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THE BIG READ

Private equity

Apollo's lucrative but controversial bet on insurance

Firm's investment in Athene yielded profits for both but some worry about conflicts of interest

SUJEET INDAP AND **MARK VANDEVELDE** – NEW YORK

Marlene Albert had $110,000 in her investment account when she left her job at AT&T a decade ago. But what she needed instead, she told her broker, was a monthly cheque for the rest of her life.

"He didn't charge [for advice], because my mother would bake him fudge," recalls her daughter, Sherrie Kelly. "She just felt very comfortable with him." All the same, when Ms Albert decided to put her money into an annuity contract from a British insurer called Aviva, Ms Kelly phoned her son in England to ask what he knew about the company.

A few years later, her policy passed to a new owner — Athene Holding, a controversial and highly acquisitive life insurance company which has shaken up the way the annuity business operates in the US. Americans hand over $200bn a year in annuity premiums, usually opting for an insurer that will invest the money in safe bonds and then keep a modest portion of the investment returns for itself. But in the past decade, a private equity billionaire has elbowed those incumbents aside, devising a way to push a portion of the retirement savings of people such as Ms Albert into complex credit instruments conventional insurers would not dare touch.

The result of this exercise in financial engineering has been Athene, whose hundreds of thousands of policyholders often had no say in the transfer of their retirement savings to the new and untested vehicle. Its unusual relationship with its original backer, the private equity powerhouse Apollo Global Management, risks creating conflicts of interest that some say could sting Athene's investors and policyholders in the next market downturn, as the relatively easy returns of the last decade start to recede.

© FT montage; Bloomberg. Marc Rowan, co-founder of Apollo Global Management

Yet in its short history it has notched up an impressive financial record. Even its critics concede that from the standpoint of its creators, Athene has been perhaps the greatest investment strategy of the past decade. Apollo has created both a listed $10bn life insurance company as well as a perpetual stream of fees that account for several billion dollars of its own $13bn equity value.

The architect of this trade is Marc Rowan. Nearing 50 when the financial crisis hit, the co-founder of Apollo already stood atop one of the world's biggest private equity firms. In 2009, fresh from engineering the $30bn takeover of the Las Vegas-based Caesars gaming empire, he helped create Athene as a platform to make a big bet on insurance.

The move into insurance was a departure for Apollo, whose bread and butter had become big leveraged buyouts of whole companies where it would keep 20 per cent of the profits. Such profits could be huge but they occurred erratically and involved the protracted process of flying around the world every few years, hat in hand, asking pension and wealth funds to commit capital. Athene's assets now amount to $100bn, a figure that eclipses the money housed in Apollo's own famed buyout funds.

For Apollo, Athene was a way to double dip. Along with its stake in the insurer — for which it put up little cash — Apollo earns hefty fees for managing Athene's asset base. In 2017 alone, the firm earned more than $400m from its contract to manage Athene's portfolio, which includes esoteric credit instruments linked to residential mortgages, corporate debt, aircraft leasing and even the deals of private equity rivals.

Yet some insurance experts worry this gusher of fees gives Apollo powerful incentives that may sit uncomfortably with the interests of Athene's policyholders and investors. Apollo has a 10 per cent stake in Athene, but that obscures its far more extensive influence: Apollo controls 45 per cent of the voting shares at Athene and has even installed one of its own employees as the insurance company's chief executive.

A Financial Times investigation paints a worrisome picture of the governance arrangements meant to keep this conflict in check. Based on interviews with insiders, competitors, bankers and other industry observers, as well as a review of securities filings, it shows how investors raised concerns Apollo had exploited its position.

Jim Belardi, the insurance veteran who is chief executive of Athene, receives 5 per cent of the private equity firm's profits from Athene, an agreement that calls into question his oversight of an arrangement critics say is far too costly. Even some Apollo insiders concluded that Athene could save hundreds of millions of dollars a year if it replaced Apollo with an independent asset manager.

"Marc Rowan is a genius but in a twisted way," says a former senior Athene executive who claims his concerns prompted him to resign. "What was happening at Athene left me cold."

Apollo said its "broad-ranging partnership with Athene has been, and continues to be, a great success that has helped Athene significantly outperform its peers, benefiting its customers and investors." The private equity group added: "The claims cited in the Financial Times article, which Apollo strongly denies, are baseless."

Apollo, founded by three former Drexel Burnham Lambert bankers in 1990, made a fortune in insurance investing in its early years. By 2009, it had decided that insurance was ripe for a new model. "[We have] seen the best returns following chaos," Mr Rowan told an audience that year at his alma mater, the Wharton School of Business. He signed up a team including insurance veteran Mr Belardi and set about building a different kind of life insurance platform.

Athene's maiden deal took over a $1.6bn block of annuity liabilities from a struggling insurer called American Equity Investment Life and ploughed the matching assets into securities that the typical portfolio manager had been trained to avoid. A quarter of the total went into securities backed by residential mortgages and other debts, snapped up at deep discounts at a time securitised products were deemed too risky.

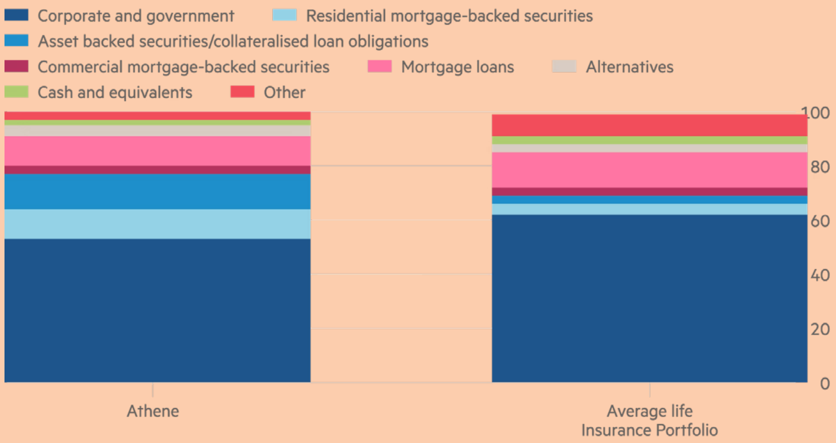
While annuity contracts promise customers a return of perhaps 2 or 3 per cent a year, a resourceful credit investor such as Apollo could earn perhaps as much as 4 percentage points on top of that. With every $10 of Athene's assets funded by only one dollar of equity, returns could reach 15 to 20 per cent, double what the banking sector has offered in the past 10 years.

Athene's biggest deal by far came in 2013, when it acquired Aviva USA and its $56bn of annuity contracts, along with its market-leading sales team. Athene was no longer a niche operator of legacy assets; its backers, now including sovereign investors from Abu Dhabi and state pensions from Canada, Texas and South Carolina, owned a piece of a growing insurance heavyweight.

Apollo was in line to receive hundreds of millions of dollars a year for running Athenes book of assets. It decided it could do without the separate, far more modest fee it earned for overseeing Athene on behalf of Apollo's fund investors. So it struck a deal with the Athene board. In return for cancelling these so-called monitoring fees, it would receive a generous allocation of Athene equity — an exchange that allowed Apollo to amass much of its 10 per

Athene's more complex asset mix

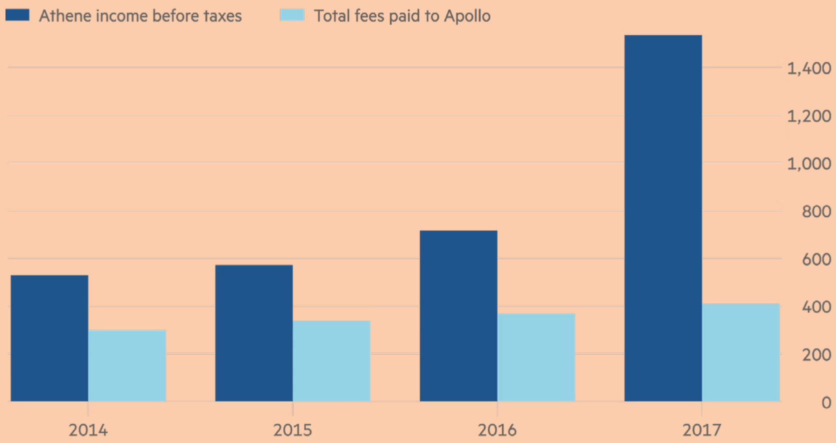
Asset allocation versus a typical life insurer portfolio (%)



Source: Athene Holding
© FT

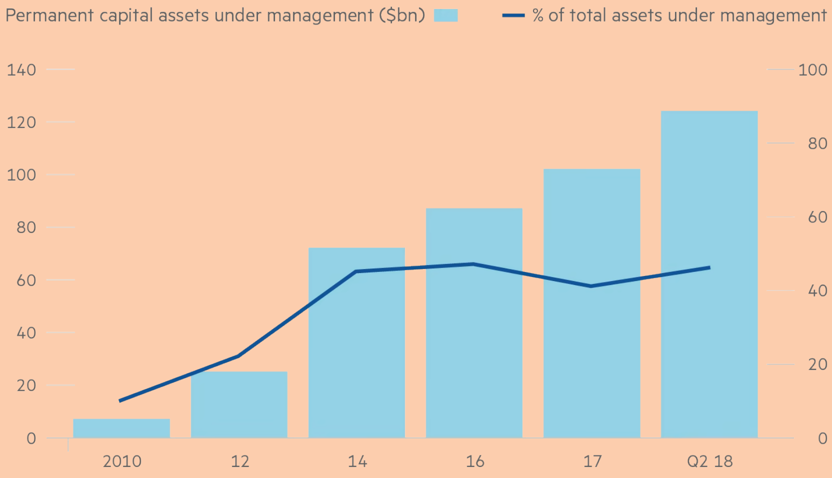
Apollo takes a large chunk of Athene profits in fees

$m



Source: Athene Holding
© FT

Apollo's permanent capital strategy



Source: Apollo Global Management
© FT

cent shareholding in Athene while handing over little of its own cash.

The logical next step was to list on the stock market, a move that would give Athene a better credit rating and a currency for buying other companies. There was just one snag. Public companies attract big and powerful investors — the kind that demand a say in how their companies are run. But when Athene filed for its initial public offering in May 2016, it became clear that for the daughter of Apollo, life as an independent company would amount to something less than freedom.

"Marc Rowan's attitude towards us was: 'You've made a good return on your investment, why don't you just be quiet?'" recalls an executive at one of Athene's blue-chip investors who voiced concerns in 2016 over Apollo's fees and influence.

The disagreement centred on Athene's now sprawling asset base and how much Apollo was charging to invest it. None of the typical arrangements for managing it were considered suitable. An internal investment team could not match the capabilities of Apollo, which was able to obtain and analyse any fixed income instrument an insurer could imagine buying. An external manager such as BlackRock or Pimco suffered from the opposite problem: Apollo judged those firms too big to care much about even the $60bn Athene had to manage.

So Apollo set up a California-based firm, Athene Asset Management, which took charge of Athene's portfolio in exchange for a fee. Despite the name, Athene had no economic interest in AAM, in which Apollo has a 95 per cent stake. The rest belongs to Mr Belardi. Some Athene executives regarded it as highly unusual that Mr Belardi, who as Athene's chief executive was duty-bound to Athene shareholders, simultaneously received $5m of every $100m in profits that Apollo generated from the fees it charged Athene. "Belardi was on the same side as Rowan. He was never going to rock the boat," says the longtime Athene investor.

As the IPO neared, this unusual set-up needed to be justified. In late 2016, a "conflicts committee" of five Athene directors called in Houlihan Lokey, an investment bank, to compare Apollo's fees with what other insurers were paying. Mr Belardi was initially among them (he is no longer a member of the committee).

At the time Athene was forking over annual fees of more than 0.4 per cent of assets, public filings show. The bankers reckoned anything from about 0.3 to as much as 1 per cent would have been within market norms, according to people familiar with their work.

Critics inside Athene said Houlihan's report, based in part on mutual fund data that Morningstar makes available to retail investors, did not reflect the keener terms they thought a $60bn portfolio could easily secure. Apollo itself had already started to gather competitive intelligence from leading names in investment banking and insurance, and reached a similar conclusion. Apollo's internal study, described by multiple people as far more rigorous than Houlihan's exercise, concluded that the private equity firm was charging Athene at least two times the 0.15-0.25 per cent an unaffiliated investment manager would demand for similar services.

Apollo appears not to have disclosed these findings to the insurance company. Athene's conflicts committee had been created to prevent Apollo from using its 45 per cent share of the vote to trample the independent investors who owned 90 per cent of the shares. But some of its members were still closely connected to Apollo. One was Hope Schefler Taitz, an independent director of Athene who had worked alongside the Apollo founders at Drexel in the 1980s. Both she and Mr Rowan invested in a media start-up called ATTN:, according to the venture capital directory Crunchbase. She also told Athene's board of a number of philanthropic ties to the Apollo founder.

Athene said the directors on its conflicts committee have no commercial interests in the transactions they evaluate. It said its recently revised deal with AAM had further aligned interests and was "reasonable by any definition", considering its investment outperformance and the services provided.

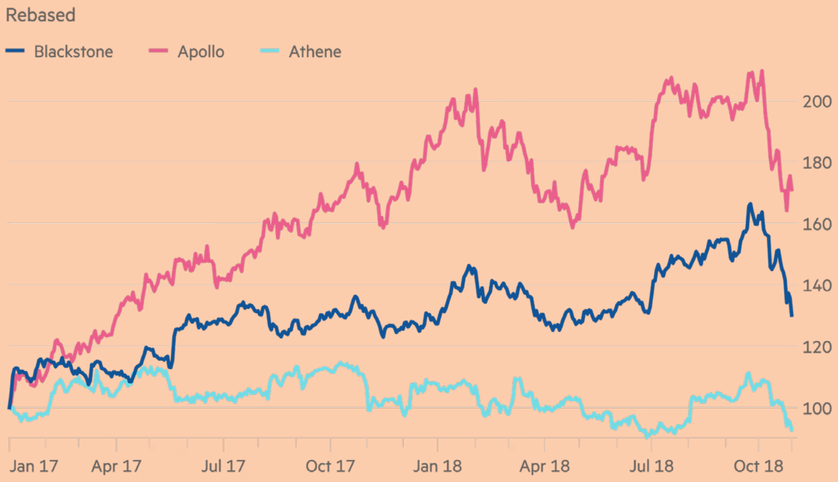
I was just uncomfortable with Apollo's greed and how they operated

Blue-chip investor

"Apollo has sourced investment opportunities for Athene that other managers simply can't provide, including some of our most successful investments to date," Athenes aid, pointing to its profits, top credit rating and acquisition-driven growth. It added that Apollo was Athene's largest shareholder, "providing a degree of alignment which far exceeds the vast majority of commercial asset management relationships".

Whatever the doubts about Athene's governance, defenders of the Apollo relationship point to two facts. First the outperformance of the portfolio. At the time of its IPO the insurer claimed an annualised return of 5.3 per cent net of fees, ahead of the 4.5 per cent average return of a group of competitors. Second, the shares that Apollo and its executives hold in Athene align the pair's interests. Even after a sharp sell-off this year, Athene shares remain above their late 2016 IPO price.

Total returns compared



Source: Refinitiv
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"The Athene story is misunderstood," argues one portfolio manager who holds one of the largest stakes in Athene. The person believes the partnership with Apollo has been extremely successful so far and was equally confident about the pair's ability to keep exploiting corners of the insurance world that have fallen out of favour. "Jim Belardi taught Apollo everything they know about insurance, and I don't have an issue with Apollo. The relationship is transparent."

Still, concerns about the fees are one reason why Athene trades at a discount to peers. Apollo seems to have acknowledged the tension, agreeing last month to cut its base asset management fee while charging Athene higher fees when it selected riskier investments

"I was just uncomfortable with Apollo's greed and how they operated," the blue-chip investor says. "The fee had hamstrung Athene in competing for acquisitions. Apollo is very good at managing their own interests in advance of their [investors]. In retrospect, I fault myself for not resisting."

Apollo is not short of admirers — or imitators. Blackstone, the world's biggest private equity manager, last year helped finance a $2bn deal to buy Fidelity & Guaranty Life alongside Chinh Chu, a longtime Blackstone executive who had struckout on his own. While Blackstone, like Apollo, is charging hefty fees for running the insurer's assets, others are trying a lower-cost model.

Last year, Bob Diamond's Atlas Merchant Capital bought $3bn worth of annuities from The Hartford, a US insurance company, pledging to manage its assets in-house.

One of Mr Rowan's former top lieutenants, Imran Siddiqui, is being sued by his former employer after launching a rival life insurance venture. While he was still at Apollo, Mr Siddiqui objected to the high fees and risk profile imposed on Athene, according to documents his lawyer put before an arbitration panel. (The filings were withdrawn from arbitration when Mr Siddiqui filed a lawsuit in New York against Athene and Apollo, where he has not repeated the claims.)

Nick Gerhart, an industry executive and former Iowa insurance commissioner, says such criticisms have a point. "You could argue that some of these alternative firms have been white knight[s], rescuing troubled companies and saving policyholders," he told the FT. "But some of these fees — 30, 40, 50 basis points — should be looked at."

The true test of the insurance companies' strength — and the moment of maximum peril for the shareholders and policyholders such as Ms Albert who rely on them — will arrive long after those fees have been paid. As one insurance executive who has sold assets to Athene asks: "When we go through a down cycle in the credit markets, will these strategies hold?"