed. As most leveraged loans fund private-equity-sponsored buyouts, this is also a prediction for p.e. pain.

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Partners Group was founded in 1996 by a trio of Goldman Sachs Group, Inc. alumni in Baar, Switzerland. While the focus from the start was on private markets, Partners made an early name for itself by investing in other p.e. funds rather than buying companies for its own account. In 1998, Partners and Coller Capital made the largest secondary investment in private equity at the time with the $265 million purchase of Royal Dutch Shell plc's U.S. p.e. portfolio. The Swiss group completed its initial public offering in 2006, one year before Fortress Investment Group kicked off the seemingly anomalous vogue in private-equity businesses going public.

As of Dec. 31, Partners Group managed $94 billion in assets across private equity (48% of assets), private debt (23%), real estate (16%) and infrastructure (13%). While Partners has moved towards making direct investments in companies, positions in other p.e. shops' funds still account for 32% of assets. At its current size, Partners manages just under half of the AUM of KKR & Co., Inc. However, 29 funds make up the vast majority of KKR's assets whereas Partners manages more than 300 individual entities.

The bull case for Partners begins with rapid growth. Since 2009, the company has compounded AUM at a 14.3% rate to the aforementioned $94 billion. And that growth is expected to continue: Industry-wide last year, around 60% of fundraising was concentrated in a handful of large p.e. shops, up from 40% in 2012, as clients increasingly focus on fewer managers. As a past fundraising winner, Partners is positioned to keep gaining share as the big get bigger.

Partners concentrates on small and medium-size companies, a market segment it judges to be less frothy than the mega-deal branch of the p.e. market. "We have a portfolio that is more conservative and less leveraged than what I would imagine to be the case in some other portfolios in the market," co-CEO David Layton said on the March 17 conference call. In the accompanying presentation, Partners states that 72% of the companies in its flagship funds show net debt of less than six times earnings before interest, taxes, depreciation and amortization. According to Bain's 2020 Global Private Equity Report, fewer than a quarter of buyouts last year carried leverage of less than six times.

While the dominant U.S. alternative managers acknowledge that performance fees are hard to predict, Partners boasts otherwise. Thanks to broad diversification across 300 funds, says the 2019 annual report, "we anticipate that performance fees will be earned regularly from a wide range of investment vehicles going forward, making them a 'quasi-recurring' source of income, assuming market conditions remain broadly supportive." Management tells the analysts that, excluding years like 2020, performance fees should come in between 20% and 30% of total revenues. Last year, they delivered 30.5% of the top line.

For the most part, analysts see things just as the company does. "Whilst a deferral of performance fees is likely, which we reflect in our FY20 estimates, we expect the subsequent years will benefit from a catch up in performance fees from significant investments made ($84bn during 2013–19)," says Gurjit S. Kambo, who rates PGHN a buy for J.P. Morgan Cazenove. Then, too, some of the best private-equity investments are made during economic busts, so while the current pandemic-driven recession will splatter red ink, it may present the opportunity for higher returns.

So far, PGHN's portfolio appears to be outperforming the industry's. In a June 3 update, the front office disclosed that the private-equity and direct-lending businesses had dropped in value by 7.4% and 7% in the four months ended April 30, topping index returns of negative 12.4% and negative 9.6%, respectively.

However, great expectations are already priced in. Partners Group trades at 25.9 times estimated 2021 earnings versus an average of 17.1 times for U.S. peers Carlyle Group, Inc., Apollo Global Management, Inc., KKR and Blackstone Group, Inc. Nevertheless, with 13 buys, two holds and two sells, the Street likes PGHN. For their part, insiders have sold 986 shares year-to-date for proceeds of CHF 725,779.

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The bear case builds on the May 29 issue of *Grant's*, to wit: Even before the viral bug bit, p.e. managers had condemned themselves to mediocre returns by borrowing lots of money to pay fancy prices for ordinary businesses. And while the deal-doers pride themselves on infusing value through operational improvements, over half of p.e.'s returns stem from multiple expansion, not superior management, according to Bain & Co. Perhaps not surprisingly, private equity has just matched the returns in the public markets over the past decade.

But those facts don't entirely explain why American p.e. companies trade at multiples in the mid-teens. Another reason is that, since performance fees are unpredictable, earnings streams are likewise choppy, therefore deserving no great valuation. Partners commands its uptown multiple precisely because investors accept that its performance fees are recurring.

Alex Soppera, senior corporate development manager at Partners, came to the phone last week to tell me how to predict them. Start with the capital that Partners invests on behalf of its limited partners in any given year, he said. The firm earns performance fees of 5% to 10% on debt funds, 10% on secondaries (buying limited partners' stakes in other p.e. funds) and 15% to 20% on direct equity investments. It earns no such carry when it invests in other p.e. managers' funds.

Next, Soppera said, just assume that Partners can generate returns of 30% to 70% on invested capital over the lifetime of the fund. Of course, that presupposes high returns for the clients.

Private-equity performance fees are crystallized either when an asset is sold from the fund and the cash flows are realized or when investment returns within the fund clear a certain hurdle rate. Note that no cash is generated with the second method.

Partners, employing both approaches, recognizes unrealized fee revenue on the profit-and-loss statement and credits an accrued revenue line on the balance sheet.

And it seems to take some stretching to report performance fees equal to 20% to 30% of total revenue. Thus, in the year-and-a-half till June 30, 2019, according to an analysis by Thomas Beevers, co-founder and CEO of StockViews, Ltd., growth in accrued revenue was equal to about 60% of performance fees. In other words, 40% or so of performance income derived from the sale of assets, while the balance stemmed from "mark-to-model" portfolio gains.

Partners does not make this easy to figure out. For instance, management fails to disclose the breakdown between realized and unrealized performance fees. And to find the balance of accrued revenue, you must dig deep into the footnotes on the balance sheet. Updating Beevers's analysis for the full-year 2019 results, it appears that 35% of performance fees were of the mark-to-model variety.

What the Partners 2019 annual report says is this: "We include the value of unrealized investments with a significant discount (typically 50%, depending on the investment strategy)." Given that, in 2017, management was using a 50% to 80% discount range, it appears that the company might have lowered the hurdle for fee recognition. Anyway, shouldn't performance fees be driven by performance?

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Partners lacks deep experience in making direct private-equity-style investments. In 2010, only 21% of AUM was tied to direct investment strategies, with the balance in investments both primary (allocations to other p.e. managers' funds) and secondary (purchasing limited-partner stakes à la Shell in 1998) versus 68% of AUM in direct strategies in 2019. Prior to the 2019 annual report, Partners gave no performance data for its funds. In last year's report, PGHN for the first time added some comments on its p.e. performance: "Our mature buyout funds have made 67 investments to date, of which 51 are fully or partially-realized with an average of 3.2x gross [multiple on invested capital] and 29.7% gross IRR."

These returns are notable for what they don't tell you. For one, the footnotes say these are pooled returns for investment funds started between 2009 and 2012, i.e., when there were bargains on sale after the financial crisis and when Partners was managing few direct investments. For another, the returns do not include fees.

I asked Soppera why the company doesn't provide more disclosure. "As we have 300 different funds," he replied, "either we disclose all 300 of them and, then, believe me, I would probably spend half of my time in IR calls explaining why fund XYZ has gone down 5% compared to the previous quarter, which, unfortunately, it probably is not really conducive to anyhow. Or, we basically give you the assurance that our main flagship funds, in a sense, the main core strategies of the firms, that within these funds, we have always been in the top quartile."

However, some of the U.S. and UK pension funds that invest in the Partners funds do divulge performance of their investments in some detail. The San Bernardino County Employees' Retirement Association, for one, lists investments in 49 PGHN funds, ranging from secondary vehicles to direct private-equity funds with vintages ranging from 2004 to 2019. To be fair, SBCERA hit some home runs: Partners Group Client Access 8 L.P. (a 2013 investment), Partners Group Access 780 L.P. (2018) and Partners Group Princess Learning IC Ltd. (2013) generated IRRs of 69.6%, 98.1% and 36.6%, respectively. And yet, returns across the funds are all over the map and eight investments showed negative internal rates of returns. Excluding the nine 2019-vintage funds, which haven't had enough time to show their mettle, the median fund underperformed the S&P 500 by 0.6%.

While the company says that it is more conservative than its p.e. peers, you don't see it in the saga of medical-staffing company Envision Healthcare Corp., which KKR purchased in 2018 for $9.5 billion or a precarious 9.7 times trailing Ebitda. Partners bought into the deal—and quickly lived to regret it. According to a May 14 Bloomberg bulletin, Partners has written off all its $75 million to $100 million equity investment and $236 million of its $525 million debt exposure.

"So, KKR does a dumb deal," an anonymity-seeking investor who is short PGHN tells me, "and then you see that Partners Group had 7% of the total deal and probably some disproportionately high amount of the non-bank debt. What kind of special sauce is this? You are merely buying junior pieces in bad deals from American p.e. firms. Why should you trade at a premium to American p.e. firms if this is one of your strategies?"

While most of Partners' investment offerings are private, a pair of closed-end funds are open for analytical inspection. Princess Private Equity Holding Ltd. (PEY in London) is one.

"The data indicates a sharp rise in the EV/Ebitda of the portfolio, particularly over the last 3 years, where the multiple has expanded by more than 3 points, from 11.7x in Dec. '16 to 14.9x in Sept.," Beevers observed in January. "This is a much steeper rise than observed for public markets."

The other fund, Partners Group Private Equity (Master Fund) LLC, which is unlisted but does file documents with the Securities and Exchange Commission, showed multiple expansion to 14 times Ebitda from 11.3 times over the same period.

As for why Partners prefers to take such a strong, glass-half-full approach to income recognition and portfolio valuation, Beevers has found a clue: "The guidance on performance fees was first mentioned by Partners Group at the time of the FY16 results, in March 2017. This was just 3 months after the three original founders had entered into a derivative transaction which would allow each of them to dispose of 4.1% of their holding in June 2021 (for a total of 12.4% of the share capital of the company)."

If PGHN's share price is above CHF 855 on June 17, 2021—versus CHF 871 today—the founding trio would each receive around $1 billion.

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