

Private equity fees and terms

September 2009

Introduction

Negotiating terms has previously been challenging due to limited capacity in high quality general partners (GPs) and the restricted ability of limited partners (LPs) to pool their bargaining power. The former has clearly contributed significantly to the latter.

This paper:

- Highlights how Watson Wyatt thinks about fees across asset classes and explains how we are applying this thinking to private equity.
- Discusses currently accepted fees and terms in order to encourage debate in the LP community, with the ultimate purpose of eliminating some of the more egregious terms seen in private equity.
- Discusses additional features of terms that are not yet common in the private equity community but would represent significant progress in improving alignment for LPs.

In this paper we emphasise that management fees form too high a share of a GP's compensation and are therefore the most significant factor misaligning the interests of a GP relative to those of its LPs. This misalignment is exacerbated by the manner in which performance fees are most commonly calculated in the US. We believe that the following changes would represent significant steps in redressing this imbalance:

- The basis upon which a manager sets its management fees must be reconsidered. For example, there is a strong case to budget for management fees on the basis of the number of investment staff and other fixed costs.
- GPs should consider phasing in management fees over the investment period to reduce the significant fee drag from paying on commitments early in the life of a fund.
- GPs should not generate additional fees from working with portfolio companies. Where they do this, fees should accrue to the fund.
- All GPs should employ a European waterfall — that is, the LP receives all its capital and its preferred return before the GP receives carry.

We also explore additional changes that are likely to be simple to implement, such as a significant step-down in management fees after the investment period, as well as other changes that represent a more significant step-change from the status quo, such as the introduction of a hurdle rate (rather than a preferred return).

What proportion of the alpha generated represents fair compensation to an investment manager?

We recognise that private equity attracts much of the highest quality talent in the investment world and that these strategies require a high level of skill to generate out-performance. As such, we accept that investment professionals in this asset class need to be compensated appropriately. In aggregate, this should entail a higher level of fees than in traditional asset classes and a different fee structure, for example, a performance fee to better align the investor and the manager.

However, we strongly believe that accepted fee conventions in alternative asset classes need to be more effectively compared to traditional asset classes, to better assess whether, on a forward-looking basis, these alternatives truly represent an attractive net of fees proposition. In many instances, current structures do not effectively align the investor and the manager. More specifically, management fees per professional are often so high that investment professionals can become very wealthy before consideration of performance fees.

We have had significant traction in negotiating our clients' fees in the hedge fund space by asking a simple question: **What proportion of the alpha generated represents fair compensation to an investment manager?**

This question is effective in challenging the concept of absolute returns, encouraging debate on what out-performance ('alpha') the manager has previously generated and what we expect the manager to generate on a forward-looking basis. It also encourages fee discussions with an investment manager in a manner that directly relates fees to skill.

Applying the concept to private equity

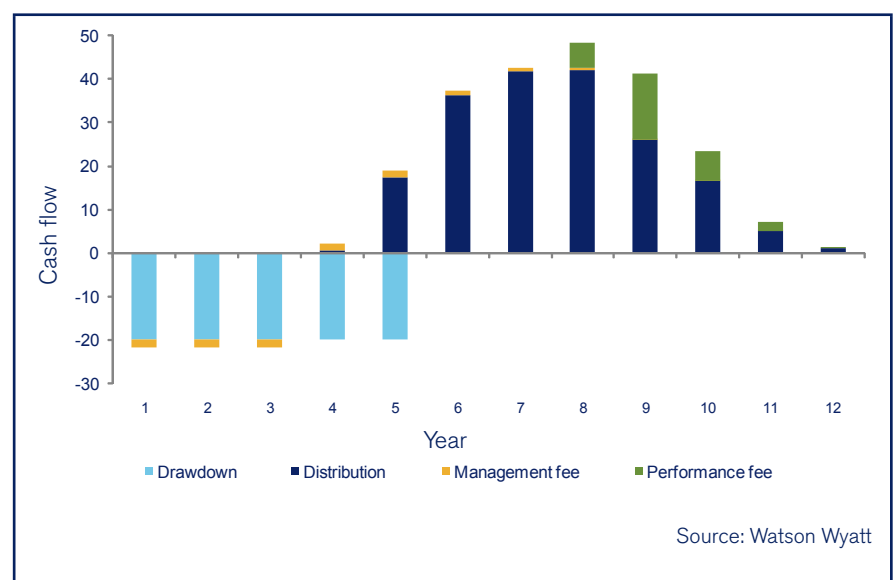
Applying this concept to private equity is relatively simple for the majority of buyout managers as it is essentially a long-only equity investment with additional leverage applied. The challenge is in

estimating the likely cash flow profile of the fund and accounting for different fee conventions. We accept this analysis is even more challenging in venture capital and other specialist strategies such as 'distressed for control'.

As such, we run this analysis below under the following assumptions:

- We use a simplified set of terms in private equity:
 - 1.75 per cent management fee based on commitment size for an investment period of five years, reducing to 1.5 per cent of the cost of remaining investments after the investment period.
 - 20 per cent carry over a preferred return of 8 per cent and GP 'catch-up' of 100 per cent.
 - European waterfall — that is, the LP receives all its capital and its preferred return before the GP receives carry.

Figure 1 | Cash flow distributions



- We assume capital is drawn down evenly over five years and that the average holding period for an investment is four years (with some volatility applied to this to adjust the total fund life to approximately 12 years).
- A benchmark of 8 per cent (an approximate long-term expectation of public equity returns) adjusted for average leverage 50 per cent higher than that commonly found in publicly listed securities and a cost of debt capital of 5 per cent.
- No transaction fees or monitoring fees are paid to the GP. In practice, both of these are relatively common terms and serve to increase the proportion of alpha paid to the manager as these fees are paid by companies owned by the LPs.
- The GP consistently generates 10 per cent of alpha over the benchmark returns on a gross basis — that is, before the manager's fees are paid. This results in a gross internal rate of return (IRR) of approximately 20 per cent, greater than we would expect from the **average** private equity manager. This assumption also ignores optionality in the performance fee; that is, a private equity manager cannot earn negative performance fees.

The resulting cash flow profile is shown in Figure 1 opposite and the split of alpha is shown in Figure 2.

Figure 2 shows that approximately 60 per cent of the alpha generated is paid to the GP, far too high a proportion for the disproportionate

amount of risk being taken by the LP. **Relating this to performance, a gross IRR of approximately 20 per cent is reduced to a net IRR of 13.7 per cent.**

It is important to emphasise that, in this example, many of the more egregious terms in private equity have not been included, and as such, the proportion of alpha paid to the GP is often greater than that outlined above. We therefore look to challenge some of these conventions in the next section with the purpose of better aligning GP and LPs' interests.

Management fees and related terms

We believe that management fees should give GPs the ability to pay competitive salaries without diminishing the team's desire to generate strong performance. Attempting to set a standard percentage management fee is challenging given it is not obvious that you are paying for the same service from all private equity firms.

As such, we do not believe there is a single answer as to the level of management fees that are appropriate across the asset class. The appropriate level of management fees should be a function of the overall costs of the firm — that is, budgeted in some way. This should include:

- What is the volume of the firm's assets under management on which they charge fees?
- How much is the GP being paid per investment professional across all of its existing funds?
- What are reasonable expenses for professionals outside of the investment team that are necessary for the manager to perform its strategy?
- What other reasonable fixed costs does the GP incur, for example, the number of offices to achieve the necessary geographical reach of its strategy?
- What other fees does the manager generate?

Figure 2 | The split of alpha — base case assumptions

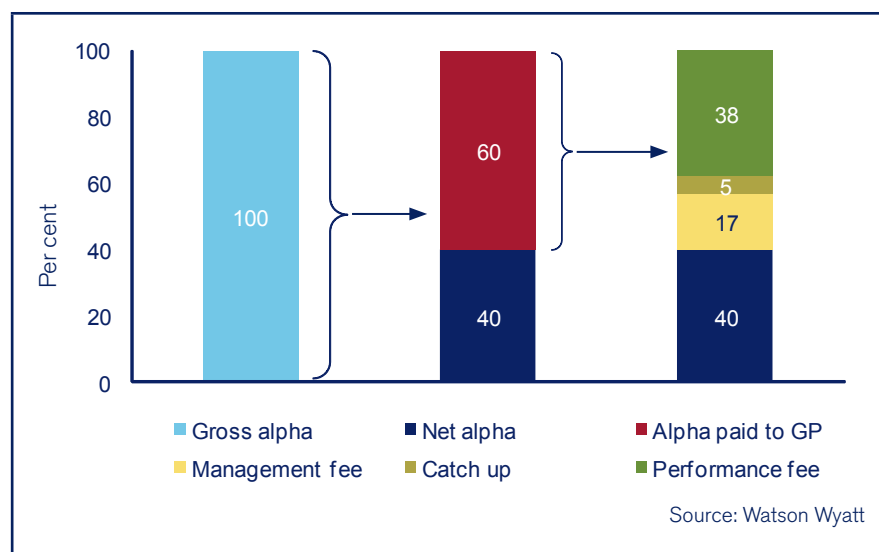


Figure 3 is an example of how a selected group of GPs differs in terms of annual management fees per investment professional on all existing funds, excluding non-management fee sources of GP income.

In this example there is considerable disparity across managers. We therefore need full transparency in terms of total fees earned to understand a manager's economics more clearly. For example, Manager 1 charges no transaction fees whereas this is a significant

component of remuneration for Manager 3. Ideally these other sources of income would be removed. If not, fee revenues need to be considered as holistically as possible.

It is important to consider carefully the terms that dictate the management fee calculation as this can make a significant difference to the expected fee level or can weaken alignment of interests. Below are the key terms we believe should become standard moving forward:

- **For the purpose of calculating management fees, the investment period (also termed the commitment period) must end once the GP raises a successor fund and it holds a first closing.** This has become increasingly important as we have seen investment periods being extended to six years for some funds that have recently come to market.

- **Once the investment period has ended, management fees must be reduced significantly and be rebased to the cost of remaining capital employed.**

This is particularly important as basing the fee calculation on drawdowns less the cost of realisations essentially means paying fees on fees. We also believe a fair reduction in the percentage basis to be approximately 50 per cent. The cost of remaining capital employed should then be recalculated with the same frequency as that with which management fees are paid.

- **All other fees related to the GP's interaction with portfolio companies on behalf of the fund must accrue to the fund.**

This includes transaction fees, monitoring fees, any compensation from investment banking related activity and compensation linked to GP professionals assisting a portfolio company, for example, a board seat. This emphasises the need for transparency as to how the GP is being compensated.

Figure 4 reruns the previous analysis assuming the GP raises a successor fund after three years, not uncommon prior to the credit crunch, and that the percentage basis for

Figure 3 | Example of management fee revenues to staff ratios per annum

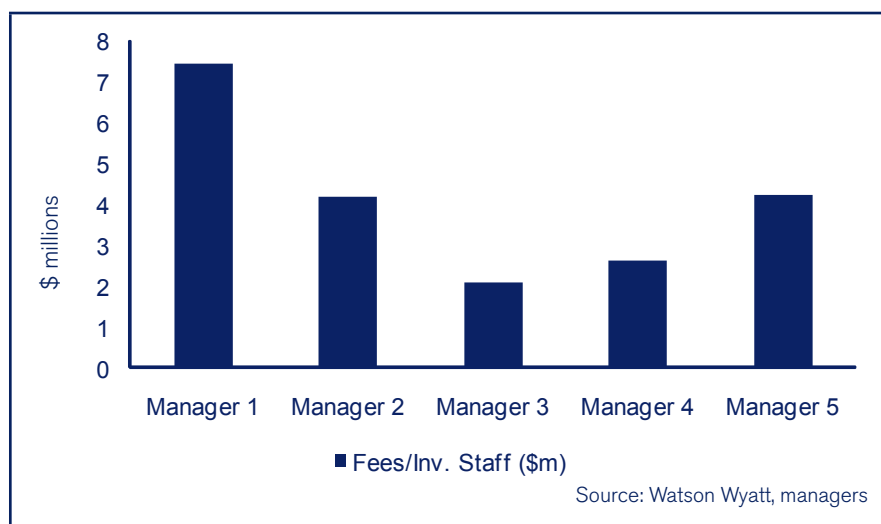
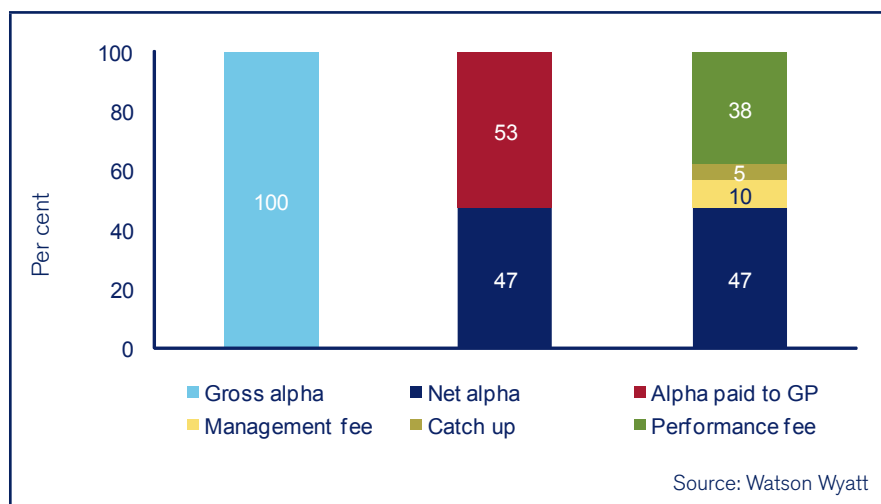


Figure 4 | Successor fund raised after three years triggering reduction in management fee



calculating management fees is halved from 1.75 per cent to 0.875 per cent once the investment period has ended. Again it is important to note that all other fees are excluded.

These terms would reduce the proportion of alpha paid to the GP to approximately 53 per cent. **From the original gross IRR of 20 per cent, the net IRR is increased from 13.7 per cent under our original assumptions to 14.5 per cent in this scenario.**

A more fundamental shift that the LP community should consider is management fees being phased in throughout the investment period. Phasing in of management fees minimises the impact of fees being charged on commitments and ensures fees broadly increase as the invested assets increase.

In **Figure 5** we continue the example above but assume that fees are phased in over three years at 0.875 per cent on committed capital in year 1, 1.3125 per cent in year 2 and 1.75 per cent in year 3. As can be seen, this significantly reduces the proportion of alpha that is paid to the GP to approximately 49 per cent, a broadly equal share of the alpha generated. **Relating this to performance, the net IRR is increased to 15 per cent from 13.7 per cent under our original assumptions.**

We should note that, as the gross alpha assumption is increased, the proportion of alpha paid to the GP falls. The converse is true in periods of poor alpha generation. Under the final scenario, gross returns of approximately 27.5 per cent are required for the split of alpha to fall to a 67:33 split in favour of the LP

(arguably an equitable split between manager and investor). Under our original assumptions the gross returns required to achieve this split would be 32.5 per cent.

One additional consideration is to assess what proportion of the GP's commitment is being paid via a management fee waiver.

Whilst we accept this currently offers tax advantages over committing cash, we do not believe that the GP commitment being largely funded in this way provides the same level of alignment of interests. It increases the GP's need to generate additional sources of income, such as monitoring and transaction fees, which are not in the LPs' interests.

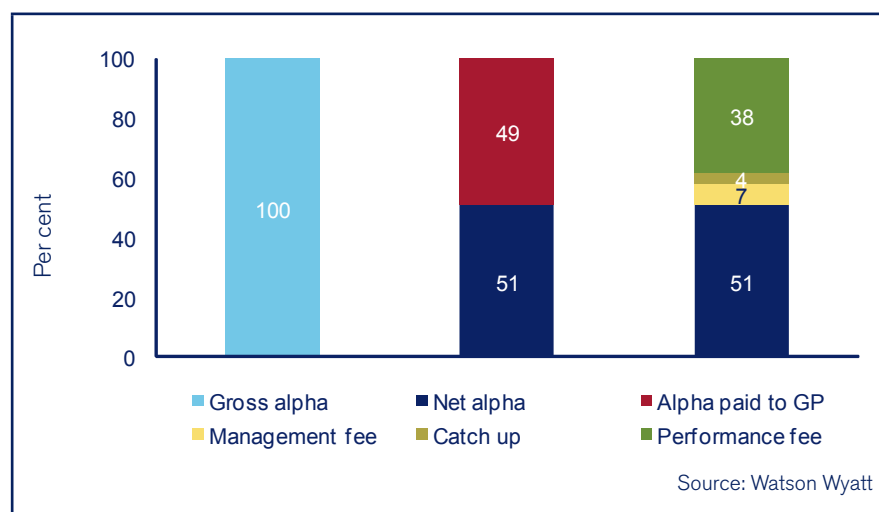
Carry and related terms

Carry is an important element in aligning the interests of the GP with its LPs. However, it becomes considerably less powerful where management fees comprise a large part of the GP's compensation. With this covered above, we believe that the manner in which carry is currently structured must be adjusted to better serve LPs who bear a disproportionate amount of

the risk. The terms we consider to be most important are:

- **GPs must employ a European waterfall — that is, the LP receives all its capital and its preferred return before the GP receives carry.** This is already largely in place with European GPs and significantly reduces the LP's risk. In contrast, a US waterfall entails carry being paid deal by deal, with the performance of all prior realised and written-off deals included in each successive calculation of carry. The US waterfall calculation leads to problems with the clawback provision. Note that the analysis in this paper is conducted based on a European waterfall.
- According to a paper in The Institutional Real Estate Letter¹, moving from a US waterfall to a European waterfall has the same effect on net IRRs as shifting from a 20 per cent carry to a 17 per cent carry. Additionally, this represents a significant opportunity cost to the LP as capital used to pay carry early in the fund could have been re-invested elsewhere.

Figure 5 | The split of alpha — management fees are phased in



- **Should a GP not consider adopting the European waterfall, carry must be paid into an escrow account with carry recalculated and paid on a pre-determined frequency.**

We believe LPs should be 'made good' on overpaid carry at regular intervals as opposed to when a fund terminates in order to minimise the issues outlined above.

- **Management fees must be included in the definition of capital contribution in the preferred return calculation.**

Next we highlight two further considerations for LPs, recognising these represent somewhat more fundamental shifts in terms and conditions within the private equity community. We note that these changes would both improve alignment of interests and result in a fairer distribution of proceeds relative to the respective risks taken by GPs and LPs.

- **A preferred return is a very poor substitute for a hurdle, in that it is equivalent to a 0 per cent hurdle if the preferred return and GP catch-up is exceeded.** It provides the GP with an incentive to hold onto otherwise poor investments in the hope public markets will provide some tailwind to achieving the preferred return. This means LPs are often paying for market beta, an issue that could be avoided with either an equity-linked or 'hard' hurdle — that is, no GP catch-up.
- **An alternative (or potential complement) to a hurdle is to introduce ratcheted carry that is based on multiples as opposed to, or as well as,**

IRRs. For example, once the GP achieves its preferred return (or hurdle) it is paid a 10 per cent carry, with this increasing to 20 per cent once a multiple of 2x is achieved and extending to a 25 per cent carry on a multiple exceeding 3x. This ensures the manager is well compensated for significant out-performance, is not overly rewarded for average performance and is not incentivised by an IRR hurdle to exit without meaningful cash on cash returns.

However, as with all of the potential changes to fee structures, LPs need to be watchful for unintended consequences. For example, in the case of ratcheted carry, there could be a danger of creating an incentive to focus on high beta industries and/or to take excessive amounts of risk with LPs' capital.

Other potential areas of concern

There are a number of other areas where we believe the LP community could work more closely together to better align interests. Below is a (non-exhaustive) list of examples of terms that we regularly spend time considering closely:

- Key person provisions, not just which professionals are included, but also voting mechanisms surrounding replacements.
- No fault termination clauses.
- Re-investment provisions.
- Ability to raise successor/similar funds.
- Allocation policies where a manager has more than one family of private equity funds, or funds focusing on multiple asset classes.

- The powers of the LP advisory board and its composition.
- Investment restrictions.

Conclusion

The exponential growth in private equity that occurred between 2004 and 2008 has led to a significant misalignment issue in the industry. This paper provides a summary of the key changes to private equity fee structures that we believe should be considered by the LP community to address this situation. In recognition of the misalignment in the level of risk being taken by the LPs in comparison to the GP, these changes should serve to better align the LP in terms of the proportion of alpha that is being paid to the GP and to ensure the manager is appropriately aligned to generate exceptional performance for its LPs.

Watson Wyatt Investment Consulting

No action should be taken on the basis of any article without seeking specific advice. If you would like to discuss any of the areas covered in more detail, please contact your usual Watson Wyatt consultant, or

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¹ 'Nothing But Net – Maximising the impact of private equity real estate fund negotiations', by Martin Rosenberg, The Institutional Real Estate Letter, October 2008, www.irei.com

Glossary of terms

Alpha	Performance achieved in excess of a benchmark.
Clawback provision	The mechanism by which overpaid carry is returned to LPs.
Escrow account	An account in which a GP's carry is held prior to carry being recalculated and paid out on a pre-agreed date.
European waterfall	The GP is not paid carry until LPs receive distributions equal to their total contributed capital and a preferred return. Also known as back-ended carry.
General Partner (GP)	The private equity manager.
GP catch-up	After the preferred return is exceeded, this mechanism sees the GP generally receive all distributions until profits are split 80:20 between the LP and GP.
Hurdle rate	The minimum return that must be achieved before the GP is paid a performance fee. The hurdle rate usually means no 'GP catch-up'.
Limited Partner (LP)	Investors in the GP's private equity fund, for example pension funds.
Management fee waiver	The GP waives management fees to cover its commitment to the fund, as opposed to providing a cash commitment.
Management fee offset	The extent to which transaction, monitoring and other portfolio company related expenses paid to the GP are offset against management fees.
Management fee	Fixed percentage paid by the LP to the GP to make an investment into a private equity vehicle, for example 2 per cent per annum based on commitments.
Monitoring fee	A fee paid to the GP by the portfolio company for monitoring work.
Performance fee or 'carry'	Variable fee paid by the LP to the GP for positive performance, for example 20 per cent of profits.
Preferred return	The minimum return that must be achieved before the GP is paid a performance fee, for example an 8 per cent IRR. The preferred return generally involves a 'GP catch-up'.
Step-down	The point at which the management fee calculation adjusts after the investment (or commitment) period ends.
Transaction fee	A fee paid by the portfolio company to the GP upon its acquisition.
US waterfall	The GP's carry is calculated and paid out on a deal by deal basis as each transaction is realised. The split of carry between the GP and LPs is rebalanced either at each subsequent transaction and/or at the end of the fund's life.

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