Private Equity Fund Terms Research

2017

MJ HUDSON
LP UNIT

Welcome to the third edition of the MJ Hudson Private Equity Fund Terms report, published by the MJ Hudson **LP Unit**

The **MJ Hudson LP Unit** advises more than 100 institutional investors (representing more than $500bn AuM) on primary and secondary investments into, and co-investments alongside, a wide range of private equity funds.

The fund investment environment.

Despite the mounting challenges of regulation and disintermediation, we find ourselves in a time of almost unprecedented investor interest in private equity funds. Against this backdrop, this report compares the investment terms for private equity fund investments now, with the findings of our previous research and discusses the drivers and implications for both investors and fund managers. The report aims to provide both LPs and GPs with an enhanced understanding of the current strengths and weaknesses of fundamental economic and fund governance terms impacting private equity fund investments.

This year's sample.

This edition presents the **MJ Hudson LP Unit's** review of key economic and non-economic terms across a representative sample of private equity funds that have come to market between April 2016 and the date of this report. Although the data in this report is aggregated from funds encountered by MJ Hudson through our advice to their managers and investors, commentary in the report draws also on our team's broader investor advisory experience.

Fund terms and issues covered.

The report looks at core matters of GP/LP economic alignment: GP Commitments, Management Fees, the Hurdle Rate (aka Preferred Return), innovations in Carried Interest and the Distribution Waterfall (including Catch-up). As we expect LPs overall to increase their allocations to U.S. funds, we pay particular attention to Deal-by-Deal enhancements i.e. Interim Clawbacks (including related issues of single vs. multiple interim clawbacks and FMV tests), carry escrows and guarantees of GP clawback obligations.

Alongside these economic terms, the report examines:

- key investor protections such as Key Person, Most Favoured Nation and GP Removal For and Without Cause;
- investor alignment in the context of Management Fee Offsets, Co-investments and Successor Funds; and
- the extent to which ILPA has been successful in its attempts to standardise GP reporting to LPs, in particular measuring the impact of ILPA's much publicised Fee Reporting Template.

If you have any questions about the report or about the conclusions that are reached within, please contact one of the MJ Hudson representatives listed below - we would be very happy to assist.

Yours,

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Summary of Report Findings

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Interim clawback and guarantees of GP's clawback obligation feature in nearly 75% of deal-by-deal funds

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100% catch-up near ubiquitous, with the vast majority of funds reporting it as fast to the GP

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KEY PERSON

87% of funds automatically suspend the investment period upon a key person event

GP NO-FAULT REMOVAL

68% of funds allow LPs to remove the GP without cause

GP FAULT REMOVAL

In 96% of funds, the GP can be removed for cause

MOST FAVOURED NATION

61% of funds report MFN disclosure right

MANAGEMENT FEE OFFSET

93% of funds reduce the management fee by transaction fees received by the GP and its affiliates

SUCCESSOR FUNDS

93% of funds restrict the GP's ability to raise a successor fund during the investment period

Overview of Report Findings

Improved GP/LP alignment through stronger fund governance

The last year has seen unprecedented investor interest in private equity since the global financial crisis, with record fundraising levels and many LPs signalling their intention to increase allocations to private equity.

However, the number of funds that closed in 2016 decreased when compared with previous years – LPs appear to be investing more capital with a smaller number of proven and well-known GPs, with the largest funds accounting for a greater proportion of overall fundraising.

What impact has this had on fund terms since the previous edition of this report, published in April 2016? Does this mean more GP-friendly terms, with LPs willing to accept weaker protections in order to gain access to these funds?

The data does show lower GP commitments and increased management fees (see Section 3). But, as always, there is a balance to be met - outside of economic provisions, Sections 4 and 5 show many GPs are committed to offering other ways to meaningfully align GP/LP interests through fund governance.

Pro-GP movements in core economic terms?

GP Commitments: counterintuitively, LP pressure on GP commitment has softened

- majority of GPs making 1.5-1.99% commitment c.f. 2016 report data which showed majority of GPs making commitments in 2-2.99% range
- 2017 data suggests that GP commitment is becoming less prominent than other factors in investors' GP evaluation process

Management Fee: 2% dominates

- number of funds charging 2% has increased c.f. 2016 report data, being the dominant fee level by both number of funds and capital (with 62% of capital in 2017 sample attracting 2%)
- 2% dominates small cap funds (<$500m) to large cap funds ($1.5bn-$4.5bn)

Catch-up: 100% is back ... and it's fast

- 100% catch-up near ubiquitous, with the vast majority of funds reporting it as fast to the GP

Drivers for LPs' apparent tolerance of lower GP commitments, increased management fee metrics and 100% fast catch-up to GP:

- Search for yield. In the current low interest rate environment, private equity continues to appeal to LPs looking for high absolute returns and portfolio diversification

- High returns. For the past six years, distributions to LPs have exceed capital calls, and it is the third year in which net cash flows to LPs have been well in excess of $100bn [1]

- LP demand. 2016 was the fourth consecutive year in which private equity fundraising surpassed $300bn. 40% of institutional LPs intend to invest more capital in private equity in the next 12 months then they did during 2016 [2]

- LP liquidity. Many LPs are sitting very liquid as a result of continuing distributions and are reinvesting that liquidity back into private equity funds

1 Source: 2017 Preqin Global Private Equity & Venture Capital Report, page 17.
2 Source: Same as above.

SECTION 1

Overview of Report Findings

But...

Distribution Waterfall: Whole-of-Fund carry dominates Europe and making inroads in North America:

- European Funds: 88% of sampled European funds offer whole-of-fund carry
- North American Funds: 36% of North American funds offering whole-of-fund carry c.f. 2016 data which showed only 20% of North American funds offering whole-of-fund carry

Hurdle Rate: 8% rate still presides

- even though low interest rates have persisted for a number of years, 8% hurdle rate continues to be iron-clad in the private equity market
- 93% of sampled funds report a 8% hurdle rate

And (albeit with some caution)...

Deal-by-Deal Enhancement: interim clawback features in 71% of deal-by-deal funds. **However:**

- mainly based on pro-GP FMV test and only a minority of interim clawbacks have multiple test dates
- emphasis still on getting carried interest out to the GP (and, ultimately, to the fund executives):
  - in our sample, no deal-by-deal fund with an interim clawback offers carry escrow protection, with 80% of such funds offering guarantees as an alternative to escrow restrictions on carry distributions to the GP
  - this raises questions as to the credit worthiness and enforceability of such guarantees

Innovations in Carried Interest.

20% share of a fund's profits arguably remains the general market norm for carried interest. However, our data shows some GPs offering alternatives to the traditional "20%" carry model. At Section 3, we detail some of those variations.

These alternative carry structures suggest that carried interest, properly designed, is a formidable tool to align incentives between the GP and its LPs. Reforms to the taxation of carried interest that are expected on both sides of the Atlantic this year may lead to yet more disruption of the old certainties of "two and 20" model, traditionally an integral part of a private equity fund manager's compensation arrangement.

Stronger fund governance.

When combined with an understanding of why LPs appear willing to tolerate certain pro-GP economic movements, the continued overall gains in fund governance paint an encouraging picture of improved GP/LP alignment.

Compared to the 2016 report findings, there is a strengthening in fundamental investor protections such as key person event, GP cause removal and no-cause removal clauses and MFN disclosure. This edition also reports on the prevalence of management fee offsets and restrictions on raising successor funds, these also being important investor protections.

- Key Person Event: incremental improvement in key person protections:
  - 87% of funds (up from 86% in 2016 data) report automatic suspension of investment period
  - 81% of funds (up from 80% in 2016 data) report automatic termination of investment period
- GP No-Fault Removal: 68% of funds (up from 55% in 2016 data) have a no-fault removal right
- GP Fault Removal: 96% of funds (up from 85% in 2016 data) have a removal for cause right
- MFN Disclosure: 61% of funds (57% in 2016 data) report an MFN clause
- Management Fee Offset: 93% of funds reduce the management fee by transaction fees received by the GP and its affiliates
- Successor Funds: 93% of funds restrict the GP's ability to raise a successor fund during the investment period

SECTION 2

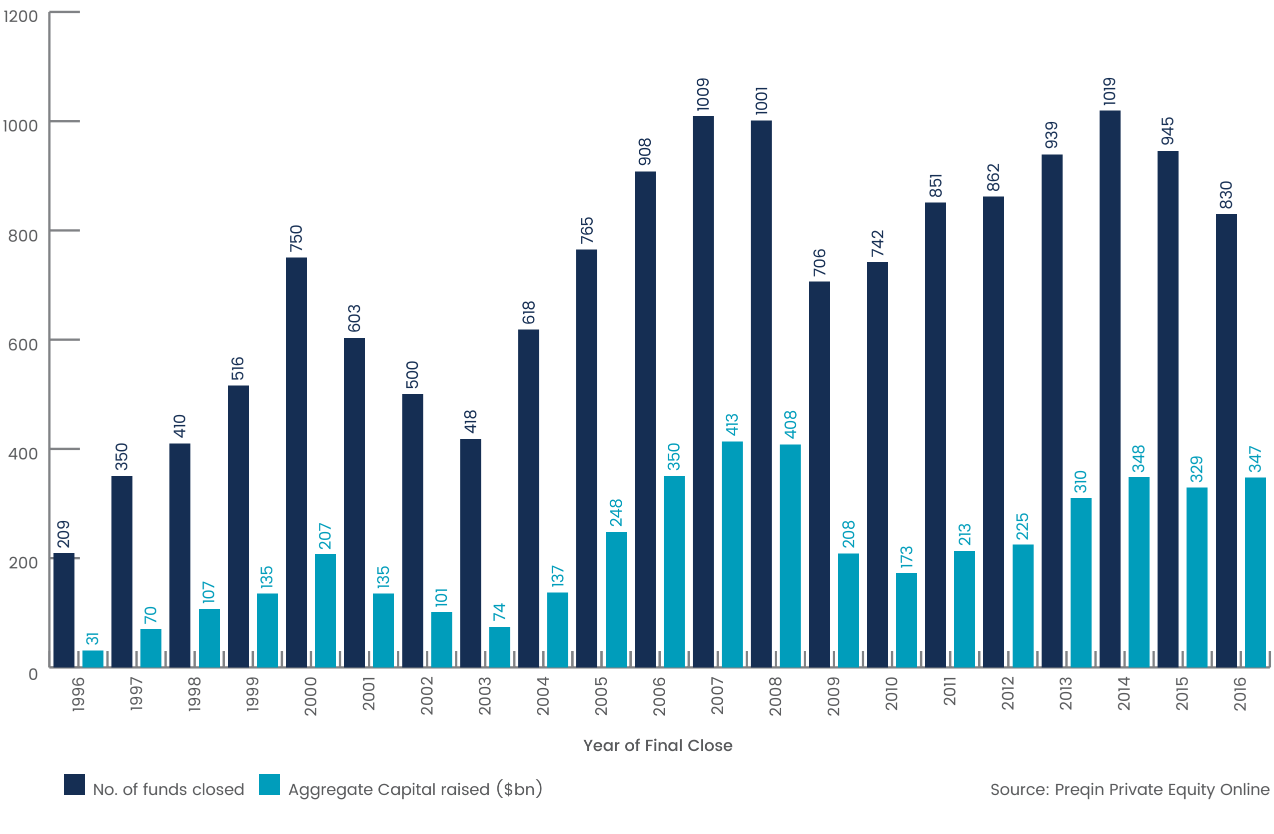
Private Equity Fundraising

Private Equity Fundraising

2016 was one of the best years for private equity since the GFC

Hunger for yield in a low return environment and buoyed by liquidity is driving LP appetite for private equity.

$347bn raised by 830 private equity funds that closed in 2016. This figure is likely to increase as more data becomes available and likely to result in the largest amount of capital raised by private equity funds since the GFC.



Source: Preqin Private Equity Online

Note: Note that the above chart details commitments to private equity funds and does not include "shadow capital" – i.e. private equity commitments to co-investments, direct investments and separate managed accounts – which are more difficult to track accurately.

SECTION 2

Private Equity Fundraising

Fundraising market in a snapshot

LP appetite for private equity is strong but evolving.

LP APPETITE REMAINS HEALTHY	BUT	THAT APPETITE IS CHANGING
86% of LPs intend to make fresh primary commitments to private equity [3]		Many LPs plan reducing number of GP relationships
48% of LPs intend to increase allocations to private equity [4]		Focus on re-ups
57% of institutional LPs have an allocation towards private equity [5]		Increased co-investment and separate managed account activity
		Small but noticeable trend in certain large state pension plan and SWF investors making more direct investments

Investment continues to be concentrated in larger funds.

LPs appear to be investing more capital with a smaller number of proven and well-known GPs, with the largest funds accounting for a greater proportion of overall fundraising.

- 10 largest funds raised 26% (c.f. 17% in 2016)
- Average fund size increased to $471m, an all-time high

Market continues to be tough for others but not at 2016 report levels.

The general LP clamour for private equity has meant that more funds closed and first-time funds represent a greater proportion of capital raised when compared to our 2016 report.

- number of funds closed decreased by 12% (c.f. 24% in 2016)
- first-time funds represented 7% of capital raised (up from 6% in 2016 but still significantly down from 2014)

Otherwise a robust fundraising environment...

- exceeding target size: many funds which closed in 2016 exceeded target size [6]
- reaching final closing quicker: on average, funds which closed in 2016 reached final closing in around 14 months, the lowest figure in any year during the period 2009-2016 [7]

3 Source: 'Full steam ahead', Private Equity International's 2017 Perspectives, p.4, December 2016/January 2017.
4 Source: The Preqin Private Capital Fund Terms Advisor report, page 18.
5 Source: The Preqin Private Capital Fund Terms Advisor report, page 17.
6 Source: The Preqin Private Capital Fund Terms Advisor report, page 33.
7 Source: Same as above.

SECTION 3

Core Economic Terms

Core Economic Terms: GP Commitments

Less is more? Reversal in trend for GPs to put more ‘skin in the game’

1.5-1.99% is main minimum GP commitment, down from 2-2.99% in 2016 report. Many LPs are committing to funds where the GP has a relatively smaller amount of “skin in the game” c.f. 2016 data despite the variety of GP-friendly financing models available.

By Number of Funds

Fig 1: 2016 GP Commitments

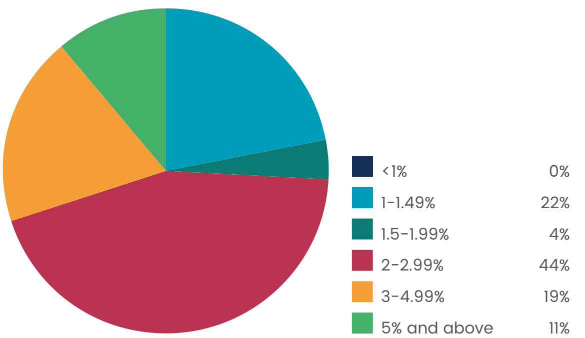
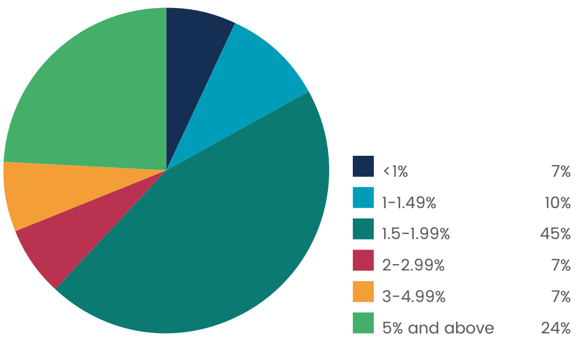


Fig 2: 2017 GP Commitments



Though perceived as the epitome of GP/LP alignment, our 2017 findings show that counterintuitively LP pressure on GP commitment has softened when benchmarked against the 2016 findings:

- 1.5-1.99% range is now the majority GP position with a corresponding collapse in the number of GPs with commitments of 2-2.99%
- new trend is the emergence of a small minority of GPs with sub-1% commitments, something entirely new when contrasted with our 2015 and 2016 findings
- however, number of GPs with 3+% commitments remains comparable with the 2016 data, with a doubling in the number of GPs with commitments at 5% or more

2017 data suggests that GP commitment is becoming less prominent than other factors in investors’ GP evaluation process. If this trend away toward proportionately smaller GP commitments continues into 2018, LPs with alignment concerns may try to temper it by looking at:

- **How the GP commitment is being financed?** this could lead to greater pushback against some of the more GP-friendly models available e.g. management fee waivers, bank debt financing or contributions-in-kind

- **Who is participating in the GP commitment?** across our 2015, 2016 and 2017 findings, fund managers often defined the GP class quite broadly - so a large chunk of the GP commitment may not actually be funded through the personal resources of the fund’s own managers

SECTION 3

Core Economic Terms: Management Fee

Management Fee during the Investment Period

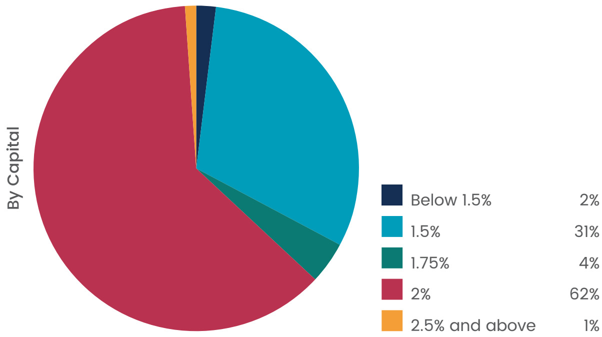
Because you're worth it? Management Fees on the tick up with 2% dominating when measured by both number of funds and capital.

- number of funds charging 2% has increased
  - 62% of capital in 2017 sample attracts this fee level
  - 2% dominates small cap funds (<$500m) to large cap funds ($1.5bn-$4.5bn)
- drop in the number of funds charging 1.5%
  - nevertheless, 31% of capital in 2017 sample attracted this fee level, making 1.5% the second most prevalent management fee level after 2% when measured by capital
  - but 1.5% concentrated among mega-funds (>$4.5bn)
- number of funds charging 1.75% has significantly fallen
  - only 4% of capital in 2017 sample attracted this fee level
- number of low cost (i.e. sub-1.5%) funds has roughly halved since 2016 report

Fig 3: 2016 Management Fees (Investment Period)

Fig 4: 2017 Management Fees (Investment Period)

Fig 5: 2017 Management Fees (Investment Period)



Despite our findings, it is becoming harder to gauge a fund's true level of fees because of:

- **Management fee discounts**
  Management fee discounts being offered to select LPs, typically "early bird" LPs (i.e. first-closers), LPs making big commitments, and as a reward if a LP in the GP's predecessor fund re-ups into the next fund

- **Side deals**
  Growth in LP-specific side deals that remain undisclosed or, if disclosed, are not available to the LP base as a whole

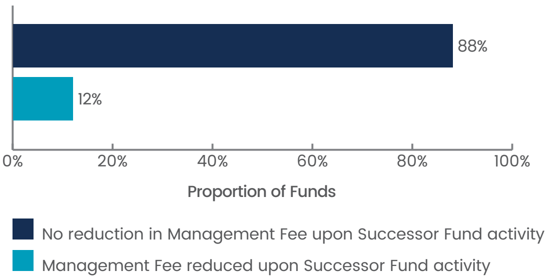
Step down in the Management Fee during the Investment Period

Many sampled funds report stepping down the management fee, either temporarily or permanently, during the investment period in one or more the following situations: a key person event; an unauthorised change of control; and/or (typically) when fees begin to accrue or be paid in respect of a successor fund.

Key person event.

For funds that suspend the investment period upon a key person event, Fig.6 details the proportion of those funds stepping down the management fee during the period of suspension:

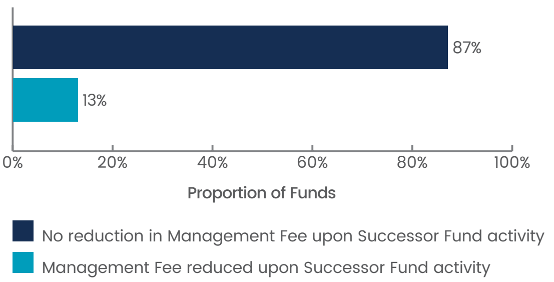
Fig 6: Management Fee Step Down due to Key Person Event



Unauthorised change of control.

For funds that suspend the investment period upon an unauthorised change of control, Fig.7 details the proportion of those funds stepping down the management fee during the period of suspension:

Fig 7: Management Fee Step Down due to an Unauthorised Change of Control



Successor fund.

For funds allowing a successor fund to be raised prior to the end of the investment period, Fig.8 details the proportion of those funds where the investment period is deemed ended and the post-investment period step down in the management fee inaugurated where, for example, fees begin to accrue or be paid in respect of the successor fund. In turn, Fig.9 details the types of successor fund activity that triggers such step down.

Fig 8: Management Fee Step Down upon Successor Fund activity

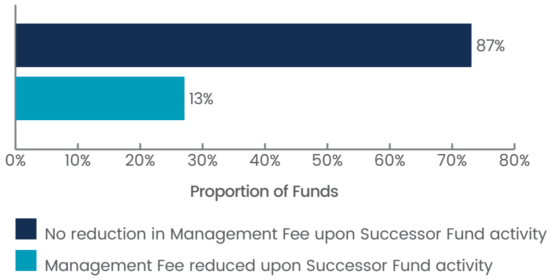
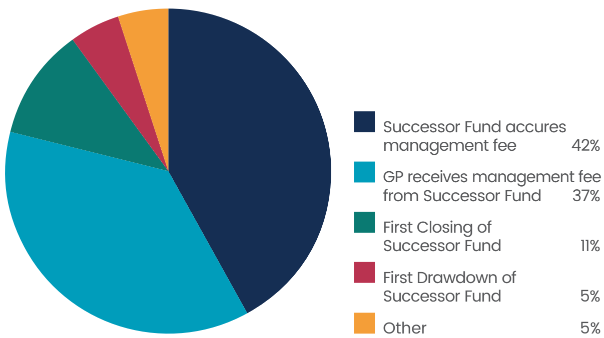


Fig 9: Types of Successor Fund activity triggering Management Fee step down



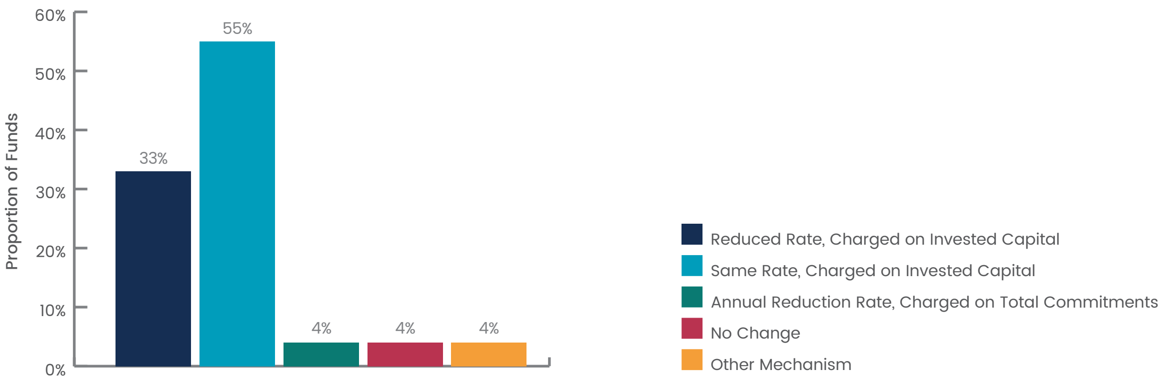
Management Fee after the Investment Period

Base to which management fee rate is applied almost universally switches from commitments to invested capital at the end of the investment period.

Fig.10 shows the proportion of sampled funds using different mechanisms for reducing after the investment period the management fee and by strategy:

- most prominent method utilised is to charge the same percentage management fee rate, applied to the cost amount of capital actually invested by the fund at that point in time
- next most prominent mechanism employed to management fees during the post-investment period is to reduce the percentage rate charged on invested capital

Fig 10: 2017 Mechanisms for reducing Management Fee after Investment Period



Core Economic Terms: Hurdle Rate and Carried Interest

8 continues to be the magic number

Good for LPs - even though low interest rates have persisted for years, the customary 8% hurdle rate continues to be iron-clad in the private equity market.

2017 data reveals:

- 93% of sampled funds having a hurdle rate of 8%
- only 7% of sampled funds had a lower hurdle, in all cases at 0%

2017 findings see continuity with the 2015 report data, where 93% of capital raised was with the 8% hurdle rate (and similarly 7% was committed with a lower, often 0% hurdle).

This corrects the anomaly in the 2016 data, which reported less than two-thirds of capital raised with a hurdle of 8% - two large funds ($25bn in total) raised by Advent International dropped the hurdle altogether, thus skewing the 2016 data.

Points to note:

- is the 8% compounded or just a simple 8% return?
  - if only a simple return, depending on the investment strategy, the actual returns may be lower than 8%
  - it is often a matter of commercial due diligence for a LP to satisfy itself that it is comfortable with the hurdle approach

- ILPA recommends that it should be contractually clear the hurdle rate is calculated from the day capital is contributed to the date of distribution

Innovations in Carried Interest

20% share of a fund's profits arguably remains the general market norm for carried interest. However, our data shows some GPs offering alternatives to the traditional "20%" carry model, including the following variations:

- **Super carry**
  A handful of top-tier GPs have been able to negotiate "super carry" i.e. carried interest fixed at a higher percentage level than the traditional 20%
- **Ratchet-based carry**
  Seeks to reward the GP with a higher carry percentage as the fund achieves certain benchmark cash multiples e.g. carried interest set at an initial 10% until the fund returns 2x the amount of LPs' called capital, then ratchets up to 20% until the fund returns 3x LPs' capital, and ratchets up to 30% above the "3x" multiple
- **Deal-by-Deal carry enhancements / hybrid carry**
  Seeks to address LPs' concerns about deal-by-deal carry by augmenting it with various LP-protective features to make it behave more like whole-of-fund carried interest e.g. by instituting interim clawbacks along with escrowing some of the carry and/or offering guarantees of the GP's clawback obligation. Discussed further in this Section 3 under "Deal-by-Deal Enhancements in U.S. Funds"
- **Hybrid carry twist**
  A take on hybrid carry that diverts deal-by-deal carry distributions to the LPs until they have received amounts equal to the sum of called capital, preferred return and undrawn capital. The LPs themselves do not have to return diverted carried interest to the fund but subsequently the GP is allowed to catch-up on the diverted distributions
- **Dual waterfall carry**
  LPs choose type of carry to pay: a whole-of-fund carry waterfall in which the LP is charged the full management fee or an alternate waterfall in which the LP pays deal-by-deal carry in exchange for discounted fees
- **Blended carry**
  Blends management fees and carried interest into a single performance-based fee. The fund marks its assets to market daily, with the performance fee accruing only on those days when (and by how much) it outperforms a benchmark stock market index, with the fee accrual being reversed on days when the fund underperforms the benchmark

The above new variants suggest that carried interest, properly designed, is a formidable tool to align incentives between the GP and its LPs.

Core Economic Terms: Distribution Waterfall

Whole Fund vs. Deal-by-Deal

Whole-of-Fund carry resumes dominance in Europe and makes inroads in North America

North American Funds.

U.S. market responsive to LP appetite to adopt European-style waterfall.

Deal-by-deal carry still predominates but less than in 2016 with swing back to lower 2015 report levels – indicates continuing LP pressure on U.S. funds to have European-style waterfall.

European Funds.

Whole-of-Fund carry, regains pole position.

88% of European funds in 2017 data sample report whole-of-fund carry, reversing this somewhat anomalous 2016 insurgent appearance of a sizeable minority of European funds with deal-by-deal carry.

North American Funds	Year	European Funds
68% of North American funds offered deal-by-deal carry	2015	All European funds offered whole-of-fund carry
In 2016, 80% offered deal-by-deal carry	2016	2016 was an usual year for European funds, with 33% offering deal-by-deal carry
But in 2017, swing back to 2015 levels with 64% of North American funds offering deal-by-deal carry	2017	2017 reverses (anomalous) 2016 trend, with 88% of European funds offering whole-of-fund carry

SECTION 3

Core Economic Terms: Distribution Waterfall

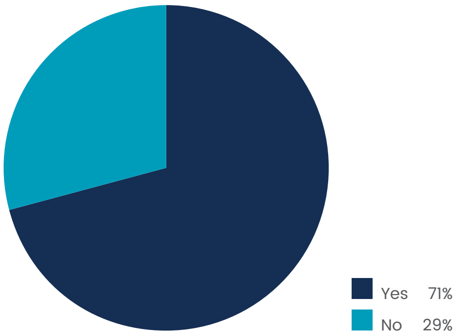
Deal-by-Deal Enhancements in U.S. Funds

Interim Clawbacks.

Progress - interim clawbacks feature in majority of deal-by-deal funds. But... only a minority of interim clawbacks have multiple test dates and predominately based on pro-GP fair market value ("FMV") test.

LP pressure seems to have paid off – 71% of sampled deal-by-deal funds offer an interim clawback:

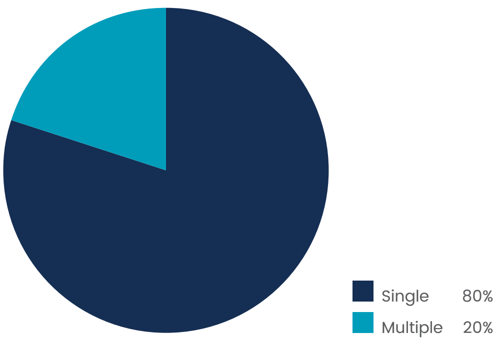
Fig 11: Interim Clawback offered by No. of Deal-by-Deal Funds



Single test Interim Clawbacks - mainly determined on a single date.

However, only a minority of deal-by-deal funds with interim clawbacks have multiple test dates, with a clear majority determined on a single date:

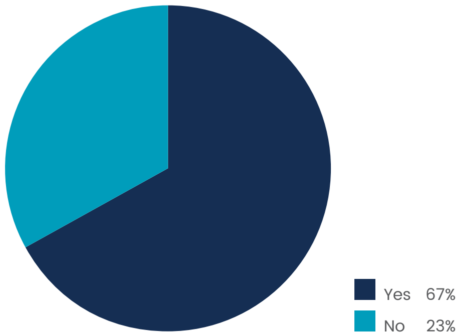
Fig 12: Single vs. Multiple Interim Clawback



Interim Clawbacks - FMV test.

Interim clawbacks are still predominately based on a FMV hypothetical sale of the entire portfolio:

Fig 13: Interim Clawbacks based on Hypothetical FMV Sale of Entire Portfolio



- FMV test is predominate U.S. market practice (c.f. European general market practice of a nil-value hypothetical sale test)

- FMV test is GP-friendly that risks carry overpayment, especially in a deal-by-deal context

SECTION 3

Core Economic Terms: Distribution Waterfall

Deal-by-Deal Enhancements in U.S. Funds

Carry Escrows.

Lack of escrow protection in deal-by-deal funds.

Only 14% of deal-by-deal funds reviewed provide escrow protection. Breaking that down:

- no deal-by-deal funds with an interim clawback provide carry escrow protection
- 50% of deal-by-deal funds with no interim clawback provide for an escrow, requiring 25% of carried interest otherwise distributable to the GP to be deposited into a carry escrow account

Guarantees.

Guarantees offered by majority of deal-by-deal funds, as an alternative to carry escrows.

71% of deal-by-deal funds sampled back up the GP's obligation to return excess carry with guarantees.

> To an extent, this offsets the overall lack of carry escrow protection across deal-by-deal funds
>
> However, raises questions as to the credit worthiness and enforceability of such guarantees, particularly where carried interest is onwards distributed or assigned along with the churn within fund houses of executives who have received or entitled to carried interest

Of those deal-by-deal funds offering guarantees:

- 80% of such funds have guarantees from direct or indirect members of the GP entitled to receive onward distributions of carried interest received by the GP; the remaining 20% have guarantees from the parent sponsor
- 80% of deal-by-deal funds with an interim clawback offer guarantees
- 50% of deal-by-deal funds with no interim clawback offer guarantees

Catch-up

100% catch-up is back ... and it's fast.

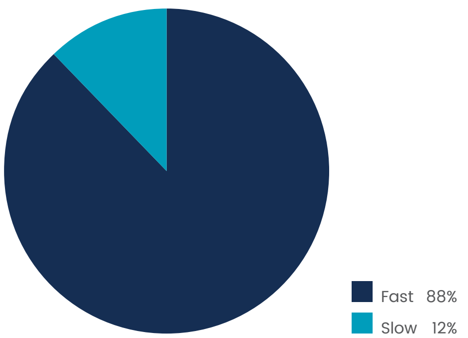
93% of funds sampled build in 100% catch-up

- only 7% of funds have no catch-up but only in 50% of such funds is this in favour of a lower hurdle

Fig 14 shows that where the catch-up features, it is fast:

- 88% of funds with 100% catch-up distribute all post-hurdle distributions to the GP until the GP has fully caught up. In other words, the catch-up is fast to the GP
- 12% of funds feature a 'slow' catch-up, mainly featuring in funds with tiered distribution waterfalls with either the first or second catch-up slowed

Fig 14: 'Fast' Catch-up vs. 'Slow' Catch-up



SECTION 4

Key Investor Protections

Key Investor Protections: Key Person and Most Favoured Nation (MFN)

Key Person protections consistent across 2016 and 2017 data, however standards vary between funds

Automatic suspension of Investment Period.

87% (up from 86% in 2016 data) report key person event triggering automatic suspension of investment period.

Automatic termination of Investment Period.

81% (up from 80% in 2016 data) report key person event triggering automatic termination of investment period if suspension of investment period not lifted within prescribed time limits.

Though Key Person protection is now commonplace across all direct private capital fund-types, nevertheless the extent and strength of that protection varies across funds, including (but not limited to) the following:

- substantially *all* business time and attention vs. substantial *majority* business time and attention. For direct funds, former is preferable

- dilution of time and attention standard - time spent on existing, successor and predecessor funds increasingly extended to include co-investment vehicles, alternative investment vehicles and sponsor group members

- duration of suspension of investment period - 6 months, 9 months, 12 months? 12 months is excessive

- is the GP required to propose replacement key persons? If so, how long does the GP have to propose replacements for LPAC/LP approval?

More funds providing MFN right - 61% of funds report an MFN clause

Up from 57% in 2016 data. However, GPs giving with one hand and taking with the other

- increasing number of carve outs from the scope of MFN electability blunts the increased prevalence of MFN clauses
- tiered MFN clauses not only continue to be a trend but 'tiers' also increasingly being applied to disclosure itself i.e. the right to see an LP's side letter is restricted to those LPs who have subscribed at least the same commitment

Key Investor Protections: GP Removal - Without Cause

GP Removal - Without Cause

It's you, not me - 68% of funds (up from 55% in 2016 data) have no-cause removal right

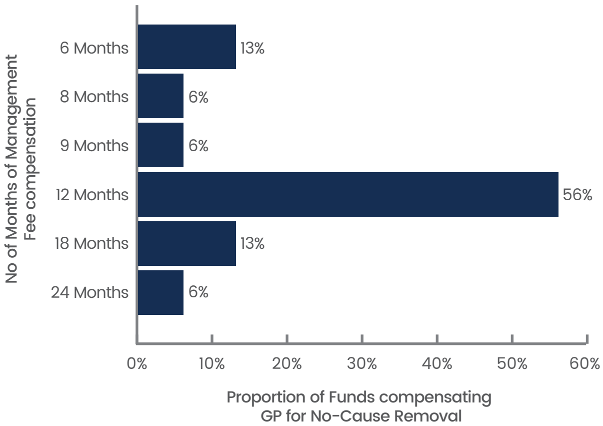
Super-nuclear option for LPs, often where GP turns in bad performance or GP/LP relationship is dysfunctional. However, very rarely invoked.

LPs becoming more (re)assertive? Possibly - 2015 report data reported 66% of funds having no-cause removal right but contracted to 55% in 2016 data.

However, a deeper analysis of the 2017 data suggests GPs are tempering LP re-assertiveness:

- **Delay**
  47% delay LPs' ability to exercise the no-cause removal right, typically by two years from final closing
- **Voting thresholds**
  63% allow no-cause removal by a supermajority (i.e. 75%) of LPs, with 21% opting for higher off-market voting thresholds, typically at 80% (and, to a lesser extent, at 85%)
- **Management fee compensation**
  84% entitle the GP to management fee compensation if removed for no cause. Fig. 15 provides the following breakdown of those funds entitling the GP to such compensation
- **Carried interest compensation**
  No funds imposed a 100% haircut, with:
  - 69% entitling the GP to 100% carried interest in respect of investments made prior to the date of removal
  - 5% imposing a 25% haircut and a further 5% imposing a 50% haircut
  - 21% adopting various vesting approaches

Fig 15: No-Cause Removal - Management Fee compensation for GPs



A deeper analysis reveals that only 33% of sampled North American funds provide for no-cause removal, confirming a widely-held perception that U.S. funds continue to be resistant to this much sought investor protection when contrasted with their European peers.

Key Investor Protections: GP Removal - For Cause

GP Removal - For Cause

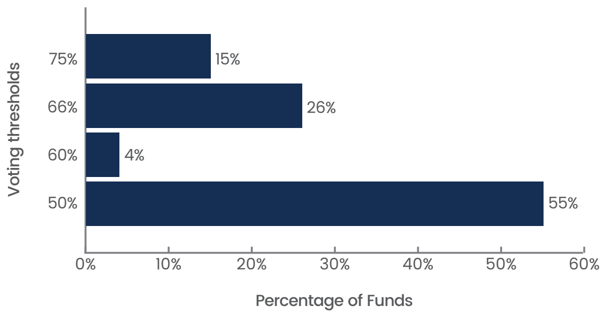
96% of funds (up from 85% in 2016 data) have a removal for cause right

However, effectiveness of cause removal right blunted in many cases by: (1) off-market voting thresholds to trigger removal; and (2) lack of economic disincentive for a GP not to transgress - majority of GPs retain 50% to 100% of carry if removed for cause.

Voting Thresholds.

Only 55% allow fault removal by a majority (i.e. 50%) of investors, with 45% opting for higher off-market voting thresholds.

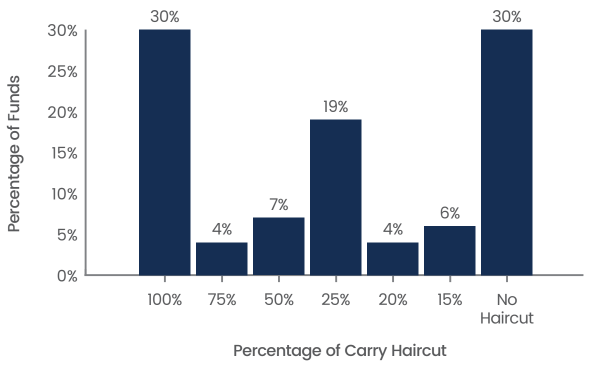
Fig 16: Voting Thresholds for GP Removal for Cause



Carry Haircuts.

Majority of GPs not economically disincentivised not to transgress: 67% of sampled funds allow the GP to retain between 50% to 100% of carry where removed for cause (with only a minority (30%) imposing a full haircut).

Fig 17: Levels of Carry Haircut



Correlation between voting thresholds and 'light' touch carry haircuts

61% of sampled funds allowing the GP to retain 50% or more of carry if removed for cause require a two-thirds or supermajority LP vote to remove the GP for cause.

SECTION 5

Investor Alignment

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Investor Alignment

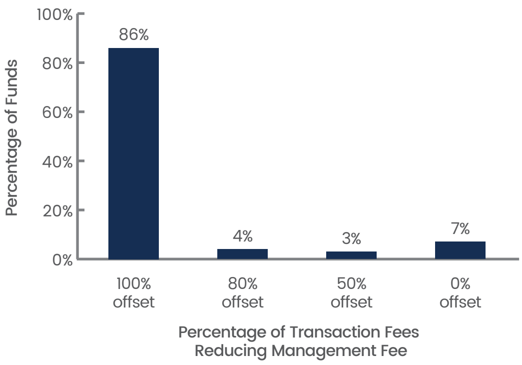
It's the economics, stupid

Management Fee Offset.

LPs generally expect 100% offset.

- 93% of sampled funds offset the management fee by transaction fees received by the GP and its affiliates
- But, on a closer look only 86% apply a full or 100% offset:

Fig 18: Management Fee offset



- LPs willing to tolerate sub-100% or no offset in bespoke situations; otherwise, 100% offset is market standard

- Nevertheless, were 100% offset seemingly on offer, LPs generally failing to ensure that 100% means 100% i.e. are all potential sources and recipients of transaction fees captured? non-cash transaction fees captured? excess offset rolled forward? excess offset remaining at termination distributed to LPs?

Successor funds.

GP and key persons expected to fully focus on current fund rather than be preoccupied with raising a successor fund.

- 93% of sampled funds typically prohibit successor funds until earlier of (i) expiry of investment period or (ii) when current fund is fully invested or fully committed (e.g. 75% of total commitments)
- Only a minority of sampled funds prohibit the marketing or raising of a successor fund, with the majority restricting, for example, the holding of first closing or the making of investments:
  - the former position is more relevant to first time funds or small fund houses
  - LPs typically relaxed with the more lenient latter level of restriction for larger funds/fund houses where marketing is mainly carried out by a dedicated investor relations team rather than the deal team itself
- LPs increasingly scrutinising provisions on deal allocation between current fund and successor fund
- Some LPs increasingly looking for step down in the management fee for the current fund where the GP or its affiliates receive a management fee from a successor fund during the investment period

Co-investments.

2016 report noted increased LP appetite for co-investments. In the intervening period, that appetite has intensified.

- Co-investments continue to attract LPs looking to boost returns and to lower fees through co-investments
- Many LPs seeking greater certainty on how co-investments are allocated:
  - concern that other LPs are granted preferential co-investment rights under non-disclosable side letter provisions
  - such LPs enjoy regulatory support from the U.S. SEC which has criticised GP opacity in allocation of co-investments
- GPs generally resisting formalisation of co-investment terms in the LPA:
  - GPs retaining flexibility in terms using side letters to determine co-investment allocation
- Whilst many GPs are charging management fees and taking carry on co-investments, many influential LPs are negotiating advantageous co-investment economic rights in side letters:
  - some GPs are charging LPs as much as 10% carry on co-investments and others as little as 0%
  - management fees being paid by LPs for co-investments range from 0% to circa. 1% (lower than the 2% shown earlier in this report to be dominating across private equity funds during the investment period)

SECTION 6

Transparency and Standardisation – Measuring ILPA's Impact

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Transparency and Standardisation – Measuring ILPA's Impact

ILPA continuing its efforts at standardised industry reporting but still a work in progress

Transparency.

As with our 2016 report, transparency continues to be a major concern for LPs – 47% cite lack of transparency at fund level. [8]

ILPA's standardised reporting initiatives.

To improve transparency and disclosure, ILPA has led efforts to standardise GP reporting to LPs by developing a suite of reporting templates, notably its:

- Call & Distribution Template Notice – seeks to enhance LPs' understanding of how capital is being allocated
- Fee Reporting Template – captures greater detail on fees, expenses and carried interest paid to GPs and their affiliates

ILPA's Fee Reporting Template.

ILPA's Fee Reporting Template was released with great fanfare in January 2016:

- aims to provide LPs with an improved baseline of information, better fee tracking and monitoring, leading to more informed internal decision making and reducing compliance burden on GPs
- some of the biggest GPs (mainly U.S. based) have publically endorsed the Fee Reporting Template e.g. KKR, Carlyle, TPG, Advent, Apollo, Hellman & Friedman and CCMP
- ILPA reports that, as at end March 2017, the Fee Reporting Template has been endorsed by more than 60 LPs, including many of the largest public pension plans around the world, some of whom have mandated its usage by GPs as a condition of investment

But what is the wider uptake?

Our 2017 data sample shows adoption by GPs of ILPA's Fee Reporting Template. In more depth:

- where ILPA's Fee Reporting Template has been adopted, our data suggests that to date such adoption has been confined to mainly large investors through side letters

For many GPs and LPs, particularly outside of the U.S., it would seem that awareness or the importance of ILPA's Fee Reporting Template has yet to fully percolate through. Jennifer Choi, managing director of industry affairs at ILPA, expects that it will take about two years to see a meaningful number of GPs deliver their information using ILPA's Fee Reporting Template. [9]

8 Source: The Preqin Private Capital Fund Terms Advisor report, page 19. Based on Preqin survey of LPs dissatisfied with the current alignment of GP/LP interests.
9 Source: 'Desperately seeking disclosure', Private Equity International's 2017 Perspectives, pp.18-19, December 2016/January 2017.

APPENDIX

Overview of sampled funds and LPs advised by the MJ Hudson LP Unit

Overview of sampled funds and LPs advised by the MJ Hudson LP Unit

Sampled funds.

The funds reviewed for this report are the most recent funds encountered by MJ Hudson since the 2016 report, through the MJ Hudson LP Unit's advice to investors in these funds and, to a lesser extent, where MJ Hudson has acted for the GP.

All these funds have a vintage of 2015 or 2016 and have held a final closing or are currently fundraising. These funds provide a representative sample of the industry, encompassing a wide range of fund types and geographic regions (by GP location) as shown by Fig.19 and Fig.20.

Fig 19: Types of Fund

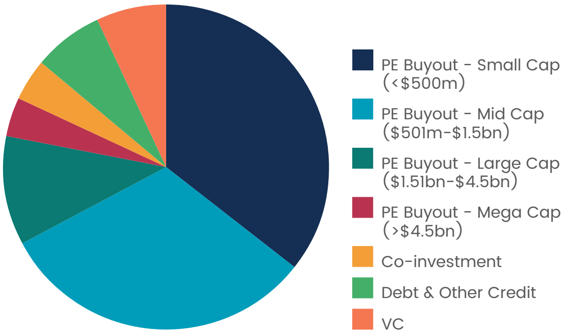
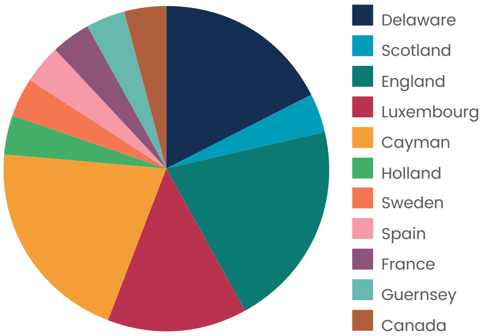


Fig 20: Funds by Jurisdiciton



Investors advised by the MJ Hudson LP Unit.

As noted above, nearly all the funds reviewed for this edition have been invested in by LPs advised by the MJ Hudson LP Unit since the 2016 report. Fig.21 and Fig.22 show a breakdown of those investors by region and type of organisation.

Fig 21: Jurisdictions of Investors (advised by MJ Hudson LP Unit)

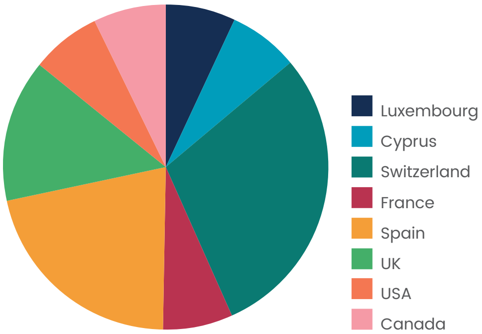
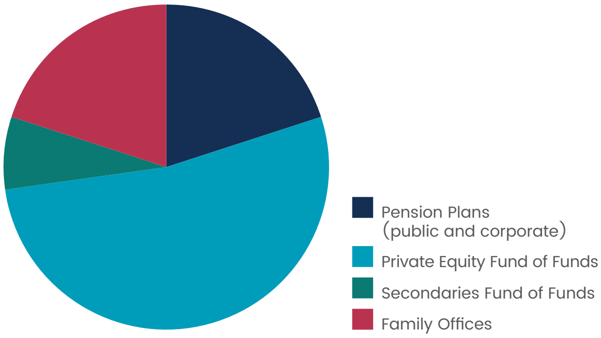


Fig 22: Types of Investors (advised by MJ Hudson LP Unit)



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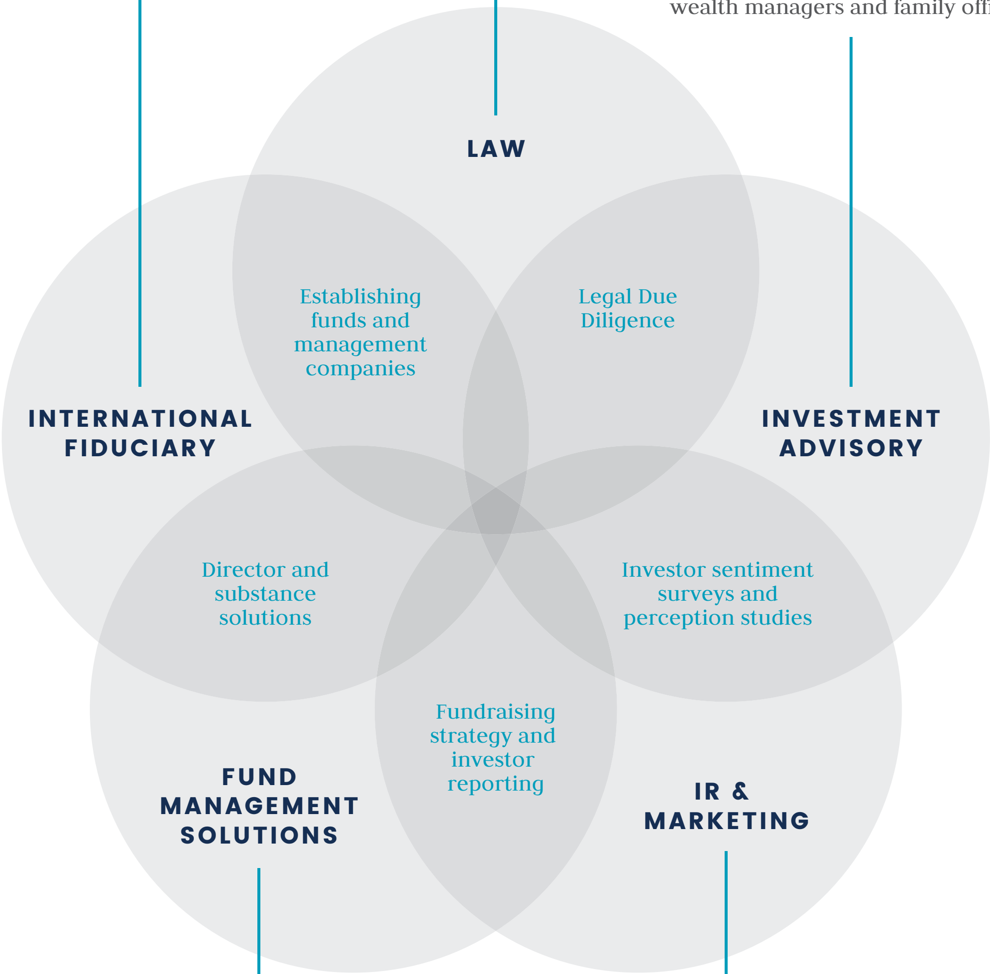

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MJ Hudson is one of the world's leading specialist legal and asset management consultancies

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MJ Hudson's lawyers work with asset managers, institutional investors and advisers across all areas of the alternative assets industry, covering venture, private equity, hedge funds, real estate, fund of funds, infrastructure and credit, with a focus on M&A and fund formation.

The depth of expertise across the MJ Hudson business provides us with in-house experts and additional perspectives on every issue in alternative assets, which we can leverage to help our clients achieve their goals.

As one of the first firms to publish its fees, our lawyers are used to introducing innovative services and working practices and this is a strategy we will continue to pursue, exploiting digital and mobile technologies for the benefit of our clients.

About the MJ Hudson LP Unit

Our LP Unit, via a team of highly experienced lawyers, focuses on LPs' interests in relation to co-investments, primaries and secondaries.

Few law firms offer a one-stop solution for LPs' needs across the primary, co-investment and secondary sectors, with a sufficient depth of legal and market experience to devote across all such sectors.

MJ Hudson is different. Our LP Unit works to enhance GP / LP alignment on every primary and co-investment opportunity reviewed and negotiated, as well as acting for buyers and sellers on direct and indirect secondary transactions and for investors on fund restructurings.

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 Credit to Ravi Longia of MJ Hudson for researching and authoring this report and to MJ Hudson's marketing team for their design and production of this report.