Private Equity Fund Fees

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Understanding Fund Fees

• The key economic incentive for investors in a private equity fund is the opportunity to earn a high rate of return on their invested capital.

• The key economic incentives for sponsors of the fund, on the other hand, are to earn management fees and a profit participation on the fund’s investments (i.e., the carried interest).
Carried Interest and Management Fees

**Carried Interest**

- The general partner will be entitled to a profits participation (also known as “carried interest,” “performance allocation,” “promote,” “promoted interest” and “override”) – usually a set percentage of profits (typically 20%, but can be higher or lower).

- The amount of the carried interest and the manner in which it is distributed will be set out in the distribution waterfall of the fund’s partnership or operating agreement.

- Distributions of carried interest will typically be subordinated to the return of capital contributions and the preferred return to the fund’s investors.

- The timing of the payment of carried interest is unpredictable; it depends on the profitability of the fund’s investments and because payments are lower in priority to various payments to the fund’s investors.

- Carried interest is generally taxed as a capital gain to the general partner of the fund.
Carried Interest and Management Fees

Management Fees

• In addition to the carried interest, the investment manager or advisor of the fund will receive management fees (typically 1.5%-2% of total committed capital) in exchange for its investment advice rendered to the fund and to the fund’s general partner.

• Management fees are used to cover the overhead costs of a fund’s operations.
  – salary of management company personnel
  – health benefits to personnel
  – rent costs
  – day-to-day costs of operations
  – costs of monitoring existing investments

• Management fees are:
  – Paid in regular intervals (usually on a quarterly or semi-annual basis), whether or not an investment has been sold at the time of payment.
  – Typically taxed as ordinary income.
  – Typically paid from two principal sources: (i) the investors’ capital contributions to the fund, and (ii) the proceeds from the fund’s investments.

• Typically, although not always, as investors make capital contributions to the fund to cover management fees, there is a reduction in their unfunded capital commitment available to make investments.
Management Fees

Typical Structure

• The market rate for management fees is approximately 1.5%–2% of the fund’s aggregate capital commitments during the fund’s investment period (i.e., the first three to five years of a fund during which it is allowed to invest in new portfolio companies).

• Often, after the end of the fund’s investment period, the management fee is reduced to a:
  – percentage of actual invested capital; or
  – reduced percentage of overall original committed capital.

• Management fees are usually the complete liquidation of the fund and funded out of investors’ capital commitments or the fund’s operating cash flows.

• However, management fees may be charged to investors in addition to their capital commitments to the fund.
Deviation from the Typical Market Structure

Management fees often deviate from the market rate of 1.5%-2% of the fund’s capital commitments:

- Larger funds and funds with less oversight and monitoring requirements typically charge lower management fees.
- Mezzanine Funds — historically 1.5% management fees.
- Smaller, First-Time Funds — may have management fees of 2.5%.
- Real Estate Funds — management fees often charged based on the amounts invested in properties.
- Side-by-side Vehicles — investors in the co-investment entities are often charged less than 2%.
- Fund managers forego market rate management fees.
Institutional Limited Partners Association (ILPA)

ILPA has released the Private Equity Principles to encourage discussion between limited partners and general partners regarding fund partnerships. The principles were developed with the goal of improving the private equity industry for the long-term benefit of all its participants by outlining a number of key principles to further partnership between limited partners and general partners.

ILPA on Management Fee Structures

- Management fees should be based on reasonable operating expenses and reasonable salaries, as excessive fees create misalignment of interests.
- During the formation of a new fund, the GP should provide prospective LPs with a fee model to be used as a guide to analyze and set management fees.
- Management fees should take into account the lower levels of expenses generally incident to the formation of a follow-on fund, at the end of the investment period, or if a fund’s term is extended.
Differing Management Fees Charged to Investors

Different investors in the same fund may be charged different management fees.

- Larger investors may require reduced management fees.
- Affiliates or other employees of the investment manager who invest in the fund are often not charged management fees.
- Having different management fees (other than with respect to insiders) can make it more difficult to market a fund, especially a fund where investors receive “most favored nations” rights.
Other Fees and Management Fee Offsets

The partnership/operating agreements of funds typically contain management fee offset provisions, which provide for reductions of management fees if the investment manager or its affiliates receive transactional fees directly from the fund’s portfolio companies. Management fees are routinely reduced by 50%–100% of transaction fees, which include:

- Break-Up Fees
- Directors Fees
- Advisory and Similar Fees
- Acquisition and Disposition Fees
- Affiliate Service Fees

Large fee offsets can present tax issues because the investors may be viewed as sharing an income for services performed by the management company (which are taxed at ordinary income rates), rather than investment income (taxed at preferential, long-term capital gains rates).

*ILPA on General Partner Fee Income Offsets:*

Transaction, monitoring, directory, advisory, exit fees, and other consideration charged by the general partner should accrue to the benefit of the fund (i.e., 100% of transaction fees should be offset against management fees charged to the fund).
Transactional Fees

*Break-Up Fees*
Break-up fees are paid to a fund when a target company of a buyout fund wishes to terminate the purchase agreement with the buyout fund because it desires to accept a higher purchase price from another party.

*Directors Fees*
Directors fees are paid by portfolio companies to their directors, including representatives of private equity funds serving on their boards. Directors fees can be paid in the form of cash or options.

*Acquisition and Disposition Fees*
Acquisition and disposition fees may be charged by fund managers to funds or to portfolio companies for structuring and negotiating documentation of investments.

*Advisory and Similar Fees*
Certain types of sponsors (and their affiliates) may provide specialized services to funds and their portfolio companies in addition to fund management services and will charge fees for which there is no or a more limited percentage management fee offset (as these are viewed as “extra” services for which the investment manager is entitled for compensation).
Transactional Fees

Affiliate Service Fees
Funds may engage and pay fees to the affiliates of the general partner in order to provide services to the fund. These services may include placement agent services, underwriting services, consulting services, and debt servicing.

Placement Agent Fees
- Sponsors of private equity funds often engage placement agents to sell the limited partnership interests of the fund.
- Investors are not accustomed to paying for placement fees.
- Placement fees are often not tax deductible by a manager, making the manager reluctant to bear such fees directly. The typical solution is for the fund to bear the placement fee, but require an offset against management fees of 100% of any placement agent fees paid by such fund.
- Typically, there is no management fee offsets for placement agent and finder’s fees paid to entities in connection with their assisting the fund to identify potential investments.
SEC Presence Examination Initiative

- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 eliminated various client exemptions which investment advisors could use to avoid registration under the Investment Advisers Act of 1940. This caused many previously unregistered private fund advisers to register with the Securities and Exchange Commission.
- The SEC staff has been carrying out a program of focused “Presence Exams” of these newly registered advisers.
- Every registered investment adviser is subject to examination by the SEC through the Office of Compliance Inspections and Examinations (OCIE) and its National Exam Program.
- As part of these on-site examinations, the SEC staff requests and reviews the books and records of the adviser, interviews various personnel, and attempts to determine if the adviser is complying with the numerous rules and regulations of the Investment Advisers Act.
SEC Presence Examination Initiative

In May 2014, in a speech by Andrew Bowden, Director of the OCIE, Mr. Bowden reported that, through its Presence Exam initiative, the OCIE had initiated examinations of over 150 newly registered private equity advisors, and had found certain concerning trends regarding private equity fees, including the following:

• “Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors. Poor disclosure in this area is a frequent source of exam findings.”

• “We continue to see “zombie” advisers, or managers that are unable to raise additional funds and continue to manage legacy funds long past their expected life. These managers are incentivized to continue to profit from their current portfolio even though that may not be in the best interest of investors. These managers may increase their monitoring fees, shift more expenses to their funds or try to push the envelope in their marketing material by increasing their interim valuations, sometimes inappropriately and without proper disclosure.”

• “[D]espite the relatively successful performance of the private equity industry, we have observed returns begin to compress and converge. As a result, fewer managers will be able to overcome their preferred return and collect carried interest, which heightens the risk that managers may attempt to make up that shortfall in revenue by collecting additional fees or shifting expenses to their funds.”
SEC Presence Examination Initiative

• “Hidden Fees. Private equity advisors are charging hidden fees that are not adequately disclosed to investors. One such fee is the accelerated monitoring fee, [which] are commonly charged to portfolio companies by advisers in exchange for the adviser providing board and other advisory services during the portfolio company’s holding period. What limited partners may not be aware of is that, despite the fact that private equity holding periods are typically around five years, some advisers have caused their portfolio companies to sign monitoring agreements that obligate them to pay monitoring fees for ten years … or longer. … We see mergers, acquisitions, and IPOs triggering these agreements [which results in] the acceleration of all the monitoring fees due for the duration of the contract, discounted at the risk-free rate. …There is usually no disclosure of this practice at the point when these monitoring agreements are signed, and the disclosure that does exist when the accelerations are triggered is usually too little too late.”

• “Other troubling practices in the hidden fee arena include:
  – Charging undisclosed “administrative” or other fees not contemplated by the limited partnership agreement;
  – Exceeding the limits set in the limited partnership agreement around transaction fees or charging transaction fees in cases not contemplated by the limited partnership agreement, such as recapitalizations; and
  – Hiring related-party service providers, who deliver services of questionable value.”
Further information

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