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Mandatory Disclosure for PE's Significant Portfolio Companies

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[Summary of thesis]

The time has come to move to a mandatory disclosure regime for companies of significant size held in private equity portfolios. There are two main reasons. The first is a traditional one: "private" companies such as PE portfolio companies can free ride on the disclosure by public companies of competitively valuable information in the formulation of strategy and the evaluation of management. This amounts to a subsidy by public companies to private companies, which can improve the performance of the latter at the expense of the former. Particularly as PE portfolio companies take over an increasingly large share of the economy, this subsidy becomes intolerable and indeed becomes a motivation to "go private."

The second reason is because of evolution of the PE model. In light of the changing pattern of "exit," PE needs a reliable accountability mechanism that public disclosure provides. Without such accountability, PE's growth could produce massive resource misallocation. The similarity to the failed conglomerate movement of the 1960s hangs over PE's evolution.

Lets spell out this second argument for mandatory public disclosure: The economics and thus the strategy of the PE model is shifting from "carry" as the predominant source of PE sponsor returns to "fees." The original PE model focused on "exit" either through an IPO or a sale to a strategic. Funds had maximum life of 7 to 10 years and exits were commonly quicker, which suited the return-seeking investors. The PE claim was that the discipline of the hard budget constraint of debt and the focused monitoring of the portfolio company created value. This gain would be realized through exit and carry was the sponsor's share of the gain. These exit channels (IPO/ sale to a strategic) became clogged in the 2010s.

Another form of exit was sale to another PE firm, which purportedly specialized in the next round of value creation at the portfolio company but of course one might reasonably wonder whether such within-PE industry transaction were pursued to maximize the welfare of the PE club. Most recently, as the exit channel has become further clogged, PE firms are creating "continuation funds" as a mechanism for providing a soft "exit" for portfolio companies that would purportedly benefit from additional period of under the sponsor's control to achieve maximum value, or perhaps, cannot be otherwise disposed of without an embarrassingly low price. The consequence is that the median/mean period of a company's life in PE portfolio has lengthened from Q/q to R/r.

This path of transactional evolution coincides with a notable growth in PE's assets under management. The total value of PE's AUM is $x trillion (2023) and PE firms have an additional $y trillion of "dry powder." PE has become an "asset class" that institutional investors commonly want to include as a meaningful share of their portfolio. This flow creates a robust demand side for PE deal hunting. As AUM increases, fee income increases; as the period before exit lengthens, AUM increases. Over the period D to E, the ratio of PE fees to carry has shifted from F to G.

The concern is this: without arms' length exit, there is no reliable verification of PE's claim of value creation. Particularly as the period of the PE shelter lengthens and AUM increases, the risk is that PE could be a source of massive inefficiency in resource allocation. Investors in specific funds may receive financials about the performance of the fund, but rarely detailed information about the performance of specific portfolio investments. This then is the case for mandatory public disclosure: as the PE industry has evolved, it needs the reliable accountability mechanism of public disclosure. Private solutions will not provide disclosure that is comparable across companies and overtime and will not provide the credibility associated with anti-fraud protection.

To repeat, the similarity to the failed conglomerate movement of the 1960s hangs over PE's evolution. Public disclosure for "significant" PE portfolio companies ("significant" to be defined) is the necessary safeguard.