Private Equity Fund Terms Research

Part II of III: Alignment

2018

MJ HUDSON
LP UNIT

Private Equity Fund Terms Research

Part II of III: Alignment

Welcome to Alignment, the second part of the fourth edition of the MJ Hudson Private Equity Fund Terms report, a detailed look at the prevailing terms and conditions that impact private equity funds, their managers and their investors.

In Part I of our report (Economics), we focused on the core economic terms of investment funds: management fees (and discounts); hurdle rates; carried interest and escrows; and clawbacks of carried interest. We noted the key trends in the market and any change in incidence and rates, as well as the investor friendliness of the terms.

In Part II we will take a close look at how the alignment of interests between investors and fund managers is safeguarded.

LPs and GPs are best aligned when fund performance is stellar. And, on the whole, performance (at least on paper) for private equity has been strong since 2010. The rate of distributions to LPs is at near record levels and IRR numbers have been especially good. Nevertheless, alignment is important.

In essence, fund management is a simple activity: the fund managers sell their expertise for a fee and the investors pay this fee in order that the fund managers take their capital and multiply it. Of course, there are certain aspects of the manager-investor relationship, particularly in private equity, where alignment between parties is not inherent. For example, calculating the management fee according to capital committed rather than invested, may not incentivise a manager to work hard to improve the performance of an underperforming fund that has no prospect of getting into carry. After all, the management fee is paid, regardless.

The closer the alignment of interests between the investors on one side and the managers on the other, the less likely it is that a conflict will occur. Alignment is primarily achieved by way of economic arrangements. The golden rule is that the managers should not benefit before their investors.

INTRODUCTION

As the Institutional Private Limited Partners Association (ILPA) explains in its Private Equity Principles:[1]

> *" Alignment of interests between LPs and GPs is best achieved when GPs' wealth creation is primarily derived from carried interest and returns generated from a substantial equity commitment to the fund, and when GPs receive a percentage of profits after LP return requirements are met "*

Conversely, where the GP/manager charges excessive management fees and retains transaction fees for its own benefit, the financial interests of the fund participants may diverge.

Despite the trend towards lower management fees for larger funds (more on this issue in Part I[2]), management fees still generate considerable income. On larger funds, the amount of income generated for a manager can be far in excess of its intended purpose – payment of the operating costs, as well as reasonable remuneration for the equity house personnel.

To counteract the tension of the managers being remunerated without commensurate benefit to the investors, the investors should receive a preferred return, before any entitlement of the manager to receive a performance linked profit share (carried interest). In principle, achieving sufficient performance for investors, in order to get into carry, should be the main driver of wealth creation - and certainly before management fees.

An additional alignment mechanism is "skin in the game" – the amount of money the management team invests in the fund, on the same terms as investors. The aim is to provide additional motivation to the manager to look after the investors' money as if it were its own – because part of it is. In order to meaningfully encourage wealth creation, the amounts invested by the house team should be relatively substantial – it ought to hurt to invest and even more to lose that investment.

For first-time managers, raising a substantial GP commitment may be particularly painful, but for the senior members of more established houses, with many years of successful investment (and carry payments) behind them, this may not be the case.

1 www.ilpa.org/ilpa-principles
2 www.mjhudson.com/private-equity-fund-terms-report-2018-part-i-economics

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SECTION 1

Sponsor commitment

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Sponsor commitment

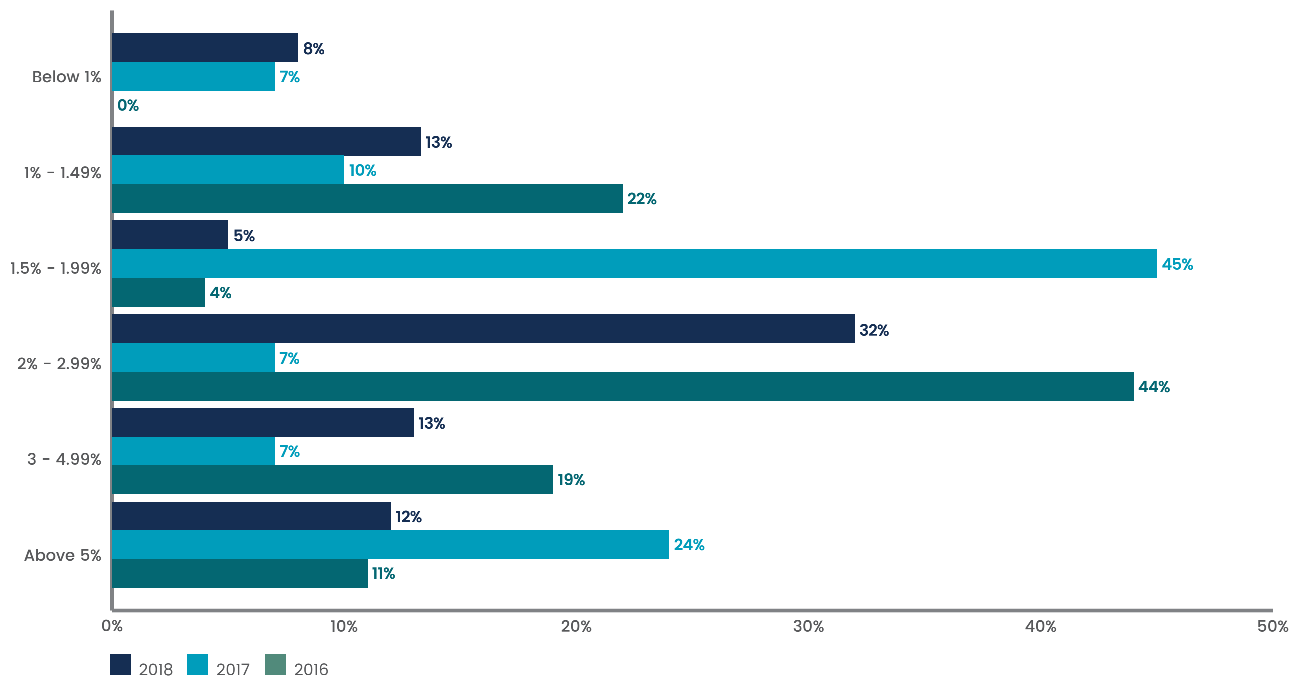
When considering the sponsor commitment (also referred to as the "team commitment" or the "GP commitment") it is the size of the investment and the party or parties paying the commitment that are most relevant. There should be direct correlation between the investment professionals contributing the commitment and their involvement in the fund. The commitment (in line with the recommendation by ILPA set out in its Private Equity Principles) should be "substantial" and paid in cash.

The most common rate of sponsor commitment for the funds we surveyed was between 2% and 2.99% of total commitments to the fund. This was true in almost one-third (31.7%) of cases.

Second in prevalence (both groups equally at 13.3% of the funds) were the commitments in the range 1% to 1.49% and 3% to 4.99%.

The least common commitment size funded by the team was between 1.5% and 1.99% (only 5% of the funds surveyed). Interestingly, in last year's survey this was the GP commitment in 45% of the funds. In 2016, this range of sponsor commitment appeared only in 4% of the funds surveyed.

FIG 1: WHAT % OF TOTAL COMMITMENTS IS GP COMMITMENT?



Looking at the entire data set from the past few years, it does not appear that variations in GP commitment are following any strong trend. Compared to the traditional 1% GP commitment, however, there is one development of note: GPs are committing more to their own funds. Whereas a small proportion of this year's cohort committed less than 1%, 2017 saw only 7% committing this amount and there were no funds in this category in 2016.

It must be remembered, of course, that there is some variation in the methodology used to calculate the percentage of GP commitment, with some managers excluding the sponsor commitment itself from the total commitments and some including it. Excluding the sponsor commitment will reduce the absolute amount committed to the fund.

SECTION 1

Sponsor commitment

Some managers, on the other hand, prefer to state the commitment as a fixed amount and others will cap the percentage of the GP commitment by reference to a fixed amount.

Investors will prefer that the sponsor commitment is paid in cash, rather than through management fee waivers. Any sponsor commitment not paid at the first closing should be subject to an equalisation premium in the same way that any investor increasing its commitment after the first closing would be.

Limited partnership agreements are often silent on these points (how the GP commitment is funded and any equalisation premium) and clarity may only be achieved through a more detailed due diligence process. Only a quarter of the LPAs of funds reviewed this year expressly stated if the team commitment would be paid in cash or not. Just fewer than two-thirds (62.5%) of LPAs that provided this information confirmed that the GP commitment would be funded in cash.

Of course, simply providing an equalisation premium for GP commitments paid post-close may not satisfy all LPs: the ability to increase the team commitment unilaterally after the final closing or only with respect to certain investments (so-called "cherry picking") will be met with a certain amount of resistance. Alignment mechanisms exist to ensure that GPs take care of third party capital in the same way that they would if it was their own, and any deviation in the terms under which the GP commitment is provided from commitments from the LPs may raise eyebrows.

SHADOW CAPITAL

" Shadow capital (including separate accounts and co-investments) is fast growing, although most GPs will not disclose how much shadow capital they manage. It may be unclear how deals are allocated between a GP's comingled funds and its separate account pools "

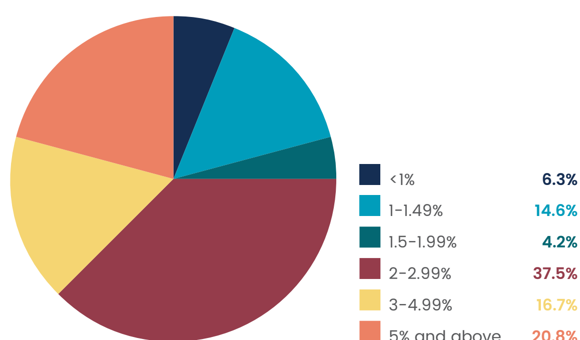
TED CRAIG, PARTNER

First-time funds versus successor funds

First-time funds were a minority cohort in our sample (under 20% of the sample and representing less than €4,500m of targeted capital). Amongst them, half had the GP commitment levels set at less than 1% of the fund's commitment (with 60% less than 1.5% of the fund's commitment). This represents a smaller team commitment than the prevailing rate expected in the industry and may be explained by the emerging managers having fewer resources, owing to a shorter history of personal wealth creation.

The remaining funds in our survey, successor funds, presented a range of sponsor commitments following the overall breakdown, with the most common size being between 2% and 2.99%. It appears that 2%+ is the new 1%+.

FIG 2: WHAT % OF TOTAL COMMITMENTS IS GP COMMITMENT? (SUCCESSORS)



SECTION 1

Sponsor commitment

GP commitment by fund type

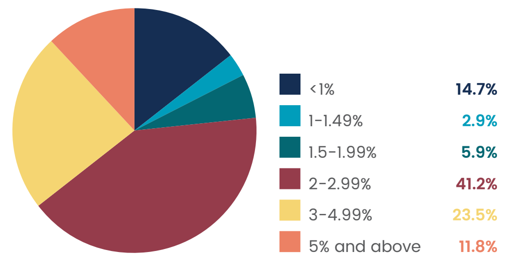
We have further analysed the team commitment in the context of the type of fund being raised to identify how, if at all, the investment strategy impacts the size of the team commitment.

Buyout funds

The slight majority (56%) of funds in the sample were buyout funds, which broadly follow the overall trend, albeit with a few notable differences.

Compared to other investment strategies, there is a far smaller percentage of GP commitments in the 1% - 1.5% range and, on the other hand, a larger share than the overall sample have GP commitments in the 2% - 2.99% and 3% - 4.99% ranges.

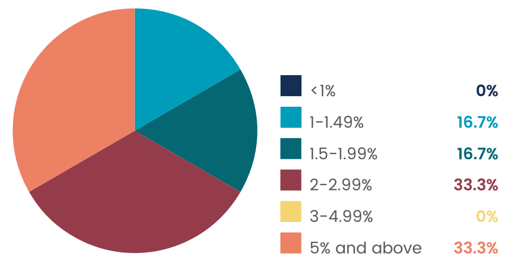
FIG 3: BUYOUT



Growth funds

The size of the GP commitments for growth capital-orientated funds is more evenly split across all categories. However, no growth fund had a sub 1% GP commitment, nor a commitment in the 3% - 4.99% range. Interestingly, one third of the growth capital funds surveyed were providing a GP commitment of 5% or higher. A word of caution: only 10% of funds surveyed fell into this category, making extrapolation somewhat problematic.

FIG 4: GROWTH



Venture funds

GP commitments for venture capital funds in our sample showed a 'barbell' factor: either being low (an equal number being sub-1% and 1-1.5%) or high, at above 5%. The higher rate may be driven by the perception amongst LPs of a riskier investment strategy profile. Conversely, the lower rate may be a recognition of the fact that founders of such strategies may not have deep pockets. Indeed, both of the funds from the venture sample that proposed a GP commitment of less than 1.5% were first-time funds.

FIG 5: VENTURE

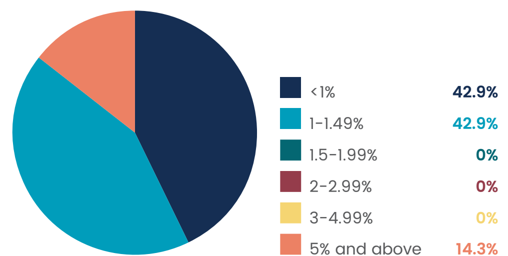
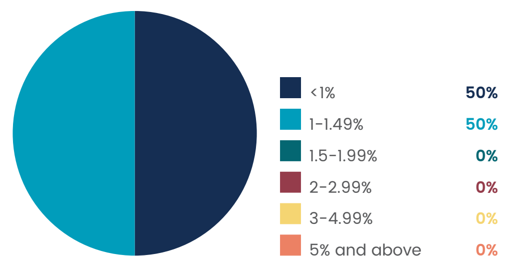


FIG 6: VENTURE (FIRST-TIME FUNDS ONLY)



SECTION 2

Additional alignment mechanisms

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Additional alignment mechanisms

Management fee offset

The intention of the management fee is not to represent a source of profits for the fund managers. Rather, it was introduced to cover the costs related to operating a fund, given that originating, executing and managing an investment portfolio incurs significant costs that would otherwise not be compensated until an exit event. For private funds, this may take years to materialise. Despite its legitimacy, on a conceptual level, there comes a point where the management fee generates income far in excess of the costs of operating the fund. Clearly, this can impact alignment between the GP and its LPs.

As a way to mitigate the quantum of management fee ultimately paid to the GP, and to ensure that additional fees beyond the management fee are restricted, it has been an industry standard for a number of years that transaction fees and others charged by the GP are used to fully offset (100%) the management fee.

92% of the funds in our cohort indeed offer a transaction fee offset and a full offset is almost ubiquitous, with only 2% of funds offering 80% fee reduction (98% of funds provide a 100% fee offset).

As with many fund terms and conditions, although the broad strokes are clear, the "devil is in the detail", and the application of the principle of a management fee offset requires close scrutiny. All fees received by the managers in relation to their activities relating to the fund should be offset. This would include transaction fees (which are on average 1% to 1.25% of the deal size but may be as high as 3%), monitoring fees, set-up fees, directors' fees, advisory fees, and break-up fees. This is not always the case.

Common exclusions from the fee offset are directors' remuneration, paid by portfolio companies to the members of the GP team serving on the boards of portfolio companies. Fees received by industry specialists or consultants advising the manager on its investments may also be excluded and this can represent an issue if there is a relationship between the consultant and the GP. Several funds have consulting teams that are relatively tightly integrated into the value creation process and ILPA recommends that those fees should be reviewed and approved by the LPAC. KKR Capstone, for example, which "is not a subsidiary or an affiliate of KKR and uses the "KKR" name under license", has been "an integral part of the overall KKR approach to value creation" [3], according to KKR's website.

As fee offsets are inevitably linked with transparency and disclosure, ILPA has produced a fee reporting template [4] and, increasingly, investors expect fees to be reported in that format.

Although not linked to the fee offset, we have also seen some fund managers charging the fund (and hence the investors) investment fees on top of the management fee. Combined with the trend of charging the fund for back-office services, such further fee granulation maximises the managers' revenue generation, with fees sometimes charged for services which some LPs might otherwise expect to be covered by the management fee itself.

In a relatively young industry, it is inevitable that there will be variations in fee structures and there may be differences of opinion with regards to which fees should be charged, how they are offset (if at all), and how these arrangements are disclosed. Any GP that wishes to focus communication with its investors on the quality of its returns will be well-served by making all details of its fees explicit, from the outset.

3 www.kkr.com/our-firm/kkr-capstone
4 www.ilpa.org/reporting-template

SECTION 2

Additional alignment mechanisms

Change of control

To ensure continuing alignment throughout the life of the fund, the GP's interest in the general partner and to the carried interest should be substantially locked-in for the fund's tenure.

74% of the funds we surveyed include a change of control provision, whereby investor consent is sought for any transfer (direct or indirect) of the ownership or control over the general partner's interests in the fund.

The threshold for the change of control varies from just more than 50% of interest upwards, and often encompasses not only the ownership of the GP and the manager/advisor (depending who effectively receives and retains the management fee and sources the deals), but also the economic rights to the receipt of carried interest.

A JOB FOR LIFE (WELL, 15 PLUS YEARS)

" The holding period for investments is getting longer and that is before the next crash. This means the life of funds is now often more than 15 years, which can harm alignment and test patience "

SHERVIN SHAMELI, PARTNER

Distributions in kind

Manager and investor interests may become misaligned in situations where there is a distribution of an investment in kind – in particular, where the securities/interests in such investments are not liquid. This may more likely occur towards the end of the life of the fund, where investors are keen to liquidate the fund and the remaining investments cannot be exited at the optimal price.

For the purpose of carried interest calculations the managers will often value the undisposed investment at "fair value", with the carried interest paid on such valuations, regardless of whether or not such value will be later obtained by the investors upon the actual sale of the assets. This may result in overvaluation of carried interest, and the recourse of the LPs to a balancing payment from the GP is not guaranteed.

Where securities are listed and then distributed in specie, there is, of course, a more objective market valuation of such an investment. However, any assets distributed in specie may subsequently also go up (or down) in value, resulting in underpaid (or overpaid) carried interest, as calculated against the moment when the investor eventually exits the asset.

SECTION 2

Additional alignment mechanisms

Successor funds

Another important mechanism to restrict fee generation is a meaningful restriction on the establishment of a successor fund and its impact on the fees due with respect to the current fund.

There is a two-fold reason for including such a restriction. Firstly, investors will feel entitled to expect exclusivity and priority allocation of deals during the investment period with no other fund cannibalising its investment deals. Secondly, investors will maintain that managers should not be diverting their attention to fund raising and creating another product with the full management fee (calculated not on performance but on the capital raised), until at least a certain level of commitments to the current fund are invested (with a corresponding step down in the full fee charge on the current fund).

In principle, full rate management fees should not be accruing with respect to multiple funds at any one time. This is usually achieved by linking the expiry of the investment period to the earliest time when the new fund may be raised, begin investment or begin to charge a management fee.

84% of the funds surveyed offer such restriction on a successor fund. The earliest trigger for the next fund's raise in the manager's stable is usually the earlier of the investment period expiry or the minimum of commitments being invested/reserved or allocated (usually around the 70-75% mark). Occasionally, it is an absolute time restriction (say, 5 or 6 years), driven by the stated length of the investment period and not affected by any earlier terminations thereof.

Although the restriction is commonly accepted, the calculation methodology of the investment threshold and the trigger for any successor fund may be relatively vague, as presented in the LPA, allowing the manager a degree of discretion. Very few managers introduce a hard benchmark of "invested" capital – more often, this is calculated as capital reserved or allocated, also including costs and expenses. As such it can be difficult to quantify accurately.

Similarly, it is not often easy to identify specifically which activities are restricted. The "commencing of marketing", "raising" or "establishing of a successor fund" are nebulous concepts, as the variety of interpretations of these terms offered by local regulators in Europe demonstrates. "Charging the management fee" as the trigger for the restriction is, on the face of it, a clearer concept, but still allows a proportion of fund raising activities (arguably, the bulk of it) to be not excluded from any provision relating to restrictions on successor funds. It may serve the useful purpose of avoiding a doubled management fee being charged by the same management house, but it does little to prevent the team's attention being diverted from investing the current fund. The establishment of a dedicated investor relations function at a private equity house mitigates this issue to a degree, but investors will always require access to senior investment staff when evaluating a fund investment.

CONFLICT CENTRAL

" As GPs grow their franchise by launching new strategies (credit, growth, impact etc.), the investing world is becoming more complex and managers are putting themselves into conflicted situations. Sadly, conflicts are still often dealt with by a manager marking its own homework "

EAMON DEVLIN, MANAGING PARTNER

SECTION 3

Concluding remarks

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Alignment is an important issue for all investors into third party funds and this is particularly the case in asset classes such as private equity, where liquidity before the end of the life of a fund is not guaranteed. And whilst investment performance will always set the context for an investor's satisfaction with a fund manager, if alignment is poor, the outcomes for LPs can be materially worse than they are for the manager.

From our research and from our wider market experience, we know that alignment between LPs and GPs has improved and the overarching trend is for this to continue:

1 Clearly, GPs should maintain a substantial equity interest in the fund, to help align its financial outcome with that of its LPs. Market data shows that 99% of funds formed in today's market have some "skin in the game" and that this is more likely to be more than 3% than less than 1%.

2 For a majority of active private equity funds, management fee levels are set at a sensible and fair level. That means such management fee covers the fund's operational expenses but does not serve as a manager's main source of long-term economic incentive. Carried interest, the GP's share of the profits of the investments, remains the driving incentive for GPs to outperform over the long term and carried interest of 20% remains an industry standard (it has been for more than 30 years). Some GPs even permit LPs to pay a lower management fee in exchange for sacrificing a greater share of their profits.

3 ESG (environmental, social and governance factors) policies are becoming better informed and better implemented and will bring GPs closer to their LPs, especially passive investors, like pension funds. ESG represents a non-financial motivation for better alignment.

CHASING WATERFALLS

" Removal of a hurdle and the continued use of deal-by-deal carry calculations both harm alignment. Best practice is to repay investors in full, plus an additional return (usually around 8%) before performance fees are paid out to the GP. "

EDYTA BROZYNIAK, PARTNER

In short, LPs and GPs are arguably much more closely aligned than they were twenty years ago. Organisations such as the Institutional Limited Partners Association (ILPA) have been at the forefront of the drive towards transparency and a level playing field and regulators have shown that they have an appetite to punish wrongdoing severely. But managers, unilaterally, have also played their part. GPs with a long-term view will appreciate that causing damage to the lucrative and long-term relationships they have built with their investors is a high price to pay for any short-term gain.

SECTION 3

Concluding remarks

Nevertheless, there remain areas of detail that can serve to drive a wedge between the outcomes for investors and the motivations for fund managers.

1 GPs now have more "skin in the game" but, often, the GP commitment in larger funds is funded by a management fee offset, which severely reduces the actual and real impact of a team investing in its own fund – or it is borrowed from a bank. Either way, LPs need to ask the question: whose skin is it?

2 The management fee rate for larger funds are falling, but not as quickly as fund sizes have risen and these fees are still typically calculated on committed capital. The quantum of management fee has increased to the point where it can be a substantial profit centre. Even for mid-size firms, cumulative management fees can creep into the tens of millions over a fund's life.

3 Although there are forces pulling LPs and GPs closer together, some activity is creating inequality in the LP base itself, making true alignment impossible. Through the demise and erosion of most favoured nations clauses, LPs may no longer have visibility on the terms agreed by other LPs with the GP in secret side letters.

CO-INVESTMENT RIGHTS AND WRONGS

" Co-investments are potentially valuable investments but how co-investments are allocated to LPs is not at all clear. This does creates misalignment "

EDYTA BROZYNIAK, PARTNER

Of course, whilst investing in private equity funds is, by nature, an illiquid activity, LPs do have options if they find themselves misaligned. Selling on the secondary market may be a possibility, but walk away rights are needed to keep any relationship in check and the GP / LP relationship is no different.

Most limited partnership agreements now stipulate that a GP must notify the LP when a key-person event or for-cause event occurs, resulting in an automatic suspension of the commitment period, followed by a vote on whether to remove the suspension or terminate the commitment period.

Ideally, the majority in interest of the LPs will have the ability to elect to bring about an early termination or suspension of the investment period, with a supermajority required to vote for the dissolution of the fund or removal of the GP, without cause.

That's all well and good, but LPs are often unwilling to remove GPs that behave badly. That means bad or poor behaviour will sometimes go unchecked.

POWER TO THE LPAC

" Limited Partner Advisory Committees (LPACs) are now common and often improve the effectiveness of a fund. The LPAC should be given approval rights in respect of transactions posing conflicts of interest, but this is not market standard as of today "

SHERVIN SHAMELI, PARTNER

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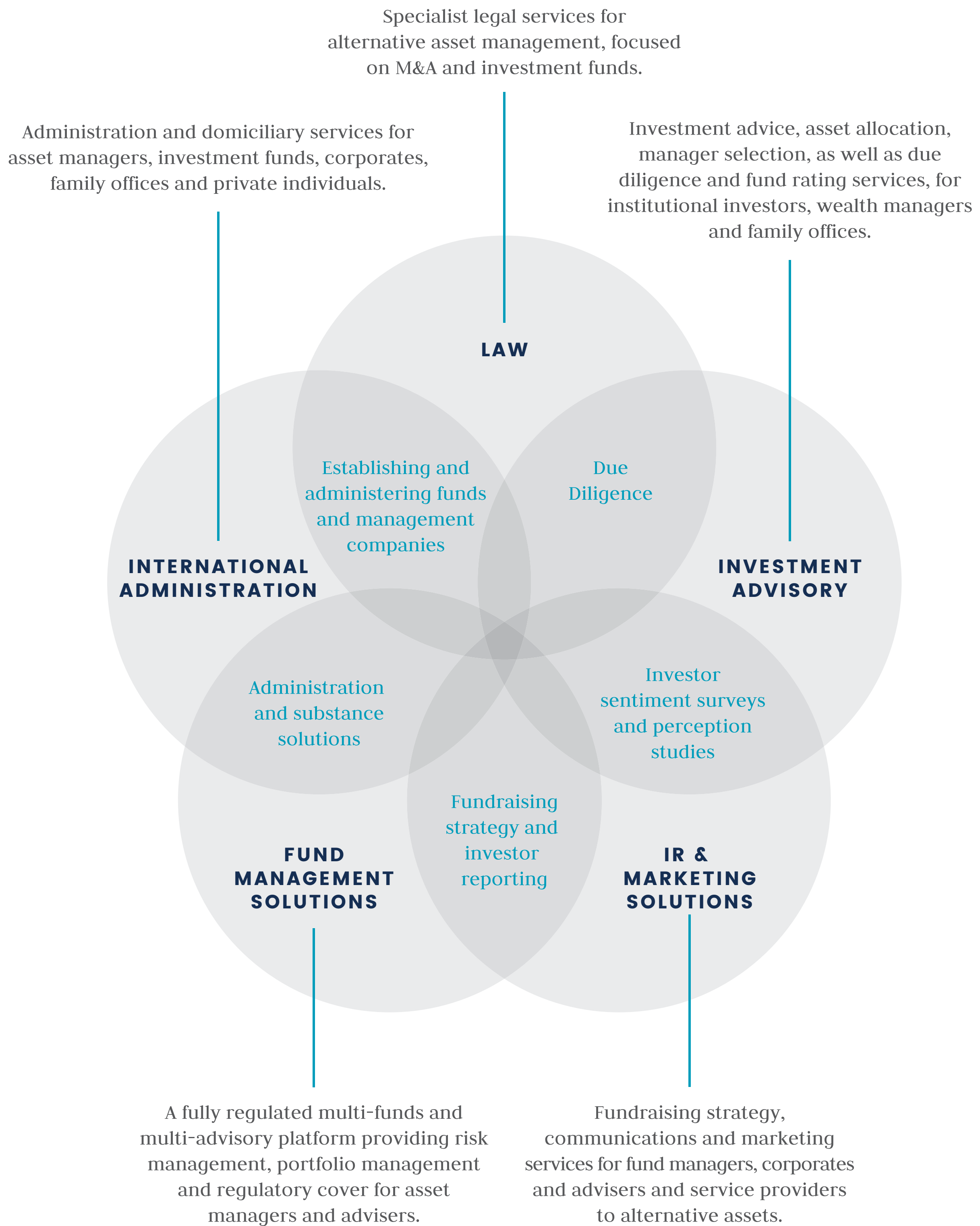

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Our LP Unit, via a team of highly experienced lawyers, focuses on LPs' interests in relation to co-investments, primaries and secondaries.

Few law firms offer a one-stop solution for LPs' needs across the primary, co-investment and secondary sectors, with a sufficient depth of legal and market experience to devote across all such sectors.

MJ Hudson is different. Our LP Unit works to enhance GP / LP alignment on every primary and co-investment opportunity reviewed and negotiated, as well as acting for buyers and sellers on direct and indirect secondary transactions and for investors on fund restructurings.

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