Fund Terms and Conditions: Swings and Roundabouts

Sam Meakin takes a look at the latest trends in private equity fund terms. Have the LP-friendly changes seen last year been pushed further? Or have headline fees swung back to favour GPs?

Alignment of Interests within Fund Terms

The terms and conditions of a private equity fund should be designed to produce a proper alignment of the interests of the LPs (limited partners/investors) and the GP (general partner/fund manager), ensuring that the structure of management fees, performance fees, and other aspects of the agreement incentivize the fund manager to maximize the returns earned by the fund, while at the same time not taking on inappropriate risk in an attempt to exceed hurdle rates if performance has not lived up to expectations thus far.

It seems unlikely that GPs would adopt terms and conditions liable to antagonize investors, as such a position would make raising investor commitments for future funds difficult (thus jeopardizing the future of the manager itself) in this highly competitive fundraising environment, and this is generally backed up by what investors have told Preqin.

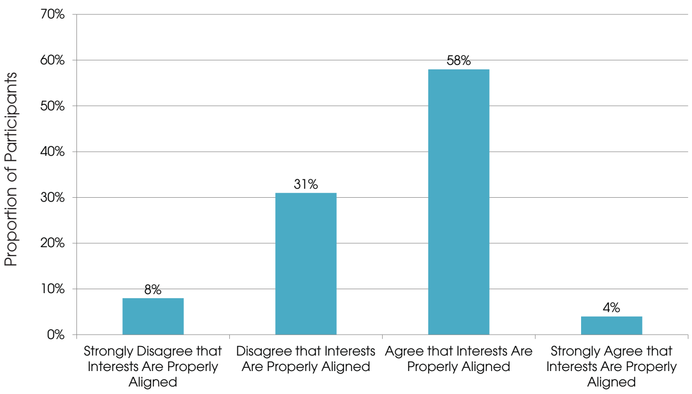
On the whole, it appears that investors are generally satisfied with the alignment of interests that the terms and conditions of their current private equity fund investments provide. Fig. 1, which is taken from the results of our most recent investor study (with further results available in the body of the 2012 Preqin Private Equity Fund Terms Advisor), shows that a total of 62% of participating LPs either agree or strongly agree that LP and GP interests are properly aligned.

Management fees appear to remain a bone of contention, however. Fig. 2 shows that 68% of investors stated management fees as an area in which alignment of interests can be improved, a higher figure than in a similar study conducted at the same time last year.

In the context of the subdued private equity fundraising environment of the last few years, LPs have been in a stronger position when negotiating the terms on which they are prepared to invest in a private equity fund being raised by a GP. However, the reality is not as straightforward as this. The challenging economic climate has meant that investors have been keener than ever to invest with what they perceive to be the strongest fund managers, and previous investor studies conducted by Preqin have suggested that the majority of investors would be willing to pay higher management fees to GPs with the best track records.

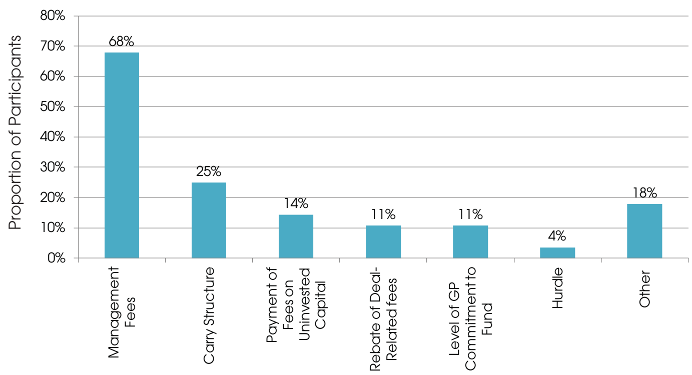
That the most sought-after funds are still able to command a high level of investor interest could help to maintain prevailing management fee levels, and may go some way to explaining why certain investors have told us that management fees remain an issue for them. Fig. 3 shows how the average buyout fund management fees have evolved over recent vintages. While there is a clear difference in the mean management fee of pre- and post-financial crisis vintages, presumably as a result of the slowdown in fundraising, the gap is perhaps not quite as large as one might initially expect. Where there has been more movement, however, is in the mean management fee for the largest buyout funds, with a difference of around 20 basis points between the peak vintage (2008) and the most recent funds, i.e. those with a 2012 vintage or those yet to begin investing as of June 2012.

Fig. 1: Extent to Which LPs Believe that GP and LP Interests Are Properly Aligned



Source: 2012 Preqin Private Equity Fund Terms Advisor

Fig. 2: Areas in Which LPs Believe that Alignment of Interests Can Be Improved



Source: 2012 Preqin Private Equity Fund Terms Advisor

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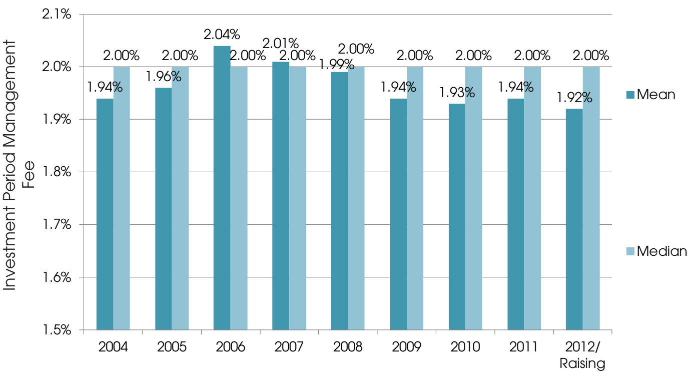
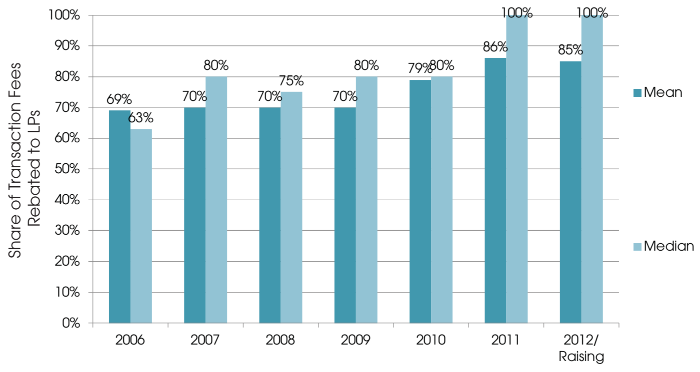
Fig. 3: Buyout Funds - Average Management Fee by Vintage Year



Source: 2012 Preqin Private Equity Fund Terms Advisor

Fig. 4: Average Share of Transaction Fees Rebated to LPs in Buyout Funds by Vintage Year



Source: 2012 Preqin Private Equity Fund Terms Advisor

The 2012 Preqin Private Equity Fund Terms Advisor contains extensive analysis on the management fees of the various private equity fund types, drilling down into the differences by fund size and vintage wherever possible, and including breakdowns of the range of management fees charged by the latest funds to have completed fundraising or those still in the fundraising process.

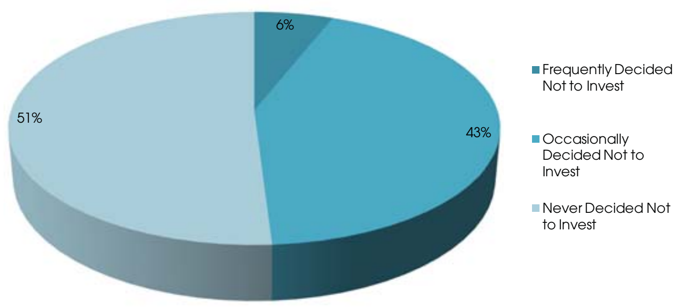
Transaction Fees

One area in which we have seen movement in recent years is transaction and other fees charged to portfolio companies by management teams, and the proportion of these fees that are rebated to LPs in the form of management fee reductions. As Fig. 4 shows, the median transaction fee rebate level for buyout funds with a 2011 vintage is 100%, and this has remained the case for 2012 vintage funds or those yet to begin investing as of June 2012. Over recent years there has been a steady move towards GPs sharing the entirety of such fees with the partnership rather than retaining them for management, and this is reflected in the fact that only 13% of participants in our recent investor study cited the rebate of these fees as an area where alignment of interests could be improved.

The movement towards fund managers sharing transaction fee revenue in its entirety with the partnership has been important both financially and as a sign of commitment to a balanced relationship between themselves and investors, which is imperative in the prevailing financial landscape. General partner fee income offsets feature in the updated ILPA Principles, and previous Preqin investor studies have found that a significant proportion of investors may be put off from investing in a fund that does not comply with the Principles. Fig. 5 shows that nearly half of the participants in our latest investor study have previously held off from investing in an otherwise attractive fund due to the terms and conditions offered. GPs that can show they are committed to a balanced relationship with their LPs will be at an advantage in this extremely competitive fundraising environment.

In addition to the headline terms such as management fee and carry levels, the 2012 Preqin Private Equity Fund Terms Advisor explores these topics in more depth, examining a wide variety of both financial and non-financial terms and conditions, including the rebate of transaction fees as discussed above, the catch-up rate used once a fund has passed its hurdle rate, carry waterfall structures (e.g. deal-by-deal vs. whole fund), LP advisory committees, fund organizational expenses, and much more.

Fig. 5: Frequency with Which LPs Have Decided Not to Invest in a Fund Due to the Proposed Terms and Conditions



Source: 2012 Preqin Private Equity Fund Terms Advisor

Data Source:

This article draws on data from the latest Preqin publication, the 2012 Preqin Private Equity Fund Terms Advisor. Now in its seventh edition, the latest Fund Terms Advisor represents the most significant and in-depth analysis of the fund terms of private equity funds of all types ever produced.

The 2012 Preqin Private Equity Fund Terms Advisor is a must-have resource for all those investing in private equity, and for those advising LPs.

For more information, please see page 5 or visit: www.preqin.com/fta

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