The Myth Of The Illiquidity Premium

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Private equity firms are known to charge some of the highest fees in the investment management business. Accounting for management fees and performance fees (also known as carry), the management expense ratio of the average private equity fund can be above 5% per year. In this competitive environment, a 5% annual fee to manage funds seems excessive and difficult to justify.

Empirical research shows that private equity fund returns have historically been driven by three quantitative factors:

- Value Factor – buying cheaper stocks has historically outperformed
- Size Factor – buying shares of smaller companies has historically outperformed
- Leverage – using copious amounts of debt magnifies returns

These three factors are relatively easy to replicate. Private equity funds have been charging high fees for returns that are somewhat commoditized. In order to justify these high fees beyond the simple 3 factors driving their returns, they need to point to something less tangible and more mysterious and complicated. This is where the concept of an "illiquidity premium" comes in. The illiquidity premium is the mysterious factor which many leveraged buyout firms claim produces outsized returns.

This illiquidity premium is a thing – what it means is that you earn higher returns for an illiquid (i.e. difficult to sell) investment. Let's consider an example. Say you can open a savings account that you can withdraw anytime and it offers a 3% interest rate. The second savings account option can only be withdrawn after 5 years. All else being equal, what interest rate would you require from the second account in which you're unable to get your money back for 5 years? Certainly higher than the first account's 3% interest rate. The higher interest rate above 3% needed for the second "illiquid" account is called the illiquidity premium.

The key to understanding the illiquidity premium is that it comes from somewhere – the discount you pay for an investment given you won't be able to sell it for a while. It is from this discount in which the illiquidity premium is earned.

The problem with traditional private equity (aka leveraged buyouts) is that they typically buy an investment from a liquid public market and take it private, where it then becomes illiquid. This self-inflicted illiquidity does not magically create the illiquidity premium. As we know, the illiquidity premium comes from buying an illiquid asset at a discount compared to the price of its liquid brethren. This is where the private equity scheme falls apart. Not only do they not buy the assets at a discount, but they pay what's called a control premium, which is typically around 30% higher than the liquid market price.

Let's take a look at another example. Say ABC Corp trades in the stock market at $10.00 per share. Over the next five years, the value of the business increases by 50% and the stock is now worth 50% more, or $15.00 per share.

Imagine that Private Equity LP wants to take over ABC Corp when it is trading at $10.00 per share. Private Equity LP will need to pay a control premium, so let's say they pay $13.00 per share (a 30% control premium). Five years down the line, ABC Corp's business increases the same amount and it now has a market value of $15.00 per share. Remember, Private Equity LP has taken ABC Corp private in this scenario and therefore it is illiquid.

The return for ABC Corp over the five years is 50% (stock appreciates from $10.00 to $15.00), but the return for Private Equity LP is only about 15% (they paid $13.00 for it and it was worth $15.00 five years later), excluding the 5% per year fee and ignoring any effects of leverage.

The illiquid investment owned by Private Equity LP earned a far lower return than the liquid investment.

This shows that not only is there no illiquidity premium attained in a leveraged buyout, as one cannot self administer this premium, there is actually a large drag on investment returns for Private Equity LP from the control premium they needed to pay (even before consideration of additional fees).

The illiquidity premium in leveraged buyouts is a myth perpetuated by private equity firms to justify their high fees. But where do their returns come from? In addition to the value and size factors, the magic of private equity returns comes from... LEVERAGE (or debt as most people call it). They are called leveraged buyout firms for a reason.

-Julian