Private Equity's Seesaw: Changing Dynamics in Fundraising Terms

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The private equity fundraising market remains robust and competitive. 2017 was a record year and 2018 has not showed signs of slowing down. The negotiation of terms between general partners and limited partners is taking place in a market divided between highly prized and oversubscribed offerings, on the one hand, and firms that are struggling to reach their target sizes, on the other hand. As a result, the negotiating leverage of general partners and limited partners differs greatly from fund to fund even though overall market terms seem largely unchanged. The available dollars in the marketplace appear to be heading increasingly to the same privileged group of firms. At the same time, the fundraising process has become – more than ever – a balancing act between the increasingly bespoke requests of individual limited partners and the need to create a pooled vehicle that serves a wide array of partners for a decade or more. In this context, a number of important trends have emerged in today's private equity marketplace.

Alternative Management Fee Arrangements

General partners are experiencing varying degrees of pressure from limited partners to lower, adjust or calculate differently their management fees. For their part, general partners are responding by offering alternative fee arrangements and discounts that are consistent with their business goals of attracting large and diverse investors, building strategic relationships and closing funds quickly. As a result, there is growing market precedent for fee discounts based on size, relationship or being an "early bird" (*i.e.*, first closer). Some general partners are creating multiple classes with varying rates of management fees, including options like a reduced management fee in exchange for a higher carried interest, management fee "holidays" early in the life of the fund and "J-curve" mitigating interests that "back-end load" management fees. While there is precedent for fees to step down after the commitment period, the trend of further lowering fees during a fund's winding-up period has gathered momentum. Limited partners routinely seek to have fees lowered, or at least renegotiated, during the winding-up period to address concerns about "zombie" funds that continue to accrue management fees.

Size-Based Discounts. Based on our experience, it is increasingly common to provide a discount on management fees based upon the size of the limited partner's capital commitment. Discounts are typically granted in increments of 10 to 25 basis points per tier of commitment (for example, a fund may offer a management fee rate of 2.0% for commitments under $150 million and 1.75% for commitments over $150 million). The investor community seems to be increasingly at ease with differing economics based on size.

"Early Bird" Discounts. In addition, some private equity funds provide a discount on management fees to limited partners who come in at the first closing (or early in the offering), sometimes only with respect to the pre-step down rate but other times with respect to both the pre-step down and post-step down management fee rates. "Early bird" discounts may be combined with size-based discounts. In some cases, these "early bird" discounts apply only to a portion of a limited partner's commitment (for example, the first $100 million of the commitment) or the total amount of capital from all investors that may be subject to the discount may be limited (for example, the discount may only be available to the first $200 million of commitments, even if additional capital comes into the first closing of the fund). In our experience, a small number of private equity funds offer "early bird" discounts on management fees, and it is often the case that firms are able to extract a better overall fee arrangement by offering only size-based discounts that incentivize larger commitments.

Performance-Based Sharing of Profits

While the carried interest rate has remained largely unchanged at the traditional 20% level, there have been some modifications at the margins of how carried interest is calculated.

Distribution Methodology. The deal-by-deal distribution methodology remains the market norm for U.S.-based private equity funds. Under this methodology, proceeds attributable to an investment are distributed to the limited partners until they recover the capital they invested in the deal generating the distribution and any capital they invested in other deals that have been disposed of at a loss prior to the preferred return and carried interest being paid, as opposed to receiving a return of all contributed capital as in an all-capital-back or "European" waterfall. Typically, the limited partners also receive a return of the capital that they contributed to fund an allocable portion of the fund's expenses at this step of the waterfall. However, there is increasing precedent for a hybrid model in which limited partners receive a return of all expenses paid to date, or all

organisational expenses (as opposed to an allocated portion of those expenses), at this step.

Preferred Return. In our experience, 8% remains the most common preferred return rate. However, a few top performing general partners have successfully argued for the removal of the preferred return. While the overwhelming majority of funds will continue to offer a preferred return, it may be time to revisit the conventional 8% rate to better reflect today's low interest rate environment. Further, given the increased use of subscription line credit facilities, some limited partners are pushing to have the preferred return clock start ticking when the fund draws on a subscription line credit facility (rather than when capital is actually called from the limited partners). However, general partners are typically successful in resisting this request given the intended alignment of interests between limited partners and general partners on the benefits of the use of a subscription line credit facility. The preferred return is conceptually intended to be calculated on the actual contributions of capital to the fund. In the context of a subscription line credit facility, calculating the preferred return on amounts drawn under the facility would cause a misalignment of the benefits associated with its use.

General Partner Catch-Up. Because the basic deal is that the general partner should receive the applicable carried interest percentage of all profits, private equity funds uniformly provide for a "catch-up" of profits due to the preferred return to limited partners. In our experience, this "catch-up" rate is split fairly equally between 100% and 80% to the general partner, while a few firms have agreed to general partner catch-up rates below 80% (such as 50%).

Carried Interest Percentage. The traditional 20% of profits going to the general partner remains by far the most common carried interest percentage. A few general partners with exceptional track records have been able to negotiate for a carried interest percentage of as high as 25% or 30%. Some general partners have also offered classes of interests that trade a lower management fee rate for a higher carried interest percentage. Additionally, a few funds provide for tiered carried interest percentages depending on the performance of the fund. For example, the carried interest may be 20% until the fund reaches a performance threshold based on the IRR of the fund and, thereafter, the carried interest may be increased to 25%.

General Partner Clawback. Historically, the general partner clawback obligation was calculated only once, at the end of the life of the fund. However, limited partners have become increasingly concerned that the clawback obligation may not be due for many years after losses begin to accrue in the fund or that the general partners (or the ultimate carry recipients) who have received carry distributions during the early years of a fund may not have the means to satisfy their clawback obligation upon the liquidation of the fund. Interim clawbacks may be requested by some limited partners to address this concern and, in our experience, a significant number of private equity funds provide for interim general partner clawbacks during the life of the fund, frequently starting at the end of the commitment period and occurring as often as annually thereafter. When interim clawbacks are provided, there is typically a true-up mechanism allowing the general partner to recover any excess clawback amounts paid by the general partner (for example, if an unrealised loss is ultimately recovered) so that the general partner is not inadvertently shortchanged to receive less than 20% (or the other applicable carried interest percentage) of the profits.

Investor Protections: Taking Away the Keys

The non-economic terms of a private equity fund are meant to achieve a balance between giving the general partner sufficient flexibility to exercise its duties and responsibilities to the fund, on the one hand, and adequately protecting the limited partners, on the other hand, given the limited partners' passive role in the fund. Limited partners typically seek to ensure that appropriate mechanisms are in place to work through unforeseen conflicts as well as changes to the investment team. These protections are usually provided either via limited partner consents or through action by a limited partner advisory committee. While limited partner advisory committees can be a useful tool to the general partner, and other limited partners are often eager to have the advisory committee weigh in on a variety of matters, their members are sometimes reluctant to decide certain types of matters put to them. To avoid operational bottlenecks, both general partners and limited partners need to exercise care in deciding which types of matters will be required to be brought to the advisory committee.

Key Person Triggers. In the event that one or some combination of principals cease to dedicate the requisite amount of time and attention to the fund, limited partners may often terminate the commitment period, usually after the expiration of a specified suspension period during which the general partner may put forward proposals for replacing the departed principals and resume the fund's investment activities. The specific parameters of key person terms, including which principals are covered and the extent of their time commitments, are necessarily tailored to the dynamic realities of each individual firm. As more firms have experienced key person departures and as the industry matures, some limited partners are increasingly requesting that the key person provisions cover a broader group of professionals (including those with less seniority). At the same time and due to the growth and institutionalisation of their businesses, some general partners have sought increased flexibility in the mechanisms and procedures for replacing individual key persons or in their ability to otherwise cure a key person event.

No-Fault Termination Rights. Limited partners typically have the right to terminate the commitment period and/or terminate the fund for any reason. Although rarely invoked, the existence of these provisions gives a measure of leverage to limited partners during circumstances where a private equity fund encounters adversity. In our experience, the voting threshold required for no-fault termination is between 75% and 85% in interest of the limited partners. Limited partners sometimes argue for a lower threshold, but the market seems to be settled at a higher threshold — which in our view provides balance and alignment in a committed product while providing investor protections.

GP Removal – for Cause. The limited partners' right to remove the general partner of the fund is often limited to circumstances in which the general partner and/or the investment professionals have taken actions constituting "cause". The threshold for actions meriting removal for "cause" is typically high, such as fraud, gross negligence, willful misconduct or material violations of securities laws; however, in our experience, there has been renewed focus on the parameters around GP removal for cause. The limited partner vote required for a removal of the general partner following an action constituting cause is typically that of a majority or supermajority of limited partners. The economic consequences of a GP removal for cause range from requiring a replacement general partner to purchase the carried interest at fair market value to applying a discount (or "haircut"), typically ranging between 20% and 50%, to future carried interest distributed to the removed general partner with respect to investments made by the fund while it was the general partner.

GP Removal – without Cause. In today's marketplace, limited partners are more frequently requesting the right to remove the general partner without cause. General partners are typically highly resistant to this proposal, which, in addition to being generally

inconsistent with the notion of a "committed" vehicle, would effectively allow the limited partners to hand the portfolio created by the general partner to another firm to manage. When a private equity fund does provide for removal of the general partner without cause, it is typically upon the vote of a large supermajority of limited partners, although some limited partners have pushed for this right at thresholds of as low as 75% in interest of the limited partners. In our experience, the majority of private equity funds still do not permit removal of the general partner without cause and, where it is permitted, the requisite voting percentage is often higher than 75%.

Succession: Handing over the Keys

General partners are increasingly confronted with succession issues in their businesses. Although many private equity firms remain tightly controlled by a few partners, the ageing of founders, the ambitions of talented "next generation" professionals and the maturation of the industry as a whole are forcing sensitive discussions among partners across the marketplace. Because the key assets of private equity businesses "walk out the door" at the end of each day, general partners increasingly appreciate that a controlled, thoughtful and well-communicated transition process can avoid a talent vacuum and maintain the confidence of investors. Many private equity firms appear to be making operational adjustments – to governance and economics – in a manner designed to foster growth as an institutionalised business. This process is most successful when done over a number of years in a deliberate, orchestrated manner, with careful consideration of related issues presented in the fundraising process, including key person triggers, time commitment covenants and assignment or change of control provisions.

Steady Demand for Co-Investments

Over the past several years, the demand from some of the largest institutional investors, state pension plans and sovereign wealth funds for increased capacity in large transactions has accelerated. Co-investments offer investors more exposure to the asset class and the ability to select specific subsectors within the asset class on potentially more favourable terms (including, in many cases, reduced or no management fees and carried interest). As the co-investment market continues to mature, the process of offering and documenting co-investment opportunities is becoming more elaborate and time consuming. While there are a myriad of other economic, governance, regulatory and tax issues to consider when structuring these arrangements, general partners have shown increasing flexibility in offering these arrangements in order to build goodwill with investors, facilitate consummation of sizeable transactions and enhance diversification at the fund-level. The access to large amounts of nimble capital allows general partners to act more opportunistically, and strategic co-investors often provide access to or insight into markets and industries that may otherwise have not been available to the general partner.

Long-Dated Funds

The formation of private equity funds with longer terms has been a notable feature in the marketplace in recent years. Instead of traditional private equity funds that wind up after 10 years, several general partners have offered fund structures and terms that offer a continuing supply of long-term and patient capital with terms of as long as 20 to 25 years. The expectation is that these private equity funds will make larger investments with longer time horizons than is permitted by the typical middle-market private equity fund. In our experience, these funds often provide for reduced management fees and carried interest rates as compared to a typical middle-market private equity fund. We can expect to see more of these types of products in the coming years as the demand for larger and longer-duration investments is being driven by both general partners and by limited partners with large cash reserves in need of sizeable longer-term allocation opportunities.

Environmental, Social and Governance Programmes

General partners and limited partners alike are increasing their focus on environmental, social and governance (ESG) considerations as part of their investment programmes. Institutional investors routinely request information about general partner ESG policies, including whether ESG forms a part of the investment process, whether an ESG officer has been appointed and what the sponsor's reporting practices are. Side letter requests with respect to ESG matters are becoming more common as well. In addition, some general partners are coupling the growing investor interest in ESG issues with the launch of niche funds. While the market for social impact funds (funds dedicated to addressing one or more ESG issues while seeking to achieve a return) is still quite nascent, some of the largest institutional sponsors have already raised dedicated social impact funds and we expect this trend to continue.

Transactions Involving Managers

The trend of investors focusing their commitments on an ever-narrowing list of private equity firms and the maturation of these businesses generally are driving consolidation and transactional activity among private equity managers. General partners seem to be increasingly interested in institutionalising their businesses by partnering with other financial institutions (and, in some cases, corporations outside of the financial services industry) through transactions that, at the same time, monetise the value of their firms. These transactions come in a variety of shapes and sizes, but most often involve majority or minority investments in managers, spin-ins and spin-outs of investment teams and, in some cases, strategic partnerships. Importantly, although limited partners seem cautiously comfortable with these types of deals, their reactions are a key factor that should be carefully managed as their consent may be required for certain transactions. The availability of willing buyers in the marketplace is likely to accelerate the rate of transactional activity involving private equity managers in the coming months and years. This trend, coupled with the continued drive towards corporate-style governance features (such as enhanced limited partner advisory committees), suggests that alternative investment managers will operate more like mainstream financial institutions in the future than they have to date.

The Unlikely Standardisation of Terms and Documents

The quest for standardisation of terms and documentation has gathered steam recently. The Institutional Limited Partners Association (ILPA) released a model form of subscription agreement for private equity funds and is at work preparing a model form of partnership agreement. The rationale for standardisation includes

an attempt to create a more efficient and fair market. However, considering the level of customisation among firms and the level of negotiation of terms between general partners and limited partners, the private equity market does not readily lend itself to standardisation. Sponsors are composed of businesses of differing sizes, strategies and histories. For their part, the investor base is equally diverse and there is growing demand from some of the largest investors for customised arrangements, co-investments and single-investor products. There are also particularised demands of investors in traditional pooled vehicles, as evidenced by the exponential growth in both the number and length of side letters. As a result, we believe the trend towards standardisation is doomed to failure in the foreseeable future.

Conclusion

There are many more trends at work in the marketplace. In terms of the regulatory environment, offering interests in private equity funds remains complicated and challenging within the United States, in Europe (especially as managers continue to grapple with the Alternative Investment Fund Managers Directive and enhanced data protection rules) and in most major jurisdictions around the globe. While the market currently has an abundance of "dry powder" and frothy deal valuations may signal challenges ahead, 2018 has continued the strong fundraising trend of the last several years. The opportunities presented within an ever evolving and maturing industry have never been more dynamic.

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