The Economics of Private Equity Investing : *Understanding Fees*

Many buy-side investors choose to invest in private equity, lured by the potential for high returns. Fewer investors do so *successfully,* because private equity is among the most complex of asset classes, and the most challenging to "get right".

One reason "getting it right" is so hard is that private equity funds are governed by opaque terms and provisions, set forth in long, complex legal documents. These provisions cover, among other things, the distribution of risks and rewards between the general partners (or "GPs", who manage the funds) and the limited partners (or "LPs", who provide most of the investment capital).

Investors may believe that their interests as limited partners are aligned with the interests of the general partners. In fact, although the GPs will usually provide some invested capital, the GP's return on its invested capital may be significantly overshadowed by the compensation the GP receives in the form of management and performance fees. The GP or its affiliates may also profit from other fees and from engaging in transactions with the fund.

For these reasons, it is important for investors to focus on the details of compensation for the GP and potential conflicts of interest between the GP and the LPs. A seemingly attractive investment can still have an unsatisfactory outcome to the investor if too much of the investment return "leaks away" in the form of fees and expenses.

This white paper describes five different types of fees incurred in private equity funds, as well as the nuances of deal terms, and the effect of various deal terms in determining who gets how much reward and who takes how much risk. Each section includes a summary of what investors should look for, and what they should look *out* for.

The paper is divided into five sections:

I. ***Management Fees*** (or "Base Fees"): Calculation Rate and Calculation Base.

II. ***Incentive Fees*** (or "Carried Interest"): Hurdle Rates and True Preferred Returns.

III. ***Ancillary fees***: Deal fees, monitoring fees, board fees, etc. Fee offsets.

IV. Other sources of ***return leakage***: Placement fees. Related-party transactions.

V. ***Summary and take-aways***

I. Management Fees

Management Fees are fees intended to compensate a money manager for the work of investing—that is, for coming to the office every day and choosing investments, whether or not the investments prove to be profitable. Almost all money managers—including those of mutual funds and plain-vanilla separate accounts—charge management fees. Management fees are usually expressed as the product of calculation rate and a calculation base—that is, as a certain percentage of…*something*.

Management fees for most kinds of investments are straightforward. If an investor chooses to invest in a mutual fund, say, the procedure is that the investor sends in the desired amount of investment to the mutual fund, and is thereafter charged expenses (such as trading costs incurred for buying and selling securities) plus an annual management fee that is a stated percentage of the market value of the investment. An investor in—for example—the Tweedy Browne Global Value fund will pay an annual management fee of 1.25% of the value of his or her account. Inclusion of the fund's expenses raises the expense ratio, or the total cost to the investor, to 1.40% per year[1].

The *Calculation Rate* in this case is 1.25%, and the *Calculation Base* is the account value. There may be minor nuances, such as when the fee is collected (quarterly? monthly?), but overall the calculation is straightforward and easy to understand.

[1]This information is publicly available on Morningstar.com, as well as on the fund firm's own website, tweedy.com. Similar public information is available for essentially all publicly-traded mutual funds.

For private equity investors, the *Calculation Rate* is also usually straightforward—It is a percentage that will be clearly stated in the GP's marketing materials and the fund's offering documents (private placement memorandum ["PPM"] and limited partnership agreement ["LPA"], usually).

It is with the Calculation *Base* that things get complicated for private equity investors. This complexity arises because of two features that distinguish private equity funds from more traditional investment structures: (1) The deferred receipt of funds by the manager (the GP), and (2) the use of leverage (borrowed money) to provide financing for investing, thereby increasing the total amount of capital controlled by the GP.

When an investor decides to invest in a private equity fund, she doesn't actually send in the money…yet. Instead, she signs a legal commitment to send funds *as and when the GP asks* for funds. "Asking for funds" in the private equity world is technically called "issuing a capital call". Failure to meet one's commitment to fund capital calls has onerous consequences for the LP[2].

Capital calls are issued by the GP, as and when the GP finds companies or other portfolio assets to buy. In some cases, this can take years. When the GP does find attractive deals, funds called from the LPs may be amplified with borrowed money, or leverage. The money that has been called typically remains invested, and therefore inaccessible to the LPs, for several years or more[3].

There are at least three different amounts that may serve as the calculation base in setting the amount of the management fee: (1) The amount of capital ***committed*** by limited partners; (2) the amount of capital ***called*** thus far from limited partners, usually reduced, in later years of a private equity fund, by the amount of capital that has been returned; or (3) the total amount of capital ***invested*** in deal assets, including borrowed money.

The question of which of these amounts is chosen as the calculation base can change the management fee meaningfully. To see why, consider the following hypothetical, but representative, set of circumstances.

1. An investor has committed $10 million to a private equity fund.
2. To date, $7.5 million of that commitment has been called for investment by the GP.
3. The GP has supplemented LP capital with borrowed money, so that each $1 of called LP capital is supporting a total of $6 in investments. That is, the fund is leveraged 5:1[4]

Now consider the following management fee calculation rates, which are typical of the rates seen in private equity funds:

A. 2% of committed capital;
B. 2% of called capital, or
C. 0.5% (half of one percent) of total asset value, including leverage.

Which produces the highest fee (that is, the worst outcome from the standpoint of the LPs)?

It should be clear that A. will be greater than B., because called capital is always less than or equal to committed capital[5] . Here, 2% of committed capital is $200,000, while 2% of called capital is $150,000.

What may be surprising to most investors is that C. actually produces the highest of the three fees, at $225,000 (which is $7.5 million X 6 x 0.005). The higher calculation base more than offsets the lower calculation rate. The fee may be at a low "headline rate" of 0.5%, but, due to the use of leverage, it becomes 3.0% of the capital actually invested by LPs—quite a high rate.

So, how should prospective private equity investors think about all of this? And what should they watch out for?

[2]The limited partnership agreement for most private equity funds provides that a defaulting LP [that is, one who doesn't fund capital calls upon request] forfeits the entire amount of his or her investment in the fund up to that point. There are also often provisions for civil suits against the defaulting LP, though such civil suits are rarely brought.

[3]Private equity funds often have terms of eight years or more. During this time, investors will typically be able to access their capital only as and when portfolio companies are sold off and the GP distributes the proceeds. There are limited secondary markets for some private equity funds, but secondary market transactions usually require steep discounts to net asset value.

[4]This is *not* an unusual amount of leverage. When leverage is easily available and GPs are bullish, leverage of 10:1 or more is not unheard of.

[5]LPs have an obligation to fund capital calls up to the amount of their commitments, but no higher.

Investors should remember an iron law of human behavior: *When you reward something, you get more of it.* And any behavior, taken too far, can become risky.

So what behaviors do the different calculation bases reward? And what risks does that entail? In sum:

A. Fees based on ***committed*** capital reward GPs for receiving the highest amounts of commitments from investors. The risk is that the committed capital will be too large to be deployed at an attractive profit for the LPs.

B. Fees based on capital ***called and invested*** reward GPs for investing capital as fast as possible, so as to raise the calculation base. The risk is that marginal deals will be done simply to get capital invested in *something*, so that fees can be charged.

C. Fees based on the ***total cost of assets acquired*** reward GPs for maximizing the price paid for assets and for maximizing the use of leverage. The risk—as anyone who has lived through the recent real estate debacle will know—is that overpaying for assets and over-leveraging deals frequently results in losing money.

So what's an investor to do? Probably the most attractive combination, for the LPs, is a management fee based on invested capital—but only where the GP is putting very significant amounts of its own capital at risk, and therefore will do only economically sensible deals. In contrast, the least attractive fee structure, for the LPs, will typically be the one based on total acquisition cost of assets, despite the low "headline" percentage rate.

II. Incentive Fees

If management fees are intended as compensation to GPs simply for the work of investing, incentive fees are intended to compensate GPs for investing profitably. Incentive fees are a percent of the profits generated by private equity deals, paid to the GPs. Twenty percent of the profits is the most typical rate.

But there are—of course!—nuances. Here are the main ones:

1. Is the 20% calculated from the first dollar of profits, or must some preferred return be paid to LPs before GPs earn their incentive?
2. If there is a preferred return, is it a "true preferred" return or a hurdle rate?
3. Is there a "clawback"?

Taking these in turn:

The drawback, to the LPs, of paying incentive fees from the first dollar of returns should be clear: Investors could earn positive returns by investing in much lower-risk instruments than private equity funds (t-bills, for example). For that reason, LPs typically balk at paying incentive fees on the total positive return. Usually, they demand a specified return for themselves before GPs are allowed an incentive.

That "specified return" is usually called a hurdle rate or preferred return. Hurdle rates ranging from 6% to 8% annually are typical.

The terms "hurdle rate" and "preferred return" are often used interchangeably, but they are not. A "true preferred" return is a much better deal for LPs than a hurdle rate at the same level. This is because, in a hurdle rate structure, after the hurdle rate has been achieved for the LPs, the GP receives a disproportionate amount (often 100%) of the next returns, until the GP has "caught up" to an incentive of 20% (or whatever the specified incentive rate is) of the total return achieved.

A "true preferred" return includes no such catch-up. After the true preferred return is achieved for LPs, the split of additional profits is 80% to the LPs and 20% to the GP[6] (again assuming that 20% is the fund's incentive rate).

An example will help make this clear. Given (a) a gross return of 20%[7] and (b) an incentive fee of 20%, below is a calculation of the difference in outcomes for LPs of a hurdle rate structure versus a true preferred return, with both set at 8%.

	Hurdle Rate Structure, 100% Catch-Up		True Preferred Structure	
	LPs	GP	LPs	GP
First 8% of Return	8.0%		8.0%	
Next 2% of Return		2.0%	1.6%	0.4%
Remaining 10%	8.0%	2.0%	8.0%	2.0%
Totals	**16.0%**	**4.0%**	**17.6%**	**2.4%**

It should be apparent from this example why a true preferred return is a more investor-friendly deal structure than a hurdle rate.

As a last point with respect to incentive fees, investors should insist on the inclusion of a "clawback" provision. A clawback is a deal provision that requires the GP to return to LPs any amount of incentive fee previously paid that exceeds the amount the GP is contractually due. This can occur, for example, when a GP is paid incentive compensation on early, profitable deals, and then later deals prove unprofitable, such that the total incentive due is reduced.

III. Ancillary Fees

Private equity funds frequently include provisions that enable GPs to charge ancillary fees for services provided to portfolio companies. These fees are often charged to the portfolio companies, rather than directly to the LPs, but they have a similar effect in reducing the portfolio value allocable to the LPs. They may include fees for arranging acquisitions and divestitures of assets; fees for monitoring portfolio companies and attending board meetings; fees for arranging financing; and more. The scope and amounts of such fees are often very broadly defined.

But wait a minute, the savvy LP may respond: *Doesn't the GP already get paid by the LPs, in the form of the management fee, for managing the portfolio? And isn't monitoring the portfolio companies and attending their board meetings, if you're a board member, the essence of managing the portfolio? And doesn't the GP usually control the portfolio companies, so that it can, in effect, cause them to undertake acquisitions, divestitures, financings, and so on? And isn't there a conflict of interest in being rewarded, via extra fees, for actions that you, yourself, can cause another party to do?*

Yes, yes, yes, and yes.

For these reasons, wise LPs often insist that any such ancillary fees be offset by reductions in the management fee payable by the LPs. A 100% offset is preferable, of course, but deals should include a 50% offset at minimum. This reduces the likelihood that the GP will engage in economically marginal behavior (such as causing portfolio companies to make acquisitions at inflated prices) in order to generate additional fees.

Here is an example of such an offset provision, in commendably simple language, drawn from a private placement memorandum:

> *Investment banking, monitoring, directors and other fee income, in each case net of associated expenses, from Portfolio Investments which are paid to the General Partner and its Affiliates will be credited in full against the Management Fee.*

IV. Other Sources of "Return Leakage"

While the discussion above covers the main fees and expenses private equity fund investors can expect to encounter, there are still other ways that projected return can "leak" out of LPs' pockets and into those of other parties. Two common such leakages[8] are placement fees and related-party transaction fees and expenses.

Placement fees are fees paid to marketers for introducing investors to a private equity fund. Two to four percent

[6]How does an investor know which structure he is being offered? It will be in the deal documents. This is not, unfortunately, easy reading. Here is a description of a hurdle rate structure, for example. It uses an 80%, rather than 100%, GP allocation during the catch-up period:

Subject to the preceding paragraph, the Partnership's Net Income and Net Gain from an Investment Disposition are allocated as follows:

First, to all of the partners pro rata in proportion to their Funded Contributions until the amount allocated equals the aggregate amount of losses allocated to all of the partners under the third bullet of the loss allocations described below.

Second, to all of the partners pro rata in proportion to their Funded Contributions until the amount allocated equals the sum of (i) an annually compounded return of 8.0% (the "Investor Preferred Return") (calculated based on Funded Contributions) on the Investment Disposition Cost of Partnership Investments generating cash flow and (ii) without duplication, the Investor Preferred Return on the Investment Disposition Cost of Sold Partnership Investments and Funded Contributions used to pay any Allocable Lost Deal and Administrative Expenses with respect to Sold Partnership Investments to the extent that such amounts were distributed to the partners or are distributable to the partners.

Third, 20% to all of the partners pro rata in proportion to their Funded Contributions and 80% to the General Partner and the Special Limited Partners (collectively, the "Special Override Partners") until the Special Override Partners have received aggregate allocations equal to 20% of the aggregate amounts distributed to all of the partners (other than in respect of return of capital).

Fourth, 80% to all of the partners pro rata in proportion to their Funded Contributions, and 20% to the Special Override Partners.

[7]*This is a very high return, used only for purposes of illustration. It is not representative of what private equity investors can expect.*

of the commitment amounts are typical placement fees. Such fees are usually charged as a price of access to smaller investors. Investors who can make large commitments to individual funds are rarely charged placement fees.

Related-party fees and expenses arise when entities related to or affiliated with, but legally distinct from, the GP provide services to portfolio companies controlled by the GP. Among others, related-party services may include accounting, property management, brokerage, and provision of credit facilities.

These services may, of course, be necessary and appropriate for the fund's portfolio companies to carry on their businesses. However, the potential for conflict of interest is clear: GPs may have the ability to cause portfolio companies to pay above-market prices for services provided by related parties.

In general, investors should steer clear of paying placement fees, and of investing in funds in which significant conflicts of interest are apparent[9].

V. Summary and Take-Aways

In private equity investing, the devil—as the saying goes—is in the details. Too many investors have forged ahead with private equity funds, expecting great rewards, only to emerge some years later, chastened and with much lower profits than they had expected.

Too often, this is because private equity funds can be structured in a heads-the-GP-wins-tails-the-LPs-lose manner. As a final example of what can happen, consider the following scenario of an unsuccessful investment by a private equity fund investing in real estate. These terms are drawn from the actual deal terms of an actual fund, which, unfortunately, lost a great deal of LP money.

According to the deal terms, in addition to charging a management fee[10] at 0.50% of the gross cost of assets acquired, the GP named itself as the "financial advisor" to each building purchased, charging 1% of the proceeds of all financings. It also had one wholly-owned affiliate that charged brokerage fees for buying and selling properties, and another that provided building maintenance at a margin, above the cost of service (which itself was at rates set by GP), of 0.12% of the entire cost of the property. There were no fee offsets; all of the ancillary and related-party fees were incremental compensation to the GP. The GP also typically provided financing itself, often at above-market rates. However, the simplified example below does not include the effect of interest expense.

Consider the outcomes to the LPs and the GP in a hypothetical, but representative, one-year transaction resulting in a modest (-10%) loss at the level of the property itself:

Assume:	
Jan 1: Purchase building at total cost of:	***$100,000,000***
Finance with 80% debt	$80,000,000
Call remaining 20% of capital from LPs as equity	$20,000,000
Provide building maintenance for one year	TBD
Dec 31: Sell building for total proceeds of:	***$90,000,000***
Loss to LPs (before fees)	***($10,000,000)***
As a % of LP capital called	***-50.00%***
Fees to GP	
1% of purchase price, as broker	$1,000,000
1% of financing amount, as financial advisor to building	$800,000
0.5% of gross acquisition cost, as fund management fee	$500,000
12 bp of building cost, as markup over cost on building maintenance	$120,000
1% of sale price, as broker	$900,000
Total fees to GP	***$3,320,000***
As a % of beginning value of building	3.32%
As a % of LP capital called	16.60%
Total loss to LPs, including fees paid	***($13,320,000)***
As a % of LP capital called	-66.60%

That is, the outcome of this transaction is a loss of two-thirds of the LPs' $20 million in capital, due to fees and to

[8] It is not possible to make an exhaustive list of return leakages, as new fees can always be invented. Investors should heed warnings to read the offering documents carefully before committing to invest.

[9] The private placement memorandum will have a disclosure section, usually toward the back, covering conflicts of interest. Some conflicts of interest—such as conflicts in the allocation of time, when a GP is managing more than one fund—are relatively innocuous. In general, however, the longer the section disclosing the conflicts of interest, the warier investors should be.

[10] There was also an incentive fee in place, but it was moot, because the fund lost money.

declining asset value amplified by financing risk. Meanwhile, the GP has charged $3.32 million in fees over the course of the year, despite the loss suffered by LPs. This example provides a perhaps-startling illustration of the facts that (1) GPs can profit meaningfully even while LPs lose; and (2) ancillary fees may provide significantly greater GP compensation than the more-visible management and incentive fees.

In Summary

There is never a guarantee in investing. All that investors can do is to try to stack the odds in their favor[11].

This may be especially difficult to do with private equity funds, in which investors usually have little leverage to negotiate terms, and essentially no ability to exit should they become dissatisfied with GP performance. Therefore, before entering into any private equity deal, investors should be fully confident the deal terms to which they are agreeing are reasonable, fair to the LPs, and as free as possible of any conflicts of interest.

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