ILPA Guidelines Have Noticeable Impact

Gus Black, Carl A. de Brito and Roger Mulvihill from Dechert LLP, in conjunction with Preqin, examine whether the ILPA Guidelines have had any impact on private equity fund terms and conditions.

Every private equity fund formation is unique, but after more than three years of the ILPA (Institutional Limited Partners Association) Guidelines and one comprehensive revision which reflected the views of many industry participants, some preliminary observations are relevant. These comments are based on Preqin's study of 2,400 private equity funds taken from the 2012 Preqin Private Equity Fund Terms Advisor and our own experiences in representing sponsors and limited partners in similar funds.

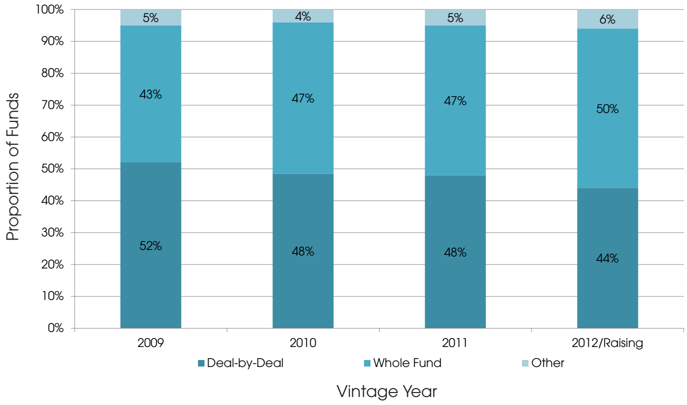
The ILPA Guidelines have clearly had an impact on sponsors and limited partners, although not in all cases, and not with respect to all of the "best practices" recommended in the Guidelines. One of the largest US pension funds, on the one hand, announced in February 2012 that it would require all private equity funds in which it is invested to comply with the ILPA terms on capital calls and distributions. On the other hand, many GPs have suggested that the ILPA Guidelines need to be modified in many cases to reflect their specific circumstances.

Distribution of Fund Proceeds

From our experience, in both the US and Europe, the best performing private equity funds were the least likely to adopt the more significant recommendations in the ILPA Guidelines. Preqin's data seems to confirm this observation. For instance, one of the more far-reaching suggestions in the Revisions directly affecting LP/GP economics was a definite preference for the European-style waterfall, where LPs receive priority distributions of all their capital contributions and any preferred return before any carried interest is distributed to the GP. Preqin's data indicates that only 50% of North America-focused funds raised in 2012 adopted a so-called "whole fund" distribution approach instead of the deal-by-deal format (Fig. 1).

Of course, there are several reasons why successful funds might persuade investors to support the traditional waterfall structure. For one thing, many funds had already adopted modifications which softened the impact of the classic deal-by-deal waterfall provisions. Limitations on distributions, such as net asset value coverage tests or carry escrows, which have been widely adopted by even top-tier funds, and interim clawback provisions, effectively create a hybrid waterfall which in some cases has an impact similar to a whole fund approach (the Revision itself suggested several such restrictions on GP carried interest distributions, as a fallback approach). Then, too, the most desirable private equity funds – generally those that have long-standing top quartile track records, and can point to a "prior vintage" position on key fund terms – often had the leverage to push back on fundamental changes to their distribution structure. This was also the case in Europe, where some sponsors – albeit a minority – continue to use a deal-by-deal model to be consistent

Fig. 1: North America-Focused Funds - Basis for Distribution of Fund Proceeds by Vintage Year



Source: 2012 Preqin Private Equity Fund Terms Advisor

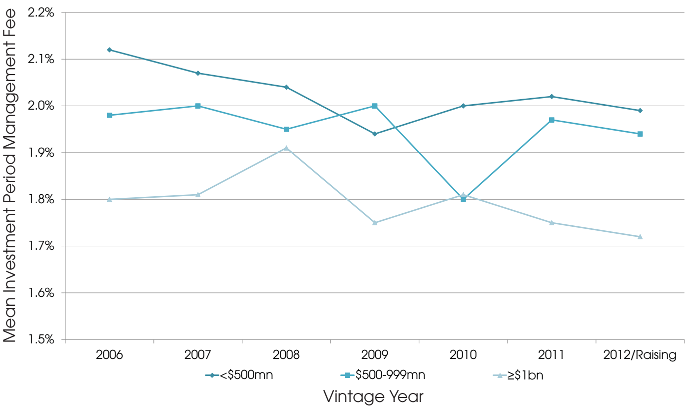
with earlier fund vintages, even though the "whole fund" basis of calculation is more prevalent overall in Europe.

Fee Rebates

It seems clear that the vast majority of investors, both institutional LPs and others, are very familiar with the ILPA Guidelines and the Revisions. In our experience, LPs cited provisions in the ILPA Guidelines in support of their preliminary investment positions even if they were more marginal investors in highly successful funds and would not have expected to have much practical impact on the terms. Indeed, the less established investors used the ILPA Guidelines as a form of due diligence checklist, with some adopting a "comply or explain" approach. Our impression, however, is that more experienced investors have their own checklist of key issues and positions, and for them the ILPA Guidelines will have been less helpful as a due diligence resource, albeit that it may have helped those investors' overall negotiation position.

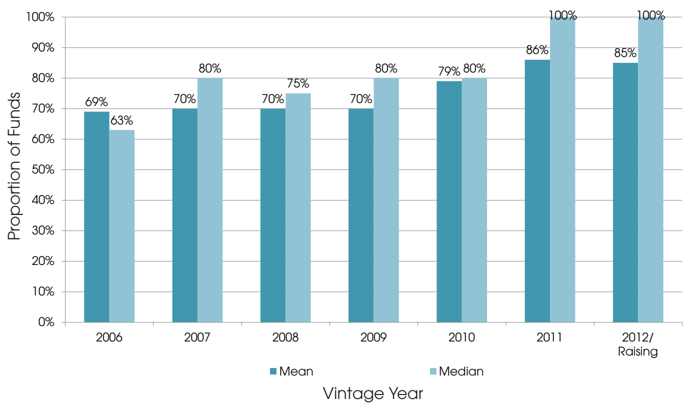
Less established fund sponsors and new funds, even those being formed by sponsors with impressive track records elsewhere, almost always incorporated most of the ILPA Guidelines suggestions in their initial offering materials. Sponsor lawyers were frequently asked to compare the sponsor's proposals at an early stage against the Guidelines even before any contact with prospective limited partners. We understand that several placement agents routinely advise new funds to adhere to the Guidelines (or to be able to justify convincingly why they are deviating from the Guidelines) and avoid potentially contentious debates with investors except on terms the sponsors consider vital.

Fig. 2: Buyout Funds - Mean Management Fee by Fund Size and Vintage Year



Source: 2012 Preqin Private Equity Fund Terms Advisor

Fig. 3: Average Share of Transaction Fees Rebated to LPs in Buyout Funds by Vintage Year



Source: 2012 Preqin Private Equity Fund Terms Advisor

In the area of fee income offsets, the ILPA Guidelines seem to have had a significant impact on private equity terms, even for many private equity funds. On average, 86% of new funds in 2011 and 85% of new funds in 2012 in the buyout fund sector rebated all transaction fees (while the 2009 Guidelines recommended a 100% offset, the Revisions did not suggest a specific rebate percentage). In the 2012 Preqin Private Equity Fund Terms Advisor there did not seem to be a significant difference on average in the treatment of fees (i.e. whether transaction, monitoring, directors, breakup or other). Deal terms have been trending in this direction for several years but the Guidelines no doubt provided additional impetus.

Management Fees

Other proposals in the ILPA Guidelines may have had a more indirect impact on actual deal terms. The Guidelines recommended that management fees be set based on sponsor-provided budgets or expense models in order to tie fees to a more realistic estimate of operating expenses. In earlier years it was suggested that a good many funds profited handsomely from the management fees even if the portfolio performance was substandard. We do see more limited partners requesting management company information, including management fee budgets, as well as management professionals compensation criteria. Although we are not aware of any established sponsors that have provided detailed budgets to prospective investors for the purpose of setting management fees, those fees have generally declined since vintage 2010 funds in all size categories. For instance in funds under $500mn, fees have declined from 2% to 1.99% in 2010 and 2012 respectively; in funds from $500mn to $999mn, fees have declined in 2011 and 2012 to 1.97% and 1.94% respectively; and in funds over $1bn, fees have declined from 1.81% in 2010 to 1.75% in 2011 and 1.72% in 2012 respectively.

The ILPA Guidelines also encouraged limitations on investment concentrations and, although such provisions were generally common before the Guidelines, it is likely that the recommendations had some favourable impact. Thus, in vintage 2011 and 2012 funds, 38% of the funds restricted a single investment to 15% of capital and 44% limited it to 20%. There has also been a noticeable increase in requests for tightening of overall investment focus so that sponsors are not able to “creep” away from the fund’s core geographic, industry or other focus.

GP Commitments

The ILPA Guidelines emphasized that general partners should have substantial cash equity investments in their funds. It is hard to generalize from the findings in the 2012 Preqin Private Equity Fund Terms Advisor since sponsor contributions in 2011 and 2012 were widely dispersed. In general, most buyout funds averaged between 1% and 3% of aggregate commitments, although some GPs (particularly in foreign funds) made substantially higher contributions. The Guidelines and the Revision disapproved of management fee waivers which appear to be less popular according to Preqin’s study and in our experience as well.

The Revision recommended that fund extensions should be limited to one-year increments after LP or LP advisory board approval. However, the 2012 Preqin Private Equity Fund Terms Advisor found that most extensions were for two-year periods, normally in two one-year increments, with about a third providing for Advisory Board approval. Sponsors generally followed the Revision on recommended no fault divorce percentages, however. The Revision suggested a three-quarters vote of the LPs in interest to terminate a fund. Preqin’s data shows that most funds adopted a 75% vote, with a few outliers at 80%, which is also consistent with our own experience.

The 2012 Preqin Private Equity Fund Terms Advisor found other developments which were not explicitly covered in the ILPA Guidelines but were consistent with the overall spirit of aligning the interests of sponsors and limited partners. The number of limited partner members on the advisory board averaged between four and six, depending on the size of the fund, which reflected a workable sized board in light of the increased responsibilities of the advisory board contemplated by the ILPA Guidelines and the Revision. The vast majority (72%) of vintage 2011 and 2012 funds analyzed in Preqin’s study restricted the final close to one year after the first close, which limited the complications for LPs if values of portfolio companies changed during an extended fundraising term. Organizational expenses also seemed consistent with the spirit of alignment in that they are generally influenced by the size of the fund.

Outlook

Last year the ILPA uploaded to its members-only website a software tool that allows limited partners to quantify limited partnership adherence to its principles. It is not clear yet what impact the Guidelines scoring tool will ultimately have on compliance with the Guidelines once it is made public, probably later this year. At least one large pension fund has instructed its analysts to use the tool when reviewing new fund agreements. Generally, the Guideline scoring mechanism includes any measurable ILPA principle in the software program which asks users to rank their partnership terms with the specific principles outlined in the Guidelines. Each ILPA principle is weighted based on its perceived importance, so that the waterfall structure, for instance, would presumably have greater weight than certain advisory board matters. A full breakdown of each principle's weighting however is not yet available to non-ILPA members. While many GPs will argue that one size doesn't necessarily fit all, GPs with less impressive ILPA scores should be prepared at a minimum to discuss why the tool is less of a factor in their particular case.

Dechert LLP

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Dechert LLP has been ranked among the leading law firms for private equity by prominent league tables, such as Preqin, PitchBook, mergermarket, Private Equity Analyst, and The American Lawyer's "Corporate Scorecard." We are also recommended for private equity by The Legal 500, Chambers and JUVE.

Data Source:

This article features data from the 2012 Preqin Private Equity Fund Terms Advisor, which contains vital analysis, benchmarks and actual listings of key terms for funds of all types, latest barometer of LP opinions and more.

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