2013 Preqin Private Equity Fund Terms Advisor: Executive Summary

This month's lead article features the Executive Summary from the 2013 Preqin Private Equity Fund Terms Advisor, the industry's most comprehensive guide to private equity fund terms and conditions.

Fundraising Recovery and Regulatory Change

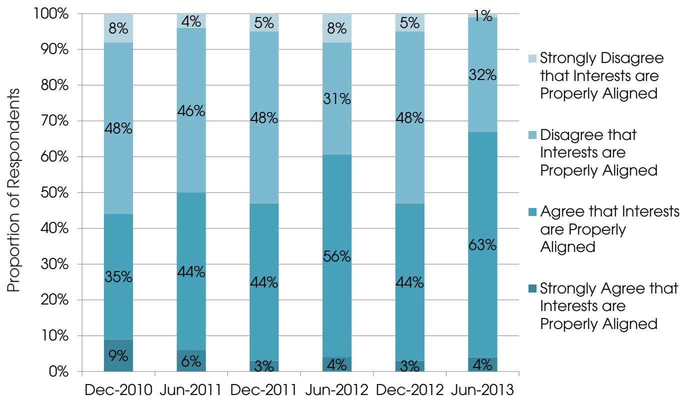
There are signs of improvement in the private equity fundraising market, with fundraising levels beginning to return to pre-crisis levels in terms of capital raised. In H1 2013, a total of 381 private equity funds reached a final close, raising an aggregate $218bn. This is the highest half year fundraising value for almost five years, when $299bn was raised by funds closed in H2 2008. These figures indicate the success GPs have had in securing LP commitments and also the healthy investor appetite that does exist.

However, the past year has also seen the announcement of a number of regulatory changes that will affect the private equity industry and the players in it, particularly in North America and Europe. The AIFMD, Solvency II, Basel III and Volcker Rule will all have a significant impact on the private equity industry in the future and investors that Preqin has spoken to have highlighted these regulations as the most prominent challenge they face when seeking to operate an effective private equity program. These regulations and the concerns of investors highlight the ever increasing importance of terms and conditions and the need for a true alignment of interests between a GP and the LP.

Alignment of Interests

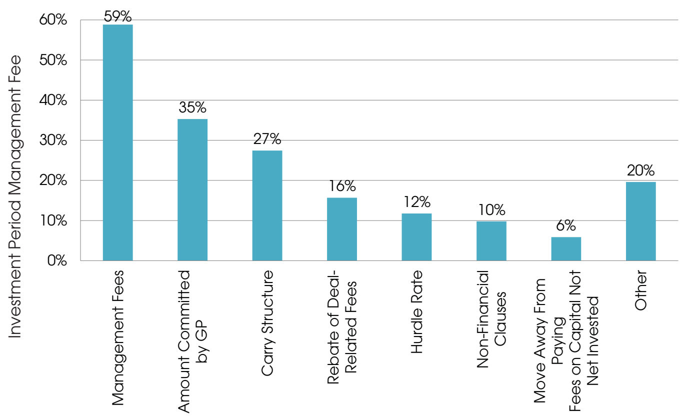
The terms and conditions of a private equity fund are important for the fund manager to get right. Investors need to be assured that the terms and conditions are structured in a way that incentivizes the fund manager enough to maximize the returns earned by the fund, while at the same time ensuring that the fund manager does not take on additional risk if the performance of the fund has not lived up to expectations. The terms and conditions of a fund should produce an alignment of interests between the LP and the GP, ensuring that an effective working relationship is developed between the two parties. In a highly competitive fundraising market, it is important that GPs do not adopt terms and conditions liable to put off investors from committing to private equity funds.

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



Source: 2013 Preqin Private Equity Fund Terms Advisor

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



Source: 2013 Preqin Private Equity Fund Terms Advisor

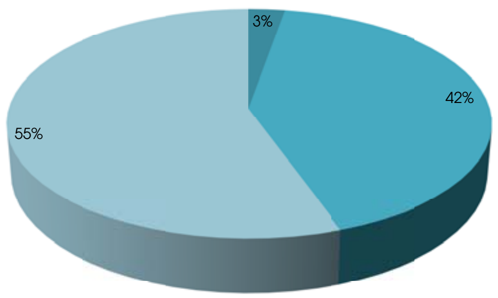
Investor Attitudes

Preqin interviewed over 100 investors in private equity funds about their attitudes towards fund terms and conditions. The results, examined in Chapter 4 of the Fund Terms Advisor, show that investors generally appear to believe that alignment of interests between GPs and LPs is improving; overall, institutional investors want to commit capital to firms with which they can form a strong relationship built on trust and confidence. Fig. 1 looks at the attitudes of investors towards fund terms and conditions since December 2010; over time, we have seen a growth in the proportion of investors which believe that LP and GP interests are aligned. We also asked investors to name areas of fund terms and conditions in which they believe the alignment of interests between LPs and GPs can be improved; as shown in Fig. 2, 59% cited management fees as the area that they think needs the most improvement, indicating that this is the area of most contention. However, it is interesting to note that this figure stood at 68% last year, suggesting that investors have seen an improvement in management fees over the last year.

Evolving Terms

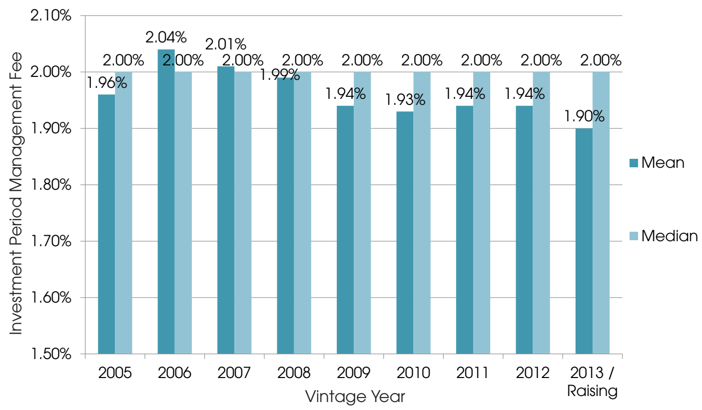
Despite an improving private equity fundraising market, raising capital remains challenging, particularly given the large number of private equity funds currently in market. As a result, there is a sense that investors will have more control and more say over fund terms and conditions. Investors are seeing changes in the terms

Fig. 3: LPs Experience Of Changes In Prevailing Terms Over the Last Six Months



Source: 2013 Preqin Private Equity Fund Terms Advisor

Fig. 4: Buyout Funds - Average Management Fee by Vintage Year

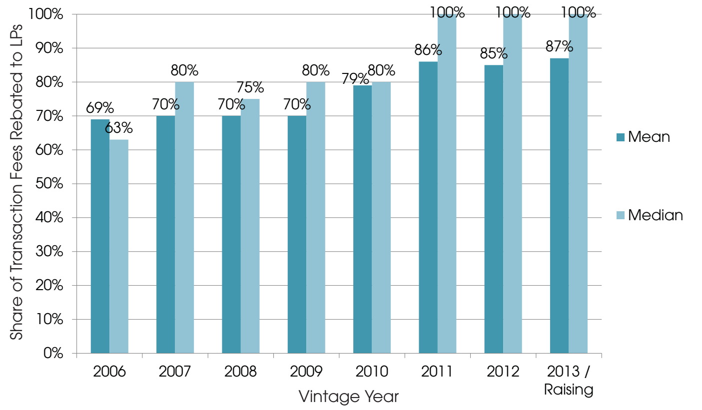


Source: 2013 Preqin Private Equity Fund Terms Advisor

and conditions that are being offered to them. Fig. 3 shows that 45% of investors that we spoke to have seen a change in terms in favour of the LP. However, they are still willing to pay a premium price to invest with top quartile managers; studies carried out by Preqin indicate that investors will pay a higher management fee for this privilege. For the investor, a higher fee can be justified by higher net performance; however, there are signs that over time there has been a slight reduction in the management fees charged by the largest buyout funds. Fig. 4 shows how the average buyout fund management fees have evolved over time, demonstrating the difference in the mean management fee from 2008 to buyout funds of a more recent vintage.

One area of continued change is seen in the transaction fees charged to portfolio companies by management teams and how much of these fees are rebated to LPs in the form of management fee reductions. Fig. 5 shows that over recent years there has been a move towards GPs sharing the entirety of the transaction fees they collect. This movement is important, as it is a sign of commitment to a balanced relationship between the fund managers and their investors; this is very much a key message of the ILPA Private Equity Principles. These principles outline three guiding tenets which are the basis of an effective partnership between private equity LPs and GPs: (1) alignment of interests between investors and fund managers; (2) good fund governance and (3) appropriate levels of transparency. Investors will be put off by a fund that does not comply with these principles and take these and other regulatory issues seriously. The median transaction fee rebate levels for 2011 and 2012 vintage buyout funds is 100%, and this has remained the case for 2013 vintage funds or those yet

Fig. 5: Average Share of Transaction Fees Rebated to LPs in Buyout Funds by Vintage Year



Source: 2013 Preqin Private Equity Fund Terms Advisor

to begin investing as of August 2013; sharing this revenue from transaction fees in its entirety with the partnership shows extensive commitment by the GP.

The 2013 Preqin Private Equity Fund Terms Advisor examines 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.

Data Source:

The 2013 Preqin Private Equity Fund Terms Advisor features extensive analysis on the very latest private equity terms and conditions information collected by Preqin. This edition provides readers with the actual terms employed by individual vehicles, as well as benchmark terms. Individual fund listings, on an anonymous basis, are provided for more than 2,000 private equity funds of different strategies, vintages, geographies and sizes.

Click here to download sample pages and order your hard copy today. For more information about the 2013 Preqin Private Equity Fund Terms Advisor, please visit:

www.preqin.com/fta