Preqin Special Report:

Terms and Conditions after the Crash

Changes in Private Equity Terms and Conditions Following the Credit Crunch

01 July 2009

Private Equity • Real Estate • Hedge Funds • Infrastructure

Terms and Conditions After the Crash

Following the global economic downturn, numerous LPs have faced liquidity problems and many GPs have seen their portfolio companies struggle financially and fall in value. These are some of the factors that have contributed to a fundraising environment which is currently extremely competitive for most GPs. LPs are unwilling to commit in the uncertain climate, and many face concerns over capital calls for existing investments in addition to over-allocation issues. Given this current state of affairs, it might be expected that the few LPs in a position to commit capital to new funds may to be able to negotiate more favourable terms and conditions from GPs than they would have been able to during the boom years, and that some GPs would offer more favourable terms and conditions in order to differentiate themselves from the competition. Our research and analysis for this Review has revealed evidence that this is the case in certain circumstances.

Fig. 1: When Negotiating Fund Terms and Conditions, Have Investors Seen a Shift in the Balance of Power towards the LP or GP in the Past Six Months?

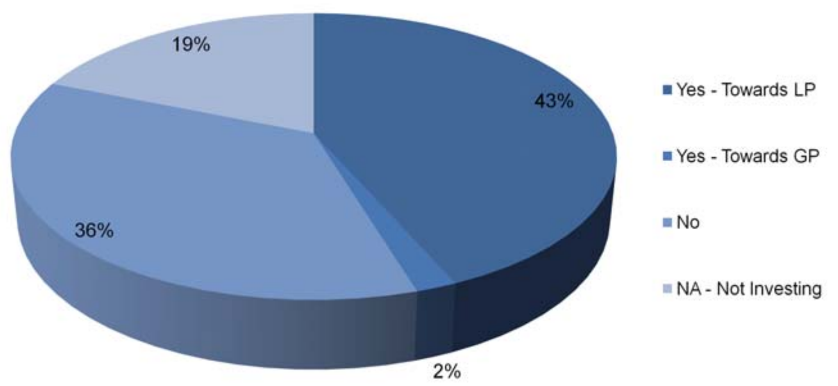
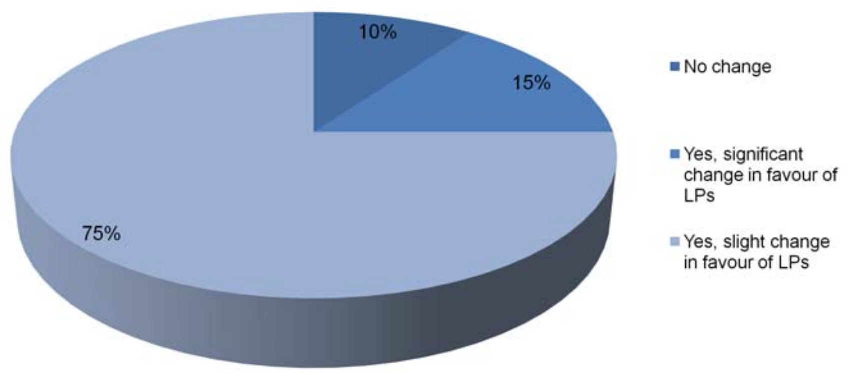


Fig. 2: Has Placement Agents' Advice to Clients on Fund Terms and Conditions Changed in the Past 18 Months?



Negotiations: A Shift in the Balance of Power?

Our recent survey of institutional investors reveals that 43% felt the balance of power when negotiating fund terms and conditions had shifted towards the LP in the last six months, compared to just 2% stating it had shifted towards the GP, as shown in Fig. 1. This perceived shift in the balance of power is backed up by the results of our placement agent survey, where 15% of placement agents said that they had advised their GP clients to make significant changes to the terms and conditions in favour of LPs, and a further 75% stated they had advised some changes in favour of LPs, as shown in Fig. 2.

Changes in Management Fees

Of the LPs that had noticed a change in fund terms and conditions, more than 60% stated that the main change had been in the rate of management fees charged by GPs.

Terms and Conditions After the Crash

Fig. 3: Buyout Funds - Trends in Management Fees by Vintage Year

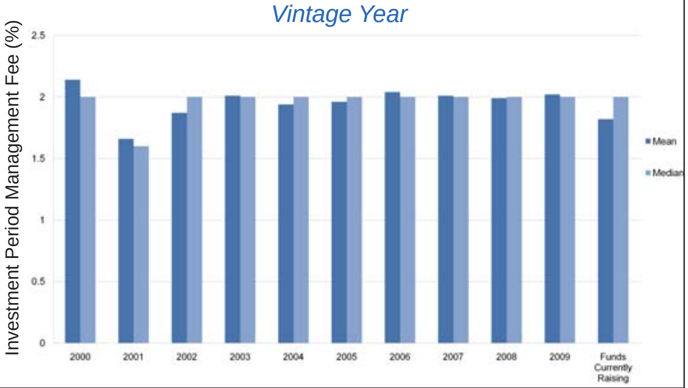
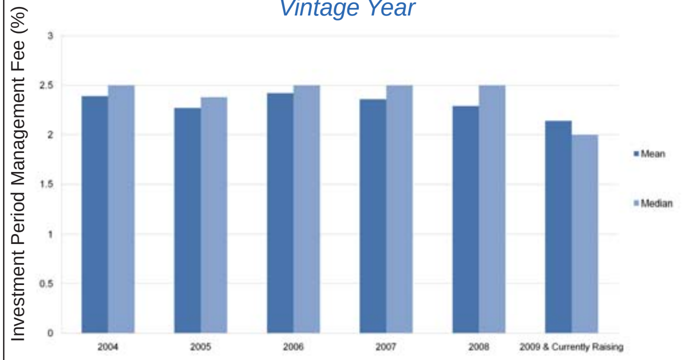


Fig. 4: Venture Funds - Trends in Management Fees by Vintage Year



This is confirmed by the fund terms and conditions that we have seen. As shown in Fig. 3, after having remained stable at around the 2% mark for many years, the mean management fee proposed by buyout funds that are currently looking to raise capital has dropped by around 20 basis points, compared to the most recently closed funds, to just over 1.8%. A similar pattern has emerged in the venture fundraising market. Venture funds of vintage 2009 and those still currently fundraising have a mean management fee 15 basis points lower than vintage 2008 funds, as shown in Fig. 4. Additionally, the median venture fund management fee has dropped from 2.5% to 2%.

Furthermore, it appears to be the largest funds that are cutting their management fees the most. Fig. 5 shows the mean management fee for different size groups of buyout funds by vintage year, and demonstrates that the biggest drop in buyout fund management fees has come from the largest funds. Buyout funds of $1 billion or more in size have seen a drop of 25 basis points from those of a 2008 vintage to those currently fundraising and of a 2009 vintage. Additionally, the mean management fee for buyout funds less than $500 million in size has fallen below 2% for the first time. Fig. 6 displays the trend for venture funds of different sizes and reveals that again it is the funds in the largest size grouping that have experienced the largest drop in mean management fees. There has been a fall in the mean management fee of nearly 40 basis points for

Fig. 5: Buyout Funds - Trends in Management Fees by Fund Size and Vintage Year

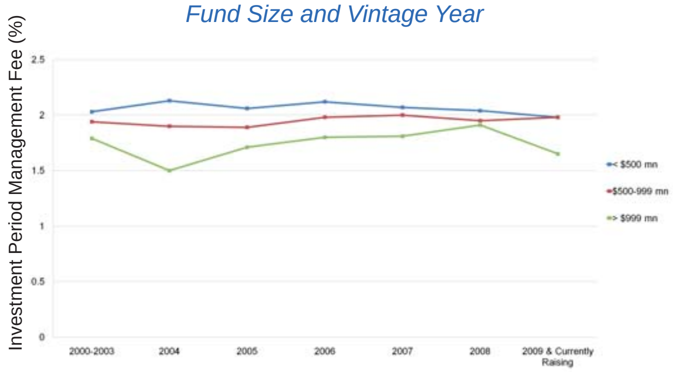
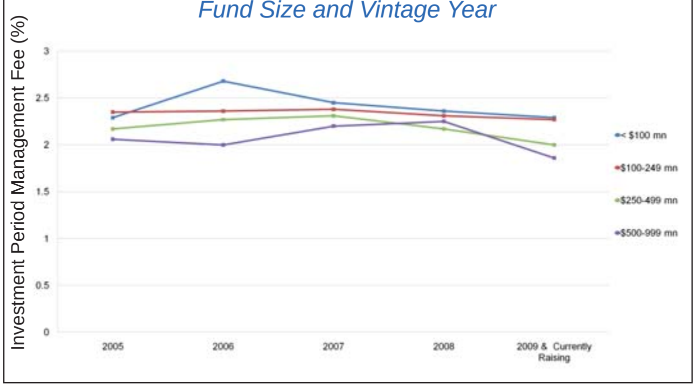


Fig. 6: Venture Funds - Trends in Management Fees by Fund Size and Vintage Year



Terms and Conditions
After the Crash

venture funds between $500 million and $999 million in size from those of a 2008 vintage to those currently fundraising and of a 2009 vintage. All of the different venture fund size groups have witnessed a fall in mean management fees.

Changes in Transaction Fees

In addition to the reductions in headline management fee rates, there have been other terms and conditions affected by the tough fundraising environment. Fig. 7 shows the average share of transaction fees rebated to LPs by buyout funds, which is of particular interest in the case of this fund type due to the larger average size of investments made compared to other fund types. The mean proportion of transaction fees rebated to LPs has remained relatively stable over the past few years, but was slightly lower for vintage 2008 buyout funds, while the median was significantly lower, at just 50%. However, this has been reversed by the most recent funds, with the median proportion back up to 80% and the mean now over 70%. In the strong fundraising climate of 2007 and early 2008, GPs felt able to retain a larger proportion of transaction fees for themselves without it affecting their fundraising efforts. However, more recent funds have adjusted the proportions of transaction fees rebated to LPs back to pre-2008 levels as they look to attract scarce LP capital commitments.

Fig. 7: Evolution in Share of Transaction Fees Rebated to LPs by Buyout Funds

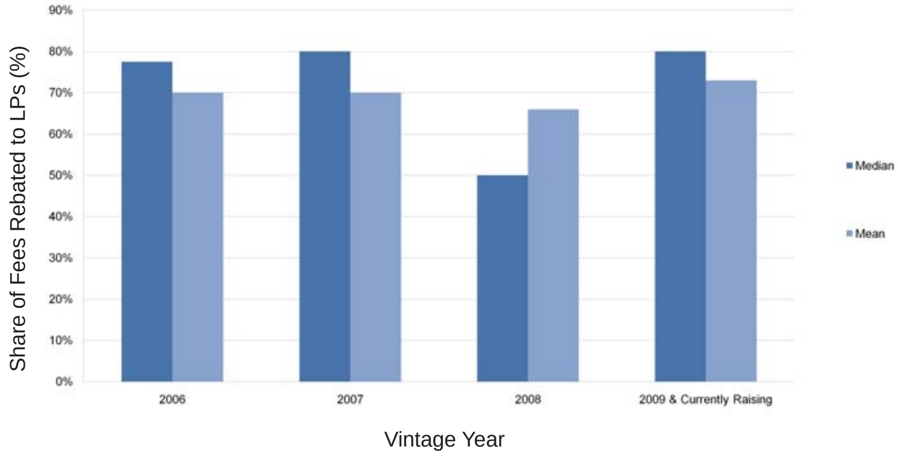
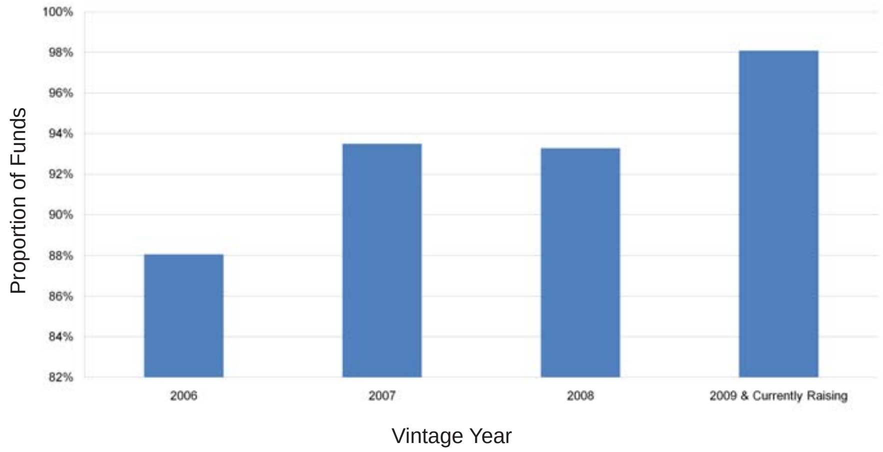


Fig. 8: Evolution in Proportion of Funds to Include a Key-Man Clause



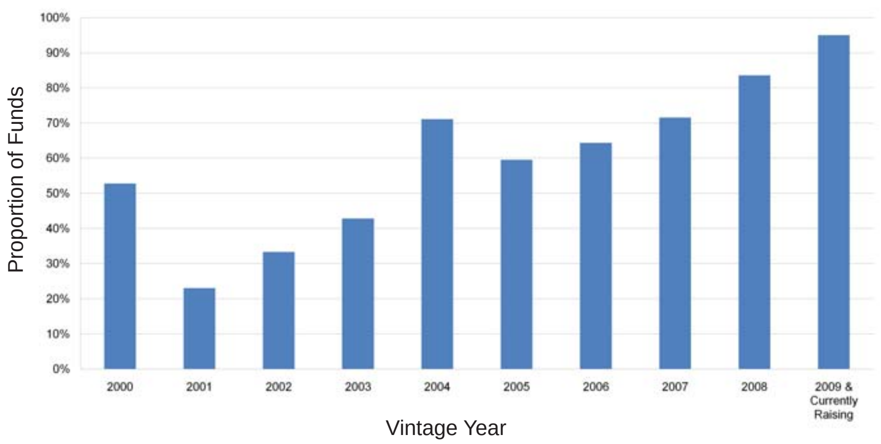
Changes in Non-Economic Terms

Non-economic terms and conditions are also important considerations for investors. The challenging fundraising climate has helped to push up the proportion of funds that include a key-man clause in their fund agreements to near-total coverage. As shown in Fig. 8, while the proportion of vintage 2008 funds including key-man clauses in their terms and conditions remained at the same level as for vintage 2007 funds at 93%, vintage 2009 funds and those currently raising include a key-man clause in their agreements 98% of the time.

Terms and Conditions
After the Crash

Another non-economic clause that has grown in prevalence is the no-fault divorce clause. As shown in Fig. 9, the most recent funds have continued the trend in increasing proportions of funds including no-fault divorce clauses in their terms and conditions, and this type of clause is also nearing total coverage across all fund agreements. 95% of vintage 2009 funds and those currently fundraising include a no-fault divorce clause in their terms and conditions, up from 84% of vintage 2008 funds.

Fig. 9: Evolution in Proportion of Funds to Include a No-Fault Divorce Clause



The results of Preqin's survey clearly show that investors are becoming increasingly concerned with terms and conditions. Placement agents are advising their clients to alter proposed fees in favour of the LP, and Preqin's analysis of terms and conditions demonstrates that GPs are listening. The evidence shows that the newest funds – those just launched or currently in market – have lower fees, and are more likely to include important governance statutes such as key-man and no-fault divorce clauses. It is therefore essential that GPs carefully consider their new offerings in the light of both long-term benchmarks and also the proposed fees for the newest vehicles if they are to garner interest from investors in the current environment.

Fund Terms and Conditions More Important than Ever

A good understanding of the changes taking place in the industry is vital, and a source of good data on current standard terms and conditions for funds of different types and size is of greater importance than ever before for all legal and private equity professionals involved with the fund formation process. It is also a vital consideration for all those investing in private equity, and for those advising LPs.

2009 Preqin Fund Terms Advisor

The Preqin Fund Terms Advisor is the industry standard publication covering private equity fund terms and conditions, featuring detailed analysis, listings, surveys and benchmarks. It also features a powerful online module, enabling you to access Excel spreadsheets of actual terms and conditions, and allowing the economic impact of proposed terms and conditions to be judged using our Fund Terms Calculator.

In order to analyse the latest trends and statistics for private equity fund terms and conditions Preqin goes to extraordinary lengths in order to collect as much accurate raw data as possible. Preqin analysts have completed questionnaires directly with hundreds of fund managers over the past four editions of this industry standard publication, and we have worked with placement agents and fund of funds managers across the world, gaining access to as many PPMs as possible for all different fund types, geographies and sizes across all recent vintage years.

2009 Preqin
Fund Terms Advisor

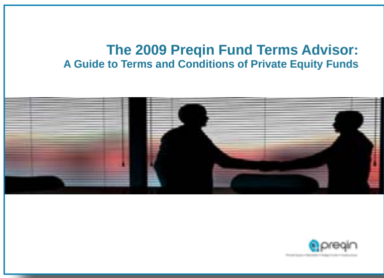
Highlights of this year's publication and online module include:

- Actual terms and conditions data for 1,200 funds, including management fees and mechanisms for reduction after the investment period, carry, hurdles, preferred return, fee rebates, no fault divorce clause, GP commitments, investment period and more…
- 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 Survey - the most comprehensive survey of LPs' 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 1,000 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 examining how conditions have changed over time, and what variations exist amongst funds of different type and size, changes in fees after the credit crunch, relationships between hurdle rates and carry plus much more.
- Listings for over 100 law firms involved in the fund formation process, including contact details and sample previous assignments.

For more information, including sample pages and details on how to order your copy, please visit: www.preqin.com/FTA

2009 Preqin Fund Terms Advisor: Order Form

With analysis based on the actual terms and conditions of 1,200 private equity funds, the 2009 Preqin Fund Terms Advisor is the most comprehensive guide to private equity terms and conditions ever produced, and is a vital guide for both investors and anyone involved in the fund formation process.



- Comprehensive analysis on all aspects of private equity fund terms and conditions examining how conditions have changed over time, and what variations exist amongst funds of different type and size, changes in fees after the credit crunch, plus much more.
- Actual listings of key terms and conditions for 1,200 vehicles with all key metrics included, plus listings showing net costs incurred by LPs for 1,000 further funds.
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- Results of LP Survey, benchmark terms for all different fund types, plus more...
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