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Private Equity Fund Distribution Waterfalls

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Key Concepts Relating to PE Distributions

- Carried Interest
 - Preferred Returns
 - Examples
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- There will be references in this presentation to the “ILPA Principles.” ILPA is the Institutional Limited Partners Association that provides a set of best practices for general partners and limited partners in the private equity industry. To date, there have been two versions of the ILPA Principles, and they can be found at <http://ilpa.org/ilpa-private-equity-principles/>.

Carried Interest – Generally

- Basic Concept: A form of incentive compensation for the recruitment and retention of talented investment managers.
- Generally treated as an interest in the profits of the Fund – also known as the “carry,” “performance allocation,” “promote,” “promoted interest” or “override”
- Size of the Carried Interest (market standard):
 - Buyout Funds and Real Estate Funds – 20% of the Fund’s profits
 - Venture Capital Funds – 20% of the Fund’s profits, although some Funds charge more than 20%
 - Funds of funds – 5% to 10%
 - The carried interest may be subject to a preferred return or hurdle rate (discussed below)
- Taxation: Generally treated as capital gains to the General Partner (US proposals exist to convert the Carried Interest to ordinary income – to be discussed in other presentations).
- Taxation UK: To ensure tax efficiency in the UK, it is important to stick closely to the British Private Equity & Venture Capital Association (BVCA) “model” partnership carried interest structure and route the carry through a separate limited partnership interest (owned by the Carried Interest Partner).

Fund Income Subject to Carried Interest

Capital Gains – In all Funds, the Carried Interest is based upon the net capital appreciation attributable to the Funds' investments.

Dividend and Interest Income Earned from Portfolio Investments of the Fund

- *ILPA Principles:* ILPA suggests that no Carried Interest should be paid on dividend and interest income earned by the Fund with respect to its portfolio investments.
- *US Market Approach:* General Partners and Investors often take the approach that dividends and interest income should be included in the calculation of the Carried Interest based upon two theories: (i) that Investors' returns should be based upon a cash-in, cash-out model, including dividends, interest, payment of management fees, and organizational expenses, and (ii) failure to include dividends and interest from the Carried Interest causes a misalignment of interest between the GP and the investors.
- *UK Market Approach:* all amounts of "income", as that term is defined in the relevant limited partnership agreement are allocated and distributed in accordance with the distribution waterfall (i.e. are included for the purposes of calculating the carry). The arguments in favour reflect those posited above by US GPs and Investors.
- Practically, most Venture Capital and Leveraged Buyout Funds do NOT receive interest and dividends so this issue is generally insignificant.

Break-Up Fees and Commitment Fees – In all Funds, break-up fees and commitments fees are included in the calculation of the Carried Interest

Short-Term Investment – In all Funds, short-term interest income is excluded.

Carried Interest – Calculation of Profits

- Hedge Funds: Hedge Funds generally invest in marketable securities for which market quotations are readily available. As a result, most Hedge Funds define and calculate profits and losses by reference to both realized and unrealized gains and losses with respect to its investments.
- Venture Capital and Leveraged Buyout funds generally invest in illiquid securities. As a result, most VC and LBO funds calculate profits and losses by reference to only realized gains and losses.
 - An exception to this model relates to distributions of securities in-kind. In such event, the calculation of profits and losses does include the unrealized gains and losses with respect to such securities.
- Management Fees and Organizational Expenses: The issue is whether profits should take into account amounts attributable to Management Fees and Organizational Expenses.
 - *ILPA Principles*: The best practices are that such fees and expenses should be included in full in determining the profits attributable to the realized investments as quickly as possible. (as opposed to pro rata as discussed below)

Carried Interest – Calculation of Profits

- *US Market Standard:* Include such fees/expenses in the calculations of profits but reduce the profits on the realized investment by only a portion of the total amount of the Management Fees and Organizational Expenses corresponding to the portion of the total capital contributions attributable to the realized investment.
- *UK Market Standard:* The GP receives a priority distribution out of profits to cover the management fee and will be responsible for paying the fee to the manager out of the GP profit share. Before profits arise, the GP will be entitled to “borrow” the amount required out of drawings from the limited partners against their commitments, to be repaid out of the priority profit share in due course. Organizational and/or formation expenses of a Fund will frequently be paid by the fund itself up to a specified limit, with any excess for the account of the general partner or set off against the management fee.
- *European Market Standard:* The manner in which profits are calculated, allocated and distributed varies depending on the European jurisdictions and the particular vehicle utilized in that jurisdiction.

Carried Interest – Timing Issues

- Issue Generally: Whether the Carried Interest is calculated on a deal-by-deal basis or on an aggregate basis and, if the latter, whether that is based upon the total unreturned capital contributions made by the investors on realized and unrealized investments or just realized investments (and unrealized investments that have been written down for financial reporting purposes).
- *US and UK Model*: Deal-by-deal basis by reference to realized investments.
- *European Model* (increasingly being accepted in the US and UK): Aggregate basis based upon unreturned capital contributions on realized and unrealized investments.
- *ILPA Principles*: Restrict calculations of the Carried Interest until the investors have recovered 100% of their Capital Contributions on realized and unrealized investments.
- *US Market Trend*: Most US VC and LBO funds assume that all unrealized investments will generate proceeds equal to their book/carrying value. As a result, they calculate the Carried Interest based upon an aggregate approach but only with respect to realized investments (and unrealized investments that are written down). As a result, the US market trend is NOT to return all Capital Contributions on unrealized investments unless such unrealized investments have been written down for financial reporting purposes.

Preferred Returns – Generally

- Standard in the Industry
 - Leveraged Buyout Funds and Fund of Funds: Preferred Returns are standard
 - Venture Capital Funds: Preferred Returns are less common but are sometimes used to attract institutional investors
 - Hedge Funds: Preferred Returns are rare
- Formulating Preferred Returns
 - Fixed interest rate approach (e.g. 8%) compounding annually (market standard), semi-annually, or quarterly
 - Typically range from 5% to 12%
 - 8% is the current standard
 - Variable interest rate approach (e.g., yield on the 1-year US treasury or the 1-year LIBOR) compounding annually (market standard), semi-annually or quarterly
 - Market Index approach (e.g., S&P 500 index, Thomson Financial US Private Equity Performance Index (PEPI) or Prequin performance benchmarks). The idea with this approach is to create a benchmark for superior performance that relates closely to the investment strategy of the Fund.

Preferred Returns – Calculations

- Issue: Whether Preferred Returns should accrue and be calculated based upon all capital contributions made by the investors or only the capital contributions that are directly attributable to portfolio investments.
 - *ILPA Principles*: All capital contributions, including capital contributions used to fund Management Fees and Organizational Expenses, should accrue the Preferred Return.
 - *US-based Funds* (No Market Standard):
 - Investors are becoming increasingly successful in having the Preferred Return accrue with respect to all capital contributions, including capital contributions attributable to Management Fees and Organizational Expenses.
 - Many sponsors are successful at resisting the accrual of a Preferred Return on capital contributions used to pay Management Fees and Organizational Expenses.
 - *UK-based Funds*: the Preferred Return should accrue on the outstanding balance of all drawn down commitments (including any that were repaid and drawn down again).

Preferred Returns – General Partner Catch-Up

- Pure Preferred Returns (or Hard Preferred Returns): The Carried Interest is applied only to profits in excess of the specified Preferred Return.
 - This has the effect of reducing the Carried Interest as a percentage of the Fund's total profits.
- Preferred Returns with GP (UK: Carried Interest Partner) Catch-Ups (or Hurdle Rates): Investors are provided a preferential return but then the GP (UK: Carried Interest Partner) is thereafter entitled to receive a share of the profits that exceeds the Carried Interest percentage until, on a cumulative basis, the GP (UK: Carried Interest Partner) has received the agreed Carried Interest percentage on the aggregate profits. In the case in which there are substantial profits in the Fund, the GP (UK: Carried Interest Partner) Catch-Up can eliminate the economic effect of the Preferred Return, other than the timing difference.
 - Example (US and UK except that a priority distribution of management fees to the GP is required): Distributions of Cash are to be distributed according to the following:
 - First, 100% to the investors until they receive their Preferred Return;
 - Second, 100% to the GP (UK: Carried Interest Partner) until the GP (UK: Carried Interest Partner) has received 20% of the cumulative amounts distributed with respect to the Preferred Return and this catch-up provision; and
 - Finally, 80% to the investors and 20% to the GP (UK: Carried Interest Partner).

Example – US Based PE Fund*

- Distributions of Distributable Cash Attributable to Portfolio Investments. Distributable Cash attributable to any Portfolio Investment (including income from Permitted Temporary Investments realized pending investment in such Portfolio Investment or pending distribution of Distributable Cash relating to such Portfolio Investment) shall initially be apportioned among the Partners (including the General Partner) in proportion to their respective Percentage Interests relating to such Portfolio Investment. The amount apportioned to any Limited Partner pursuant to the preceding sentence shall then be immediately reapportioned as between such Limited Partner on the one hand and the General Partner on the other hand and distributed as follows:
 - (i) Return of Capital and Costs. First, 100% to such Limited Partner until such Limited Partner has received cumulative distributions from any dividends or interest income received by the Partnership and paid to the Partners pursuant to any other provision of this Agreement and from distributions attributable to all Realized Investments in an amount equal to the sum of: (A) the aggregate of such Limited Partner's Capital Contributions relating to all Realized Investments, and (B) the product of: (x) such Limited Partner's Capital Contributions which were applied to the payment of all Offering Expenses, Organizational Expenses and Partnership Expenses (including Management Fees) and (y) a fraction, the numerator of which is such Limited Partner's Capital Contributions relating to all Realized Investments and the denominator of which is such Limited Partner's Capital Contributions relating to all Portfolio Investments;
 - (ii) Preferred Return. Second, 100% to such Limited Partner until the excess of: (A) the cumulative distributions to such Limited Partner attributable to all Realized Investments over (B) the amount described in (i) above with respect to such Limited Partner, equals eight percent (8%) per annum cumulative return, compounded annually, on the amount so described in (i) above;
 - (iii) General Partner Catch-Up. Third, 100% to the General Partner to the extent, if any, necessary so that the cumulative distributions to the General Partner relating to such Limited Partner equal 20% of the sum of the cumulative distributions to such Limited Partner attributable to all Realized Investments (other than such distributions described in (i) above plus the cumulative distributions to the General Partner relating to such Limited Partner; and
 - (iv) 80/20 Share. Thereafter, 80% to such Limited Partner and 20% to the General Partner.
- Distributions of Distributable Cash Not Attributable to Portfolio Investments. Distributable Cash not attributable to Portfolio Investments shall be distributed to all Partners (including the General Partner) in proportion to their respective proportionate interests in the Partnership property or funds that produced such Distributable Cash, as reasonably determined by the General Partner.

* Note: First, this example includes the following concepts: (i) an aggregate distribution approach whereby distributions are done based upon all investments rather than on a deal-by deal basis except that the return of capital is based only on realized investments; (ii) a return of capital contributions used to fund management fees and organizational expenses; (iii) a preferred return that includes an accrual for management fees and organizational expenses as well as a general partner catch-up provision; and (iv) a provision that short-term investments are not included in the carried interest calculation. Second, defined terms used herein are explicitly defined in the limited partnership agreement.

Example – UK Based PE Fund¹

- **Distributions of Income and Capital:** All amounts allocated to the General Partner, the Limited Partners and the Carried Interest Partner shall, after payment of or making appropriate provision (if any) for costs, liabilities, Tax, expenses and working capital requirements of the Partnership and taking into account where appropriate payments (if any) required to be made to Defaulting Limited Partners, be distributed in the following order:-
 - (i) General Partner Management Fee: firstly to the General Partner in respect of the amounts payable to the General Partner in relation to the Priority Profit Share (i.e. management fee) which have not been paid;
 - (ii) Return of Limited Partner Loans²: secondly to the Limited Partners (pro rata to their respective Capital Contributions) until they have received back their aggregate drawn down Commitments;
 - (iii) Preferred Return: thirdly to the Limited Partners (pro rata to their respective Capital Contributions) until aggregate distributions under this paragraph (c) are equal to the Preferred Return (8%);
 - (iv) Catch-up: fourthly 80% to the Carried Interest Partner and 20% to the Limited Partners (pro rata to their respective Capital Contributions) until the Carried Interest Partner has received amounts equal to 20% of the total amounts distributed to Limited Partners under paragraph (iii) above and to the Limited Partners and the Carried Interest Partner under this paragraph (iv); and
 - (v) 80/20 Share: thereafter 80% to the Limited Partners (pro rata to their respective Capital Contributions) and 20% to the Carried Interest Partner,

provided always that each of the above sub-clauses shall be reapplied de novo in respect of each new distribution and in all cases after payment of or making appropriate provision (if any) for costs and expenses and working capital requirements of the Partnership and taking into account where appropriate payments (if any) required to be made to Defaulting Limited Partners.

¹ First, this example includes the following concepts: (i) payment in accordance with the distribution waterfall is made after payment of or provision for costs, liabilities, taxes, expenses and working capital requirements of the Partnership; (ii) a “whole fund model” approach whereby the limited partners must be repaid all of their drawn-down loans and preferred return before the carry begins to operate; and (iii) a priority distribution to the General Partner, made for VAT purposes (to be discussed in another presentation). Second, defined terms used herein are explicitly defined in the limited partnership agreement.

² UK LPs are funded by each investor making a capital contribution of a nominal amount only and the rest of its investment by way of a loan to the limited partnership. The reason for this is that the capital contribution represents the amount of the liability of each limited partner to third parties and that liability remains, even if the capital is returned to the limited partners.

Further information

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