Preqin Special Report:

Terms and Conditions: Are the ILPA Principles Being Followed?

August 2010

Private Equity • Real Estate • Hedge Funds • Infrastructure

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Following extensive discussion, surveying and roundtable meetings, the Institutional Limited Partners Association (ILPA) released its best practise guide to private equity fund terms and conditions, the Private Equity Principles, in September of 2009. ILPA currently has 130 organizations endorsing the practices outlined in the document.

The stated aim of the Principles is to ‘serve as a common framework for continued discussion among and between the general partner and limited partner communities with the goal of improving the private equity industry for the long-term benefit of all its participants.’

Using Preqin’s extensive data on terms and conditions taken from the newly released 2010 Preqin Fund Terms Advisor publication, it is possible to assess the level to which new funds are adhering to a selection of quantifiable ILPA ‘best practices’.

Deal by Deal Vs. Whole Fund Carry

ILPA: A standard all-contributions-plus-preferred-return-back-first model should be recognized as best practice.

Preqin: 62% of funds closed in 2009, 2010 and currently raising utilize a whole fund structure

Although the majority of funds are adhering to a whole fund carry structure, 38% continue to work on a deal-by-deal basis. Within Europe, whole fund structures are the norm, with only 7% of recent vehicles focusing on the region using a deal-by-deal structure. Within North America, nearly half of all recent funds are still distributing proceeds on a deal by deal basis, as Fig. 1 shows. Similar to European funds, the vast majority of Asia and Rest of World-focused funds have a whole fund structure, with just 11% of recent funds utilizing a deal-by-deal structure.

Management Fees Post-Investment Period

ILPA: Management fees should step down significantly upon the formation of a follow-on fund and at the end of the investment period.

Preqin: Only 3% of funds maintain the original management fees upon the completion of the investment period.

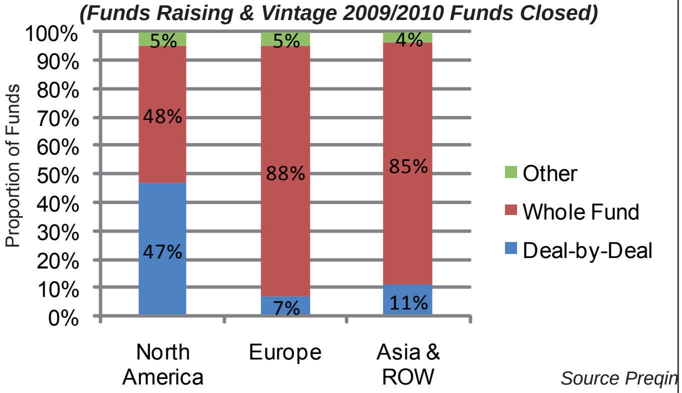
This is an area where the vast majority of fund managers are adhering to the Principles, although there is a wide range of different methods used for reducing fees, with the savings for LPs varying considerably. For buyout funds, 99% of funds will reduce the fees, but 61% still charge the same rate applied only to the invested capital. 25% of buyout funds go further, reducing the rate and applying to invested capital only, as Fig. 2 shows.

Transaction and Monitoring Fees

ILPA: All transaction, monitoring, directory, advisory, and exit fees charged by the general partner should accrue 100% to the benefit of the fund.

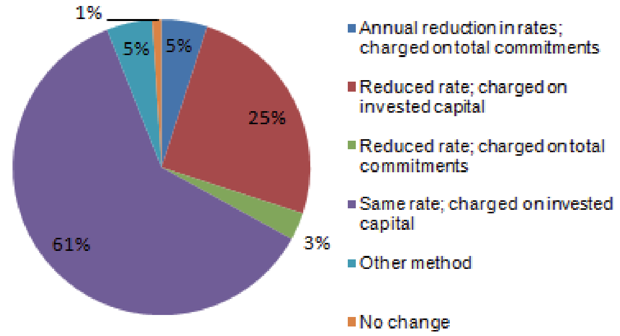
Preqin: 39% of the most recent funds rebate 100% of such fees back to the fund.

Fig. 1: Basis for Distribution of Fund Proceeds by Primary Geographic Focus of Fund (Funds Raising & Vintage 2009/2010 Funds Closed)



Source Preqin

Fig. 2: Buyout Funds - Mechanisms for Reducing Management Fee after Investment Period (Funds Raising & Vintage 2009/2010 Funds Closed)



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There has been considerable movement towards rebating fees to the fund in recent years, but the majority of funds still retain a proportion of such fees for the GP. As Fig. 3 shows, just 1% of recent vehicles rebate less than 50% of transaction fees, but a considerable 26% rebate only 50-59%, while 28% rebate 80% of such fees.

No-Fault Divorce Clause

ILPA: No fault rights upon a two-thirds in interest vote of limited partners for the following: Removal of the general partner; Dissolution of the Fund.

Preqin: Less than 4% of the most recent funds comply with this statement. 80% in interest is the most common supermajority.

Although only a small minority of funds set the supermajority as low as the 67% identified by ILPA, it is now commonplace to have a no-fault divorce clause in place. 58% of funds set an 80% supermajority, while 34% require a 70-79% supermajority, as Fig. 4 shows.

GP Contributions

ILPA: The general partner should have a substantial equity interest in the fund to maintain a strong alignment of interest with the limited partners.

Preqin: 39% of funds have a GP contribution of 1-1.99%. 22% of funds have a GP contribution of 2-2.99%. 10% of funds have a GP contribution of 5-5.99%; 14% have a GP contribution of 10% or more.

Fig. 4: LP Supermajority Required for No-Fault Divorce Clause (Funds Raising & Vintage 2009/2010 Funds Closed)

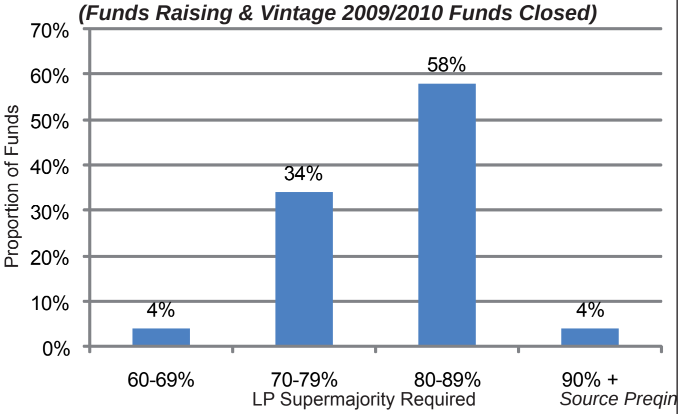
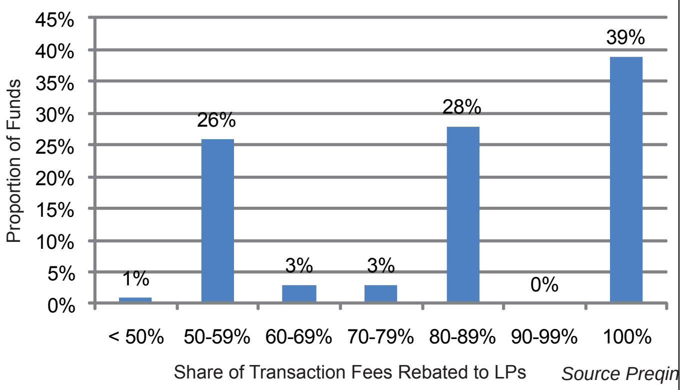


Fig. 3: Share of Transaction Fees Rebated to LPs (Funds Raising & Vintage 2009/2010 Funds Closed)

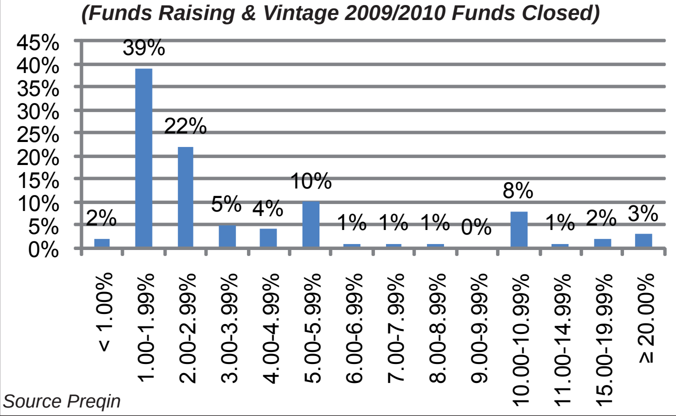


A GP making a substantial commitment to their own vehicle is an excellent way to align interests in the GP – LP relationship, and has been noted by placement agents as one of the best ways that GPs can make a statement of intent when seeking commitments for new vehicles in the current market. 31% of recent funds have a GP commitment of the historical standard of 1%, but 67% of the most recent funds have above 1% GP commitment levels, and 14% of new vehicles have GP contributions of 10% or higher, as shown in Fig. 5.

Summary

With investors having significantly less capital to deploy into new vehicles than in previous years, and with a large number of

Fig. 5: GP Commitments as a Percentage of Fund Size (Funds Raising & Vintage 2009/2010 Funds Closed)



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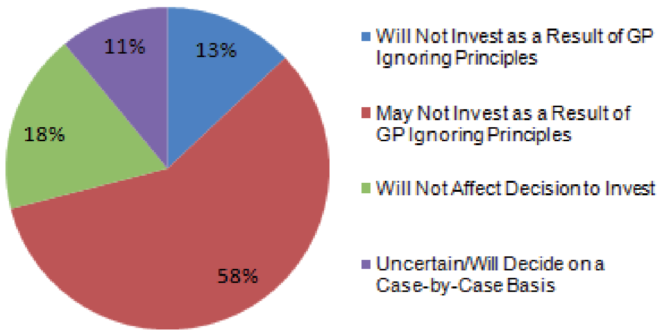
vehicles still on the road, it is clear that the balance of power has swung towards LPs in fund terms negotiations. With over 100 firms already endorsing the Principles, it is important that firms are aware of these best practices, and have considered them when assembling PPMs. Preqin's data shows that while some areas of the Principles are being followed, other areas are not enjoying such widespread support, with the continued prevalence of deal-by-deal carry funds in the US perhaps the most notable area where GPs continue to resist change.

Although only a minority of the 50 leading LPs polled in a recent Preqin survey would dismiss a fund based solely on its non-adherence to the Principles (13%), the majority would see this as a reason to consider not investing (58%), as Fig. 6 shows. As a result it is especially vital that those managers which maintain non-best practice terms are able to communicate exactly why this is to an increasingly terms and conditions-sensitive LP universe.

Fig. 6: Effect of GPs Not Adhering to ILPA's Private Equity Principles on LPs' Investment Decisions



Source Preqin

The 2010 Preqin Fund Terms Advisor

The analysis in this article is based upon data found in this year's Preqin Fund Terms Advisor publication - by far the most comprehensive source of data and analysis for industry professionals seeking to understand private equity fund terms and conditions.

Preqin's analysis is based on information taken directly from PPMs for all different fund types, geographies and sizes across all recent vintage years, as well as hundreds of direct questionnaires of fund managers completed by our analysts over the past five editions of this industry standard publication. This year has seen further continuation in the level of data collected, with the 2010 Preqin Fund Terms Advisor containing listings of actual terms and conditions data for more than 1,400 separate funds. All major fund types are represented, with analysis, listings and benchmark data for buyout, venture, real estate, fund of funds, distressed debt, secondaries, mezzanine, infrastructure and natural resources.

The Advisor focuses its analysis and benchmarks on the very latest terms and conditions information including management fees and mechanisms for reduction after the investment period, carry, carry distribution methods, hurdles, preferred return, fee rebates, no fault divorce clause, GP commitments, investment period and more. Listings for these funds (with identities disguised) can be found in the publication, and also on our Fund Terms Online module, which is available to all book purchasers. This data can be downloaded to Excel for further analysis, with other powerful features of this online module including the ability to map the real economic effects of proposed terms and conditions with our online Fund Terms Calculator.

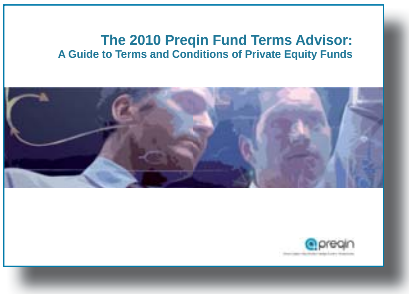
Other key features of this year's Fund Terms Advisor include listings for 1,174 additional named funds showing the net costs incurred by LPs annually. (Unlike the detailed listings of funds terms sourced from PPMs and interviews with fund managers, this summary information on total costs is obtained through Freedom of Information requests to public pension funds in the US and the UK.) The publication also includes listings for law firms active in private equity fund formation, including sample past assignments and contact details. This information is also available in the online module.

To view an informative executive report, view sample pages and to order your copy of the 2010 Preqin Fund Terms Advisor, please visit our product page at: www.preqin.com/fta

2010 Preqin Fund Terms Advisor: Order Form

The Fund Terms Advisor is a vital tool for all fund formation lawyers and for private equity firms and placement agents involved with the fund formation process. It also contains valuable intelligence for all those investing in private equity, and for those advising LPs. Key features include:

- Actual terms and conditions data for over 1,400 funds, including management fees and mechanisms for reduction after the investment period, carry, carry distribution methods, hurdles, preferred return, fee rebates, no-fault divorce clause, GP commitments, investment period.
- Benchmark terms and conditions data for funds of all different types: buyout, venture, real estate, distressed, mezzanine, fund of funds, secondaries and more…
- Results of our LP and placement agent surveys - the most comprehensive studies of current opinions on fund terms and conditions ever conducted.
- Data and analysis on the actual fees and costs incurred by LPs, with listings showing costs for 1,200 named vehicles.
- Full access to our updated Fund Terms Advisor Online product, which enables you to model the real economic impact of fund terms and conditions, and download detailed fund terms for further analysis.
- Comprehensive analysis on all aspects of private equity fund terms and conditions including how conditions have changed over time and what variations exist amongst funds of different type, size and region.
- Listings for 100 leading law firms involved in the fund formation process, including contact details and sample previous assignments.



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Preqin private equity provides information products and services to private equity and venture capital firms, fund of funds, investors, placement agents, law firms, investment banks and advisors across the following main areas:

- Buyout Deals
- Fund Performance
- Fundraising
- Investor Profiles
- Fund Terms
- Fund Manager Profiles
- Employment and Compensation

Our customers can access this market intelligence in four different ways:

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