

ILPA EUROPEAN FORUM

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Private Equity Accounting: Critical Points All Investors Should Consider

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Agenda

- Management Fees
- Expenses
- Distribution Waterfall / Carried Interest
- Deciphering LPA Operational Terms
- Q&A

Management Fees

- Management Fee Structure:

- Depending on the structure this can either be a straight fee charged to the Fund, or a priority share of profits up to a fixed amount
- “Management Fees” - more commonly seen in non-UK Funds
- “GPS / PPS” – more commonly seen in UK Funds and some European Funds
- Accounting perspective (Financial Statements) - Under IFRS and US GAAP, expensed through P&L and not shown as allocation of profits / gains regardless of how these are structured
- Accounting perspective (Capital Statement) – NAV / Capital Account balance will be shown net of Management Fees / GPS / PPS should be recorded by the LPs

Management Fees

- Management Fee Offsets:

- Fee Income / Offset Fees – 100% offset more common; other variations – 80% offset where Management fee is lower %, variable offset - full offset up to level of abort costs and any excess 80% of remaining fees applied as offset
 - Transaction Fees
 - Monitoring Fees
 - Director Fees
 - Underwriting Fees
 - Other Fees – Abort Fees, Advisory Fees
- Excess Organisational Expenses – excess over the specified cap as per LPA offset against Management Fee
- Placement Fees – either borne directly by GP / Manager or offset against Management Fee
- Historically, have noted GP's “deemed contributions” funded by the LPs to be applied as reduction against Management Fee but not common any longer

Management Fees

- Other industry trends / common terms:

- 2% is still more common but seeing more variations recently especially for subsequent funds
- Commitment Period - Common trend for basis of computation is still based on % of total commitment. Variations - % of drawn commitments and reduced % on undrawn commitment
- Post-Investment Period - Common trend for basis of computation is on % of acquisition cost of unrealized investments / outstanding investment contributions (net invested capital). Variations – step down fee year on year
- For some debt Funds, the basis for computation used throughout the term of the Fund is the outstanding balance of principal amounts of loan investments made to investee companies

Management Fees

- Other Industry trends / common terms:
 - Increasing trend of rebates / discounts being offered through side letter negotiations
 - Fee offsets are mostly 100% and placement fees if borne by the Fund will also reduce management fees
 - GPs overall budgets at times are facing increased scrutiny by LPs

Management Fees

- Practical Considerations – Post Investment Period:
 - Calculated on a “daily balance” basis or “as at period end” basis
 - Basis for adjusting disposals and write-offs: partial or full?
 - Post-investment period management fee calculation – flexibility to increase basis of computation as a result of investments being written back

Management Fees

- Key Points from some of the recent SEC investigations:
 - Allocation of Transaction / Monitoring Fees – fees shifted to an affiliated company to avoid Management Fee offset
 - Excessive Monitoring Fees – upon the sale of portfolio companies which in turn affected the value prior to the sale

Management Fees

SIMPLE MANAGEMENT FEE CALCULATION ILLUSTRATION					
Figures in £ '000s					
COMMITMENT	Unaffiliated LPs Commitment	GP Commitment	Total Commitment		LPA Terms
	100,000	1,010	101,010	-	
CAPITAL CONTRIBUTIONS					
Investment Contributions	80,000	808	80,808		Management Fees 2%
(4 equal investments)	20,000	202	20,202 each		Preferred Return 8%
Fund Expenses Contributions	2,000	20	2,020		GP Catch-up 100%
Management Fees	8,000		8,000		Carry % 20%
	10,000	20	10,020		
TOTAL	90,000	828	90,828		
Annual management fees during investment period			Total Mgmt Fees		
Based on Total Commitments, excluding GP (2% x £100,000)	2,000	-	2,000		
Total	2,000	-	2,000	-	
Annual management fees post investment period - Year X			Total Mgmt Fees		YEAR X
Basis of Management Fee computation:					Cost to Unaffiliated LPs
- Investment Contributions	80,000				Investment A Sale 100% 20,000
- Less : Cost of investments sold					Investment C write-down 20% 4,000
Investment A	(20,000)				
- Less: Investments write-off	-				
	60,000				
Total Management Fees	1,200		1,200		
Annual management fees post investment period - Period X+1			Total Mgmt Fees		Period X + 1
Basis of Management Fee computation:					Cost to Unaffiliated LPs
- Investment Contributions	80,000				Investment A Sale 100% 20,000
- Less : Cost of investments sold					Investment B Sale 80% 16,000
Investment A	(20,000)				Investment C write-down 20% 4,000
Investment B partial	(16,000)				Investment D write-off 100% 20,000
- Less: Investments write-off	(20,000)				
	24,000				
Total Management Fees	480		480		

Expenses

- Typical Fund Expenses (Line Items):

- Organisational / Establishment Expenses of the Fund
- Management Fees (Net) – with a separate note to show from Gross to Net with adjustments for rebates and fees offsets
- Other Operating Expenses – with breakdown as a separate note:
 - Deal Fees / Costs
 - Abort Costs
 - Legal and Professional Fees
 - Audit and Tax Fees
 - Administration and Accounting
 - Custody Fees
 - AIFMD / Regulatory expenses
 - Other Expenses – including annual / LPAC meeting expenses (out-of-pocket), bank charges, f/x on working capital etc.

Expenses

- General Partner and Manager Expenses / Overheads

- Typical GP / Manager overheads – Staff cost (salaries, bonuses etc.), office rent, equipment, audit & accounting, legal and professional, utilities and other office expenses, etc.
- LPA should explicitly state - GP and Manager overheads are **not** borne by the Partnership
- Exceptions – some expenses borne by the Fund:
 - Establishment / formation expenses of fund
 - Indemnity insurance
 - Reasonable travel expenses (deal related)
 - External / Non-Exec Director fees (not as common)
 - Other Reimbursements – expenses incurred on behalf of the Fund

Expenses

- Other Points to Note:

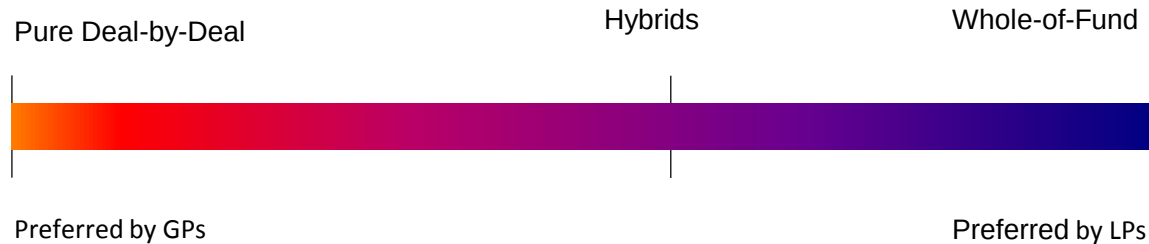
- Organisational Expenses cap – usually lower of 1-1.5% of Total Commitment or “x” amount
- Excess Organisational Expenses – more commonly offset against Management Fees rather than being borne directly by GP / Manager
- Abort Costs cap – sometimes see cap on abort costs for start-up Fund Managers (e.g. based on commitment %)
- Multi-Fund Structures – key to ensure that expenses are allocated accurately across multiple Funds

Expenses

- Key points from some of the recent SEC investigations:
 - Broken Deal Expenses / Abort Costs – amounts allocated 100% to main Funds and no allocation to co-investment vehicles
 - Service Provider Fees – reduction negotiated but benefit not passed on to the Funds and applied to internal entities
 - GP / Manager Overheads Allocation – some of GP's overheads like rent and non-reimbursable travel costs allocated to the Fund

Distribution Waterfall / Carried Interest

- A. Whole-of-Fund (European Waterfall Model)
- B. Deal-by-Deal (Pure)
- C. Hybrids – Cumulative Deal-by-Deal (US Waterfall Model)



Distribution Waterfall / Carried Interest

Whole-of-Fund vs. Cumulative Deal-by-Deal Model:

Whole-of-Fund	Cumulative Deal-by-Deal
• Return of all aggregate contributions • Return of aggregate preferred return • Carry escrow is less critical • Minimises clawback risk (lower risk option) • Emphasises wider accountability and long term approach • From GP perspective may not always be right motivational tool for individual carry holders	• Return of realised capital and costs (additionally - investments written-off) • Return of preferred return on above amounts only (outstanding on unrealised investments and remaining share of expenses) • Carry escrow is important • Higher risk of clawback • Could promote speculative approach amongst some deal team members • Better motivational tool and earlier carry receipts can assist with commitments to subsequent funds

Distribution Waterfall / Carried Interest

SIMPLE CARRY ILLUSTRATIONS

Figures in £ '000s

COMMITMENT	Unaffiliated LPs	GP	Total		LPA Terms
	Commitment	Commitment	Commitment		
	100,000	1,010	101,010	-	
CAPITAL CONTRIBUTIONS					
Investment Contributions	80,000	808	80,808		Management Fees 2%
<i>(4 equal investments)</i>	<i>20,000</i>	<i>202</i>	<i>20,202 each</i>		Preferred Return 8%
Fund Expenses Contributions	2,000	20	2,020		GP Catch-up 100%
Management Fees	8,000		8,000		Carry % 20%
	10,000	20	10,020		
TOTAL	90,000	828	90,828		
Year 5 Distribution Proceeds					
Investment A	100,000	1,010	101,010		PART 1
Investment B	40,000	404	40,404		Unaffiliated LPs GP as investor Total
					Investment A Sale 100,000 1,010 101,010
Total	140,000	1,414	141,414	-	PART 2
					Investment B Sale 40,000 404 40,404
					Investment D write-off 100% 20,000
					Investment C write-down 20% 4,000
TOTAL / WHOLE FUND BASIS WATERFALL	Unaffiliated LPs	Carried Interest Partner	Remaining balance		
			140,000		
Return of cumulative Contributions	90,000		50,000		
Preferred Return @ 8% (approx. and rounded)	32,444	30,000	20,000		
CIP Catch-up		7,500	12,500		
Final Split - 80%LP, 20% CIP	10,000	2,500	-		
Distributable Amount	130,000	10,000			
HYBRID/CUMULATIVE DEAL BY DEAL BASIS WATERFALL	Unaffiliated LPs	Carried Interest Partner	Remaining balance		
			100,000		
Return of Contributions for all Realised Investments	20,000		80,000		
Return of Contributions for any Written-down and / or Written-off Investments	4,000		76,000		
Return of Contributions for Realised Proportion of Expenses and Management Fees	3,000		73,000		
Preferred Return @ 8% (approx. and rounded)	9,733	9,000	64,000		
GP/Carry Partner Catch up		2,250	61,750		
Final Split - 80%LP, 20% CIP	49,400	12,350	-		
Distributable Amount	85,400	14,600			
	Unaffiliated LPs	Carried Interest Partner	Remaining balance		
			140,000		
			100,000		
	40,000		100,000		
	24,000		76,000		
	8,000		68,000		
	25,955	25,000	43,000		
		6,250	36,750		
	29,400	7,350	-		
	126,400	13,600			

Distribution Waterfall / Carried Interest

- Practical Considerations:
- *The two key elements to the Waterfall calculations – Preferred Return and GP Catch-up:*
 - Headline cash (funded contributions) in and out is fairly visible and easy to track
 - It is the components after repayment of contributions (especially preferred return) that are at times harder to see directly
 - For “edge case” scenarios and hard hurdle arrangements the accuracy of the preferred return is critical
 - Also the final split of remaining cash element is straightforward (80/20 or other basis as per LPA)

Distribution Waterfall / Carried Interest

- Practical Consideration:

- Preferred Return:

- Preferred Return structured as Interest Calculation or Internal Rate of Return

Compounded interest computation, typically gives higher return to LPs than Internal rate of return

IRR (XIRR) calculation taking into account cumulative cash inflows and outflows to arrive at a final cash flow (distribution) amount that is required to achieve the stipulated IRR / Hurdle rate

- Drawdown dates - we usually suggest using the drawdown due dates rather than actual payment dates of different investors (unless there are significant delays in actual payment e.g. Default)
- Annual compounding - could be done on calendar year basis or anniversary of first drawdown
- Return of Unused Contributions – usually excluded from the calculation if returned within specified number of days as per the LPA

Distribution Waterfall / Carried Interest

- Practical Considerations:

- GP Catch-up:

- 100% GP Catch-up – straightforward and calculated as a “grossed-up” % of LPs profits distributed
- Split GP / LP Catch-up – have seen different variations – 2/3rd to GP & 1/3rd to LPs, 80% to GP & 20% to LPs and 90% to GP & 10% to LPs. Not complex but slightly trickier than 100% catch-up thus always good to cross check calculation

Distribution Waterfall / Carried Interest

- Recent Trends from our LPA Reviews:

- Type of Models

- 80-85% Whole-of-Fund model and 15-20% Hybrid / Cumulative Deal-by-Deal model
- For Hybrid models, there is a good mix of return of all expenses and pro-rata of expenses

- Preferred Return / Hurdle Rates

- 8% is still the standard

- Escrow Provisions – % of distributions held

- US Funds – typically less than 30%
- European Funds - typically greater than 30%

- Frequency of Clawback

- End of term clawback is still the norm
- Interim clawback mechanisms have been noted in some of the Funds

Deciphering LPA Operational Terms

- Why LPA Operational Terms are important:
 - LPA clauses drive both the commercial / economic and administrative aspects of the Fund / operations and most importantly the GPs returns
 - Alignment of LP and GP interests has been a hot industry theme

Deciphering LPA Operational Terms

- Key Operational Clauses:

Commitments:

- Is there any GP / Affiliate Commitment and in line with minimum expected % of total commitments?
- Are there any special terms for the GP - i.e. GP Commitment not subject to Management Fees and/or carried interest and/or subsequent close interest?
- Is GP Commitment to be funded in cash or by LPs through reduction in Management Fees?

Deciphering LPA Operational Terms

- Key Operational Clauses:

Contributions / Drawdowns:

- Pro-rata basis: Commitment or Undrawn Commitment. Commitment basis generally more common especially with US Funds. European Funds – GP / Sponsor investing – Undrawn Commitment being utilised more
- Terms of drawdown notices: Business / Calendar Days – standard 10 business days. Content of notice – expected to disclose breakdown of drawdown items and investment commentary (subject to any confidentiality restrictions)
- Post investment period terms of drawdown – allowed for follow-up and legally binding investments (usually 15-20% of Commitments cap), fund expenses (including management fees) and indemnity obligations
- Default Partner – default penalty is higher than preferred return rate, default remedies, importantly the impact on non-defaulting partners

Deciphering LPA Operational Terms

• Key Operational Clauses:

Subsequent Closing / Equalisation:

- Final close – common is 12 months. Had seen 15 – 18 months after financial crisis for some new start-up funds (issue with valuation movements)
- Equalisation basis:
 - Should be in line with drawdown basis and ensure all investors (old and new) will be treated in fair / equitable manner as if all had joined the fund on day one
 - Exceptions should be specified clearly – e.g. realised income / distributions to be equalised or not (high income generating fund like debt funds will usually exclude); any adjustments for material changes in investment values
- Subsequent close / equalisation interest:
 - Close to or same as preferred return rate
 - Amounts are outside Commitments and treated as transaction between LPs
 - Two components calculated – on drawn down amounts to be repaid to LPs and other on Management Fee payable to GP / Manager; can be waived under side letters

Deciphering LPA Operational Terms

- Key Operational Clauses:

Distributions:

- Identify methodology – Whole-of-Fund or Cumulative Deal-by-Deal arrangement
- Distribution Cascade – Are the waterfall / distribution cascade clauses clearly laid out, referring to the correct clauses / sub-clauses and maths will work accurately in practice as economically intended especially for Preferred Return (correct %, compounding annually, any exceptions to note) and GP Catch-up (100% GP Catch-up or split catch-up between GP and LPs)
- Cumulative Deal-by-Deal Carry – Other key areas to look out for:
 - Return of funded Expenses – proportionate or in full
 - Write-offs / Write-downs – should generally be included for LP protection
- Preferred Return (as discussed in previous sections)

Deciphering LPA Operational Terms

- Key Operational Clauses:

Distributions:

- Escrow provisions – particularly important for Cumulative Deal-by-Deal arrangements
 - Escrow % - usually see 30% or more for European Funds
 - Release provisions:
 - Interim – Tax distributions allowed, NAV test based on yearly auditor certified valuations
 - Final – Life-to-date waterfall calculation to ascertain overall carry position
- Carry Deferral – GP flexibility to defer carry in favour of higher distributions to LPs for deal-by-deal carry arrangements
- Clawback provisions:
 - Interim – not common but are seeing recently with some of the cumulative deal-by-deal arrangements

Deciphering LPA Operational Terms

- Key Operational Clauses:

Distributions:

- Clawback provisions
- End of term / final – more common, life-to-date waterfall calculation prepared to ascertain overall carry entitlement and net-of-tax carry clawback due (if any)
- Reinvestment – usually flexibility for GP to recycle certain proceeds, common ones - investment proceeds from disposals within X months (usually 12-18) of purchase (up to Acquisition costs); amount to be distributed for return of capital drawn for Management Fee / GPs and at times expenses
- Others – Timing of distributions, distribution in specie, etc.

Deciphering LPA Operational Terms

- Key Operational Clause:

Allocations:

- Allocations should through the fund life be in line with distribution clauses / cascade - the hypothetical NAV is allocated correctly between the LPs and GP assuming at any given point the fund is terminating
 - Key Points:
 - Important to ensure the drawdown basis = distribution basis = allocation basis
 - Side Letters – can vary drawdown, distribution and allocation basis so critical to ensure correct application of side letter terms (technology is key)
 - Multiple Investor Classes / Terms – will require GP to prepare separate carry calculations as applicable
- Management Fee and Expenses (*discussed in previous sections*)

Deciphering LPA Operational Terms

- Key Operational Clauses:

Reports and Valuations:

➤ Reports:

- Accounting Standards – IFRS and US GAAP more common, consolidation exemption available for investment entities
- Frequency – three quarterly + one annual report common. At times see condensed quarterly reports with primary statements and key notes only
- Deadlines – Quarterly 45 calendar days (direct) / 60 business days (FoF); Annual 90 calendar days (direct) / 120 calendar days (FoF)

➤ Valuations:

- PE Funds – IPEV common or in line with accounting standards (Fair Value)
- RE Funds – Independent Valuation (RICS)

Deciphering LPA Operational Terms

- Key Operational Clauses:

Other:

- Definitions – ease of reference, ensure key operational definitions are consistent with the “spirit” of the LPA clauses
- Variation of LPA:
 - GP autonomy – administrative, regulatory changes only
 - LP approval – all variations having economic / adverse impact on LP(s)

Deciphering LPA Operational Terms

- Implications of Commitment vs. Undrawn Commitment basis of Drawdowns:

Commitment basis:

- Straightforward – all drawdowns, allocations and distributions are pro rata to Commitment %s of partners

Undrawn Commitment basis:

- Main reasons – either GP / Sponsor investing fee-free or LPs are subject to different management fee rates
- Varying Undrawn Commitment %s – undrawn commitment %s are going to vary between the GP and LPs (as a group) or between the LPs (in case they are paying different management fee rates). Implications:
 - Investments – all investments (except follow-on) will be shared at different sharing %s
 - Allocations and Distributions – will be based specifically on respective investment %s for profits and cash resulting from different investments

Questions?



Appendix

Distribution Waterfall / Carried Interest

- Whole-of-Fund Carried Interest Model (European Waterfall):

- Whole-of-Fund is the simpler carried interest arrangement and dictates more cash distributed earlier to LPs
- A typical Whole-of-Fund arrangement would work in the following order:
 - *Return of Contributions* - First, to the LPs, until they have been repaid all of their aggregate contributions / drawn commitments
 - *Preferred Return* - Second, to the LPs, in payment of Preferred Return / Hurdle
 - *Catch-up* - Third, to the Carried Interest Partner ("CIP"), a Catch-up amount – allowing for the CIP's returns to catch-up with that of the profit distributed to LPs (for a 20% carry, the catch-up is 25% of the Preferred Return)
 - *Final / Remaining Cash Split* - Finally, 80:20 split (or a different split as per the LPA) between LPs and CIP

Distribution Waterfall / Carried Interest

- Commercial Considerations:

- LP Perspective:

- Low risk arrangement – minimizes clawback risk
- Its fund-level view rewards patience and long term philosophy vs the more speculative approach
- Emphasizes wider accountability for the GP – tasked with profitability of the entire fund over the course of its operation before they can extract any carry profits

- CIP / GP Perspective:

- It may not always be the right motivation tool for the carry holders, especially younger / more junior members of the deal team

Distribution Waterfall / Carried Interest

- Cumulative / Partial Deal-by-Deal Carried Interest Model (US Waterfall):

- Carried interest payments are made out of the returns of a particular investment but overall the carried interest works on a cumulative realised basis
- A typical cumulative Deal-by-Deal arrangement would work in the following order:
 - *Return of Realised Investment Capital* – to LPs, until they have been returned the drawn down capital for **all** Realised Investments (the funded acquisition costs)
 - *Unrealised Investment Write-offs* - any permanent write-offs and / or write downs of unrealised investments are also often returned before the Preferred Return
 - *Return of Fund Expenses / Costs* – to LPs, a proportionate share **or** the full amount of Fund expenses (including deal expenses), Organisational expenses and Management Fees funded by the LPs
 - *Preferred Return* – calculated on contributions returned under above 3 elements
 - *Catch-up and final carry split* – would work similar to whole-of-fund model on profits distributed to LPs to date and remaining cash available split in line with applicable %s

Distribution Waterfall / Carried Interest

- Cumulative / Partial Deal-by-Deal Carried Interest Model (US Waterfall):

- Fund does not have to return capital on investments that still remain unrealised within the Fund

- **Commercial Considerations:**

- LP Perspective:

- Higher risk than whole-of-fund arrangement – greater risk overpaying GP and thus greater clawback risk and limited to net of tax amounts
- Clawback complexities - usually end of life clawback
- Could promote more speculative “one-and-done” approach amongst some deal team members

- CIP / GP Perspective:

- Accelerate the payment of carry to CIP / GP – in turn helping to assist with their capital commitment to subsequent funds
- Better motivation tool for the carry holders, especially younger / more junior members of the deal team

THANK YOU

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