

MARCH 13, 2009, 4:45 PM ET

Pension Funds to Private Equity: ABCD. Always Be Closing Deals.

Things in the markets may be slow, but to investors that means they want to see their private-equity money managers work harder.

Deal Journal earlier reported from the Women's Private Equity Summit in California that fault lines are appearing in the relationships between private-equity funds that have amassed billions of dollars to invest, and the pension funds and endowments that handed over that dough.

Friday, the depth of the new distrust was revealed. Pension funds and endowments, known as "limited partners" partly because of their limited rights, are rebelling against years of silence to actively police how private-equity managers, or "general partners," do their jobs.

LPs have always been known as passive capital—once they devote their money to a private-equity firm, they simply have to stand back and wait for the next 10 years as the firm invests the money as it wishes. LPs keep their fingers crossed for profits, and usually overlook some of the less-flattering aspects of the private equity business: that 60% of investments fail, for instance, and that GPs collect 2% of the assets every year and 20% of profit on the billions of dollars they hold.

No longer are LPs remaining silent. For the system to work, private-equity firms have to go out and actually invest money, and LPs are cracking the whip, even though there is little buying or selling to be done. Though LPs have few tools to force private-equity firms to invest faster, better and more efficiently, they are asserting their power by reminding private-equity managers that they will need more cash someday in the future. Deal Journal reports below on some of the ways that LPs are taking power back:

Strike a Good Contract: LPs are looking for evidence that they are equal partners with their GPs, not just dumb money that sits there. "We're partners up until the time we're not," one LP investor said onstage at the conference. The first places LPs are looking are LPAs, or limited partner agreements, the contracts that set the terms of their investment in a private-equity firms. GPs sometimes resist having to answer to somebody, and one panelist complained that GPs are sending out new amendments that take power away from LPs. If challenged, the GPs may be too smooth by half. "The GP will put a spin on it that is so positive and compelling but when you peel it back and really examine the amendments—I don't want to say 'sneaky,'—but, some of these are sneaky."

What are LPs examining? For one thing, they are looking for details on the rules of new fund-raising by private-equity firms. If a pension fund devotes, say, \$100 million to a private-equity fund, it doesn't want to be forced to increase its investment later. Some private-equity firms can't raise new money, so they are trying to get LPs to give them more money to put in existing funds. LPs are suspicious.

LPs also are combing agreements for language about how long a private-equity firm can extend its investment period. Usually, a private-equity firm has to use its entire fund and return money to its investors within 10 years. During that 10 years, LPs pay a management fee of 2% of assets invested. LPs aren't happy to find that many private-equity firms are having trouble selling assets and exiting their investments—meaning that the private equity funds want even more time, and thus more fees, to clean up accounts. One LP, confronted with such a request, said bluntly, “liquidate already.”

Two Can—And Must—Play This Game: LPs complained about GPs who try to twist agreements to their favor. One area ripe for misunderstanding is clawbacks; there are two kinds, one for GPs and one for LPs. An LPs can claw back some of its investment if one of the GP's portfolio companies is accused of fraud or hit with a serious lawsuit. A clawback means something different for GPs. When companies hit it big, GPs get a rich return of 20% of any profit from the investment. But if GPs make bad deals, they have to take only 1% of any losses. A clawback for GPs means the GP has to give money back to the LPs to make up for the outsize profit it made.

But some GPs aren't seeing it as a game for two. One LP onstage on the conference was shocked when a private-equity firm handed her an investment agreement that included an LP clawback, but no GP clawback. “I'm looking for a fair contract that makes us partners,” the panelist said. “I looked at that and said, ‘okay, clearly you don't consider us partners.’”

Pay for Performance: LPs no longer are willing to take a private-equity firm's word that everything is OK, and increasingly they are looking over the shoulders of GPs. One LP whose firm has invested with dozens of private-equity funds said her firm is undertaking a massive research project to comb through the finances of thousands of the companies owned by those private-equity firms. And now that times are tough, LPs are making harsh decisions about where they are paying their fees. “An exceptional GP to be paid for exceptional ability is OK,” said one panelist, noting that her firm will winnow lesser performers. LPs are willing to pay fees only if private-equity firms are actually out there investing money. Like the famous line in “Glengarry Glen Ross,” the private-equity firms should follow the ABC rule: always be closing. “GPs have to recognize that this is an era of transparency and communication with LPs,” said one panelist. And the GPs who don't cooperate? Well, the next time they try to raise funds they will find significantly fewer friends.

Copyright 2008 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com