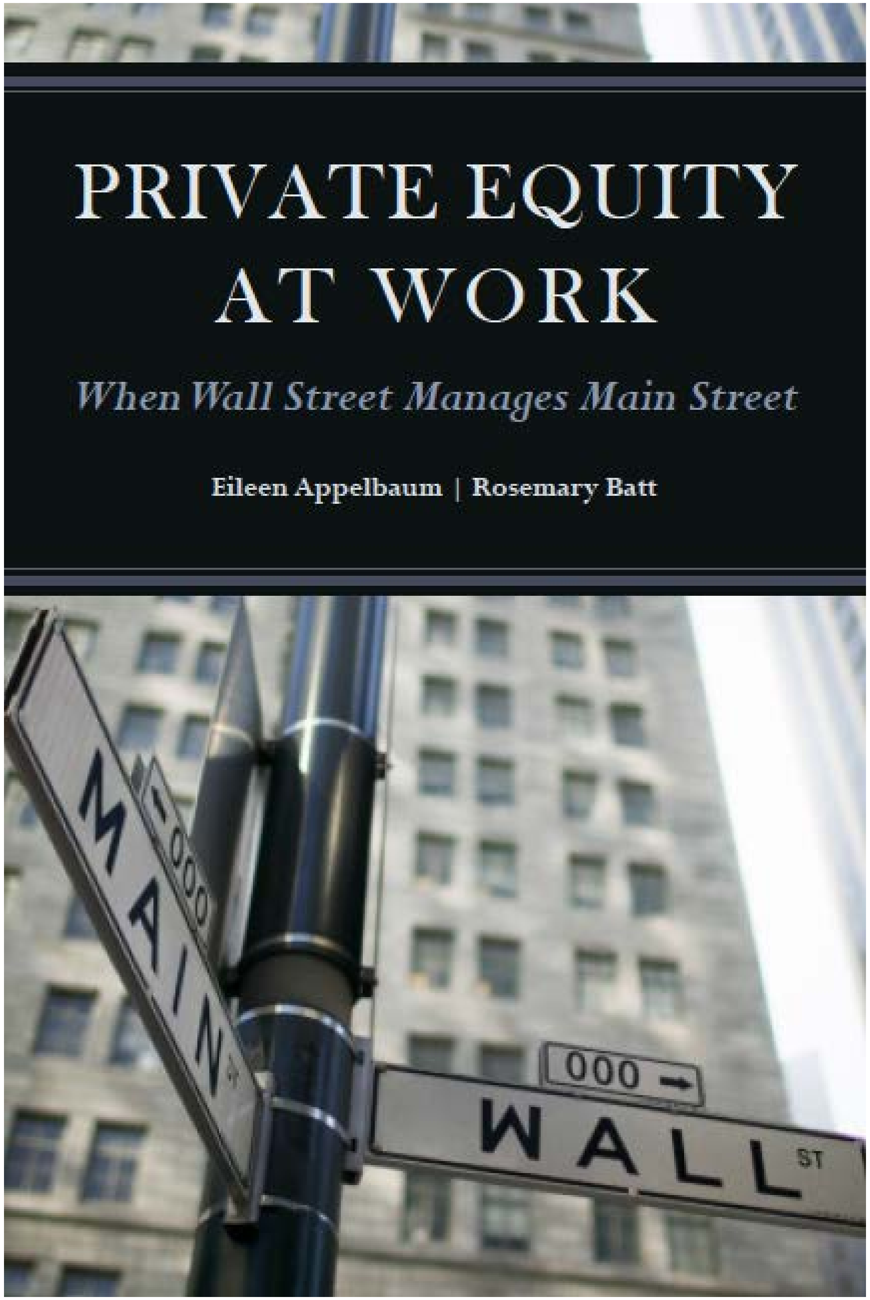

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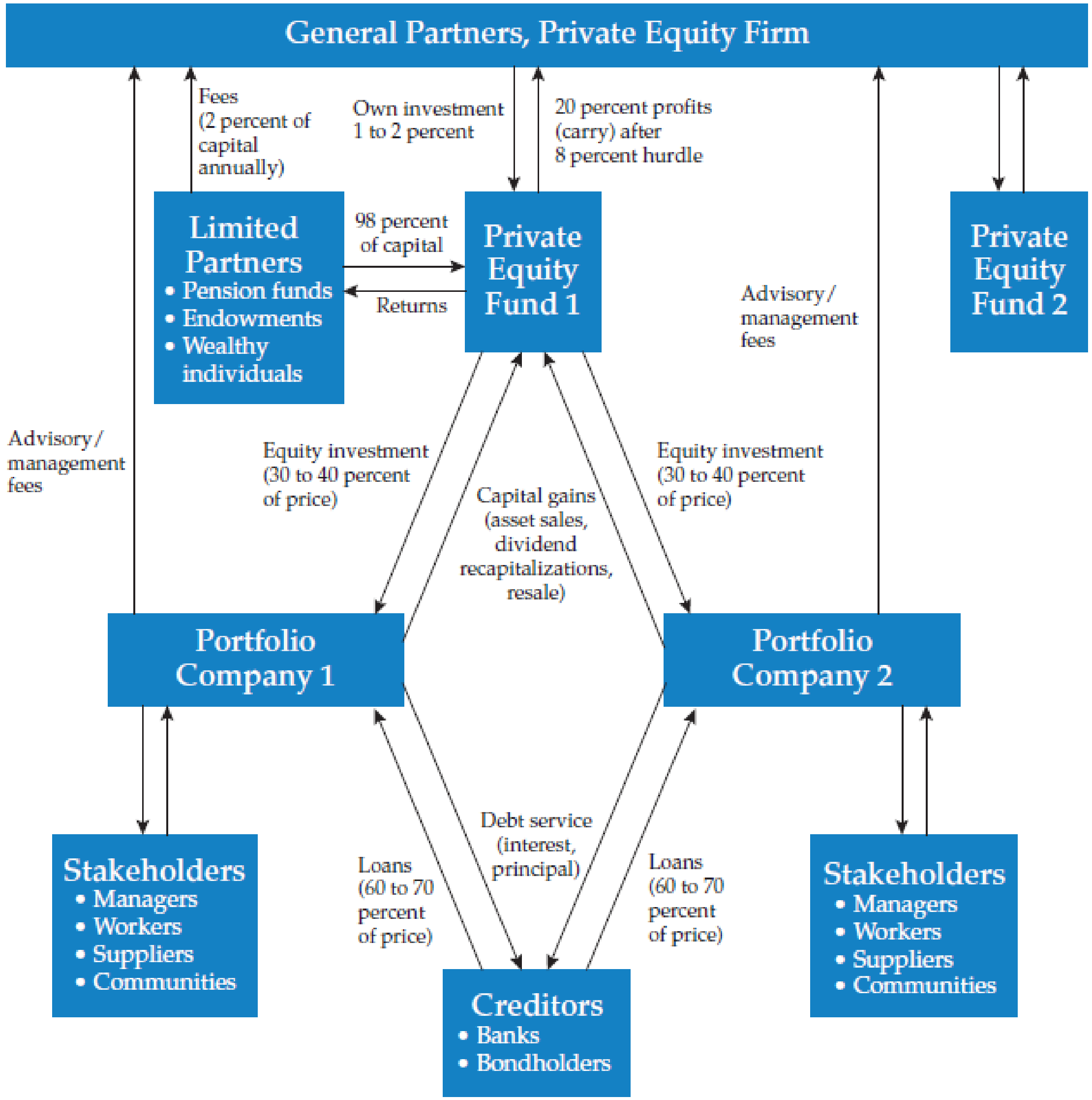
Overview of Presentation

- Private equity business model
- Investors as managers
- PE Impact: Econometric evidence
- Smart Regulation

Note: Trustees rely on fund staff and consultants to do due diligence. We will suggest questions throughout that can help you get the information you need.

Figure 1.1 The Structure of Private Equity: Firms, Funds, and Portfolio Companies



Source: Adapted from Watt 2008.

Private Equity Business Model

- Debt is lifeblood of the PE model
- Low risk, high reward for PE firm partners
- High risk strategy for portfolio companies
- Moral hazard is embedded in the model
- Taxpayers subsidize PE returns

Investors as Managers

Structure drives strategy

- Pre-buyout: Decide debt level & management plan
  - Debt level drives management plan
- Size of portfolio company determines level of debt
- Small & mid-sized companies (most deals)
  - Less collateral for debt; more use of operational strategies
- Large enterprises (most capital is invested)
  - High leverage & financial engineering dominate

GPs Make All Decisions

- LPs have no say about companies to acquire, debt to use, wage concessions, layoffs – can't withdraw if unhappy

- Pension funds commit to PE for 10 years with no say
  - How can they carry out fiduciary responsibilities to current & future retirees?

- CalSTERS is in Cerberus fund that owns company that produced guns that killed kids in Newton
  - Asked PE firm to sell, but still owns it –PE waiting for good price

Who Has Fiduciary Responsibility?

In some limited partner agreements, GPs stipulate that they may waive their fiduciary responsibilities. Some agreements stipulate that GPs may have a conflict of interest and may resolve it in their own favor. This is tantamount to waiving fiduciary responsibility.

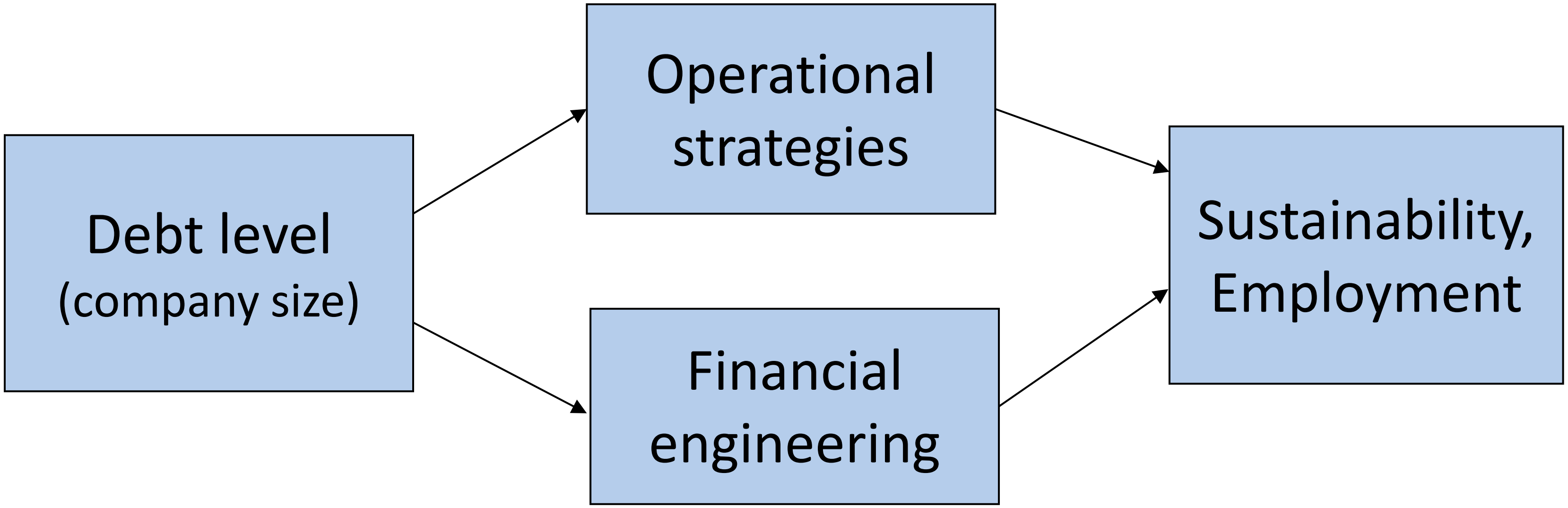
Q. Does the limited partner agreement for this fund allow the GP to waive his or her fiduciary responsibility?

Q. For any previous fund sponsored by this PE firm?

Since the pension fund commits funds to the PE fund for 10 years and has no say, it can't exercise fiduciary responsibility. If GP waives this responsibility, then no one is looking out for the interests of current and future retirees.

How Structure Drives Strategy & Outcomes

Capital structure → Strategy → Enterprise outcomes



Operational Improvements: Cases

Aidell's Sausages – Family-owned iconic SF firm ($34M)

- Bought by PE firm with expertise in food production
- Relatively low use of debt ~40% of purchase price
  - Modernized accounting, IT systems, HR management
  - Invested in technology to preserve meat w/o preservatives
  - Brought in experience in national food distribution channels
  - Annual revenues increased from $26.6M – $66.5M (2007-10)
  - Employment increased from 140 to 350
- Sold at profit to Sara Lee for its specialty meats division

Financial Engineering

- High debt: Magnifies gains, reduces taxes, increases bankruptcy risk (tax-payer subsidized capitalism)
- Debt payments drive plant closings, layoffs, wage cuts
- Asset Stripping (sell company assets in sale-lease back, PE firm – not company – keeps revenue from sale)
- Dividend recapitalization (sell junk bonds, pay dividend to PE investors) – PE sucks resources out of company
- Excessive advisory fees charged to portfolio companies
- Amend and extend agreements (haircut for creditors)

Human Resource Management: Mervyns Case

Mervyns Department Store – Iconic CA company

- Acquired in 2004 by Sun Capital-led group for $1.2B, 67%debt
- Added $400M more in debt to pay dividends to PE owners
- Tightly managed HR function; Insisted on across-the board job cuts
- Undermined supplier relations -> caused merchandise decline
- Sold off property; Sale-lease back at high rent
- Went bankrupt in 2008 - $80 M in rent > $64M liabilities
- 287 stores closed; 30,000 workers lost jobs

Excessive Debt Puts Portfolio Companies at Risk, Costs Workers Jobs, Pay, and Benefits

<u>In previous funds sponsored by the PE firm</u>

Q: Did the debt used to purchase a portfolio company ever exceed 70% of the purchase price?

Q: What were the 10 largest purchases and how much debt was used in each?

Q: What was the average amount of debt used when purchasing portfolio companies?

Q: Did any portfolio company do a dividend recap in the first 2 years after being purchased?

Q: Did any portfolio company go bankrupt under the ownership of this PE firm?

Financial Engineering: Asset Stripping

Red Lobster restaurant chain (2014)

- Darden: World's largest full-service restaurant company
- Under pressure from HFs to max. shareholder value, chain sold
  - Profitable, but declining same store sales and profit
- Bought by Golden Gate Capital 5/2014 for $2.1B
- Golden Gate sold real estate of 500 Red Lobster restaurants
  - Proceeds to PE investors; RL now pays rent for facilities it previously owned
  - Will cut net earnings in half – deprive company of resources for upgrading
  - Some locations may close – jobs, wages, benefits at risk

Sale – Lease Back Deals Can Undermine Retail and Restaurant Chains

Restaurants and retail are cyclical businesses. In an economic downturn, people don't have to go out to eat and can wear last year's clothes.

Companies in these industries typically own the real estate that houses their operations. Not having to pay rent is a buffer in difficult times and enables them to survive inevitable economic contractions.

Q: In previous funds sponsored by this PE firm, did any portfolio company engage in a sale-lease back agreement?

Quantitative Effects on Workers & Workers' Capital

- Bankruptcy Rates
- Employment and Wages
- Management Fees
- Pension Fund Returns

Net Effect on Firms: Higher Bankruptcy Rates

Best econometric study: PE versus publicly traded firms

- PE-owned firms had substantially higher debt
- 2x annual bankruptcy rate of publicly traded: 1.2% vs. 0.6% a yr.
    - For PE firm, chance of greater return worth the greater risk
    - Pension fund trustees have to think of effect on workers

Study of 2000 highly leveraged companies in U.S.

- 25% declared bankruptcy in first 2 years of financial crisis

Restaurant industry case

- 2005-7: 30 small & medium chains acquired by PE
- 30% went bankrupt; 53% financial failures (bankrupt, technical defaults, sold at large loss) (Source: Gordon 2011)

Recent PE Bankruptcies (2008-14)

- Archway & Mother's Cookies (2008)
- Fortunoff Jewelers (2008)
- Linens 'n Things (2008)
- Mervyns (2008)
- Extended Stay Hotels (2009)
- Reader's Digest (2009)
- Anchor Blue Clothg. (2009, 11)
- Simmons Mattress (2010)
- Uno's (2010)
- Friendly's Ice Cream (2011)
- NewPage (2011)
- Coach America (2011)
- Stuyvesant Town and Peter Cooper Village (2010)
- Harry & David's (2011)
- Golden Guernsey Dairy (2013)
- Energy Futures Holding (2014)

PE Effects on Jobs, Wages, Productivity

- PE targets better performing companies for acquisition
  - Faster job growth, higher paying
  - Financial engineering, downsizing => lower job growth, lower wages than comparable public companies post buy-out
  - Unionized: PE says wage structure out of line, concessions
- Job destruction outpaces job creation in establishments, firms according to best econometric evidence
- Employment, wages go down, but productivity goes up
  - May be due to operational improvements work processes & tech
  - Or work intensification & speed-up; or closing less productive units
  - Divergence between wages and productivity => increased inequality

Management Fees Are Major Source of PE Firm Revenue – Less Risky than Investment Returns

LPs pay management fees to GP for managing investment
Q: What is lowest management fee paid by an LP in this fund?

PE firm charges advisory/monitoring fees to portfolio companies
Q: Are all of these fees clearly enumerated in the LPA?

Q: Are all of these fees shared with LPs? If not, why not? What expenses does PE firm subtract from fees before sharing?

A portfolio company may be required to sign a contract to pay these fees for 10 years. PE firms typically hold companies for 3 to 5 years; collects fees for services it will never provide.
Q: Have previous funds sponsored by this PE firm done this?

Pension Fund Returns

- Problems with PE industry reports of returns
  - Lack of transparency – can’t be verified, don’t know what biases are
  - IRR – flawed measure, easily manipulated, not compared to alternatives

- Academic research by finance economists based on PME finds:
  - Top 25% of PE funds beat stock market, drive up average return
  - Since 2000, no consistent winners – can’t know which are top quartile
  - Median fund barely beats market: 1% a year or less
  - Many funds do much worse, few beat market by 3-4%
  - Study of funds at end of life found ¾ underperformed the market

- Pension funds supply 35% of PE funds’ equity
  - Top 32 pension funds average $7.9 B each
  - Despite mediocre returns, LPs pay millions of dollars in management fees

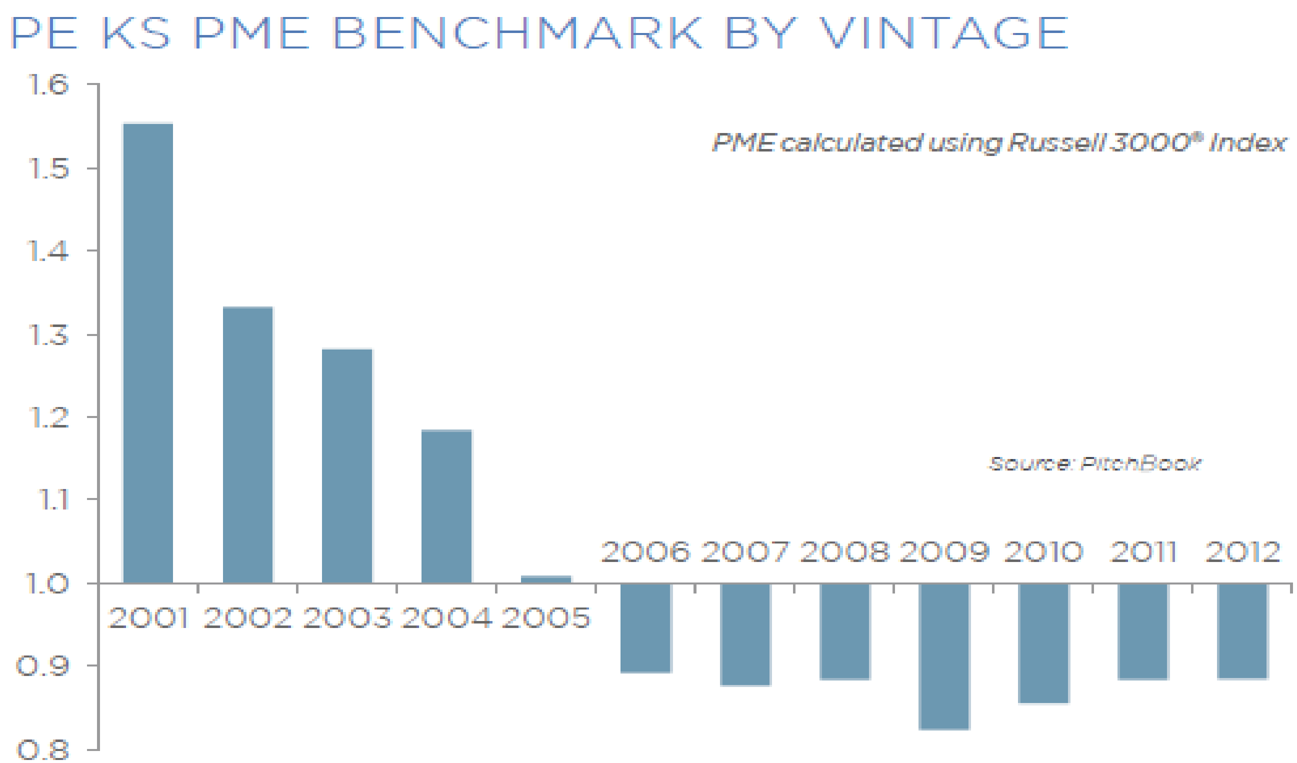
Top 10 pension funds by dollars invested in private equity

Rank	Public Pension Fund	Private Equity Investment (Bil.)
1	California Public Employees' Retirement System	$32.3
2	California State Teachers' Retirement System	$21.9
3	Washington State Investment Board	$16.2
4	Oregon Public Employees Retirement System	$14.4
5	Teacher Retirement System of Texas	$14.4
6	New York State and Local Retirement System	$14.1
7	State of Wisconsin Investment Board	$10.0
8	Pennsylvania Public School Employees' Retirement System	$9.2
9	Michigan Public School Employees' Retirement System	$8.4
10	Ohio Public Employees Retirement System	$8.2

PRIVATE EQUITY GROWTH CAPITAL COUNCIL

BISON

PE Hasn't Beaten Stock Market Since 2005



When using a KS PME, a value greater than 1.0 indicates outperformance of the public index (net of all fees). For example, the 1.18 value for 2004 vintage PE funds means investors in a typical vehicle from that year are 18% better off having invested in PE than if they had invested in public equities over the same period.

Pension Funds Continue to Invest in PE

- U.S. stock market is at record highs
  - PE portfolio companies valued by comparison with publicly traded companies – carry high price tag
  - PE "selling everything that's not nailed down" – Leon Black
  - Distributions to pension funds, other LPs at record highs
  - LPs are getting buckets of money & re-investing in PE
  - BUT, they haven't asked themselves if returns beat the market
  - CalPERS did, and has cut back allocation to PE

- High valuations good when selling, not so good if buying
  - PE is overpaying today; will make it hard to exit at a profit
  - PE returns are cyclical – investing at market peak, returns not good

Fees to PE Firms: Why the 'House' Never Loses

- PE firms prosper regardless of how well or poorly their funds perform
- Collect management fees from LP investors, charge expenses to LPs that should be covered by the fees
- Collect advisory and monitoring fees from portfolio companies; charge transaction expenses to them
- Evergreen fees: PE firm requires 10-year contract with portfolio company for advisory/monitoring fees
  - Typically holds portfolio company 3 – 5 years
  - Collect fees for years of services they will never provide

How Are Fund Returns Calculated

<u>Returns "net of fees" can be calculated in different ways</u>

Q: In calculating the *average* net return, is the GP contribution to the fund's equity included? Including GP contributions makes the *average* net return look bigger than it is.

Q: Are all fees and all carry subtracted when calculating returns?

IRR is not a good way to measure PE returns. Finance economists and others (e.g., Goldman Sachs) use PME.

Q: What is the rate of return on previous funds using PME?

Bankruptcy and Portfolio Company Pensions

363 fast track bankruptcies: For rare cases when assets deteriorate.

- PE firms don’t have to present restructuring plan or negotiate with union over employee pensions. Some PE firms use 363 bankruptcies to get rid of pension liabilities.

Q: Have any portfolio companies in funds sponsored by this PE firm gone through a 363 bankruptcy?

In multi-employer pension plans, a company that exits the plan must make a payment to pension fund. Bankrupt company doesn’t have resources. Some GPs claim they are not employers; refuse joint responsibility and don’t make payment.

Q: Has any prior PE fund faced this situation, and if yes, how did they handle it?

Smart Regulation

- Increase transparency
- Limit leverage to limit risk to workers, creditors, others
  - Limit tax deductibility of interest
  - Limit loans (< 6x EBIDTA); can be substantially repaid in 5 years
  - Expand regulatory oversight so regulators can assess riskiness of debt and impose limits if necessary
- Discourage financial engineering
- Close tax loophole: Tax carried interest as ordinary income
- Update employment, bankruptcy, & pension laws
- Hold PE firms and funds accountable as employers
  - WARN Act, 363 bankruptcies, ERISA