Private Equity International

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PUBLISHED: 23 November 2020

INVESTORS

Flexible fee structures: Should you consider one?

Hamilton Lane's dual fee structure for its latest co-investment vehicle shows how GPs are responding to changing investor preferences

Lower management fees and alternative carry structures are among ways GPs have attracted LP commitments over the years. Hamilton Lane's latest move – offering management fee classes on the basis of invested capital – is an unusual one.

On the firm's latest earnings call in early November, vice-chairman Erik Hirsch said it was offering a dual fee structure for its latest direct equity fund.

Investors in Hamilton Lane Equity Opportunities Fund V can either pay a traditional 1 percent management fee on committed capital with 10 percent carried interest or a 1 percent fee on invested capital with 12.5 percent carry. The hurdle rate remains at 8 percent, as does the European waterfall methodology, Hirsch said.

The firm held a first close for the vehicle on $320 million in October. Of investors in the first close, 67 percent opted for the invested capital and higher carry option, he added.

Hirsch said the firm altered the fee model to reflect "changing investor preferences". LPs were also becoming "more focused on early internal rate of return management", opting for invested capital models and are thus willing to pay more for performance.

Its prior four funds have had a traditional 1 percent management fee on committed capital, which then switched to a 1 percent fee on net invested capital after the investment period. Carry was at a 10 percent rate over an 8 percent hurdle, Hirsch noted on the call.

Hamilton Lane declined to comment beyond details of its earnings statement.

Private Equity International spoke with industry practitioners on the implications of offering a fee structure on invested capital. Here's what we found.

The investment strategy matters

Charging management fees on invested capital is less common in a blind-pool private equity fund, including a co-investment strategy, than in other alternative asset classes, according to legal experts.

Infrastructure funds, for example, often use invested capital as their base for fees, according to Mark Silveira, a funds lawyer at MJ Hudson.

"A conventional PE fund usually has a stable drawdown of management fees. It can also have lumpy drawdowns for acquisitions, but a GP is not going to make all the acquisitions on day one – it will make those at intervals across the investment period," said Silveira.

He noted that an infrastructure fund, on the other hand, might expect to call and deploy most of its committed capital relatively quickly, which would give it higher levels of invested capital fairly early in its long life – so the benefits for LPs of paying fees on invested capital (as opposed to committed capital) would be less pronounced for that kind of fund.

Firms that have offered LPs fee optionality before – although on committed capital – include KPS Capital Partners and Bain Capital. Pantheon, meanwhile, blended the management fee and carried interest into one performance-based fee, as an option for its private equity strategies targeted at the defined contribution market.

Quick deployment is a factor

The real difference between using a

traditional committed capital structure rather than on invested capital is how quickly a GP can invest the fund, industry practitioners noted. GPs that anticipate deploying capital quickly would be less impacted by a management fee on invested capital.

In many cases, GPs model it out – based on target returns and anticipated holding periods – such that they are relatively neutral as to which fee option investors elect, said Alex Amos, a partner at Macfarlanes.

While it is clear that a management fee on committed capital provides a more steady and reliable revenue source than a management fee on invested capital, Amos noted there is potential for greater overall fee revenue for the GP with the lower management fee/higher carry option, given that in theory there is no limit to the level of outperformance in a private equity strategy.

Hamilton Lane's co-investment vehicles – contrary to a traditional PE fund – are not limited to a specific strategy or geography. In fact, the investment universe can be "as wide as wanted", according to a statement. Hamilton Lane's willingness to take a potential hit on management fees in exchange for higher carry also highlights how well the firm believes it can perform.

It really is about alignment

Matthew Goldstein, a partner at Paul, Weiss, Rifkind, Wharton & Garrison, noted that GPs can garner goodwill with LPs by showing flexibility on fees and seeking to align interests with LPs.

In Hamilton Lane's case, its co-investment funds series provides direct equity capital into buyout and growth transactions alongside GPs, attempting to reduce the fee burden for LPs.

Goldstein added that GPs who proactively offer more creative fee discounts upfront might be able to raise capital quicker than normal, allowing them to direct their attention to deal sourcing and execution.

LPs, meanwhile, also benefit as they are able to justify to their respective constituencies committing dollars to funds quickly and at scale if they can show that the fee rates are highly competitive relative to market, according to Goldstein. To show that LPs are "paying for performance" via the carried interest, rather than being burdened by what they believe to be high fees incurred in the early years of a fund's life cycle, is also advantageous.

It's unclear whether more managers will follow suit

While the two-and-20 fee structure has been challenged over the years and the headline management fee rate for most funds is now between 1.5 percent to 1.75 percent, it is unclear whether Hamilton Lane's move will be adopted by the wider market.

By offering to change the management fee basis to invested capital in exchange for higher carry, the management team is in effect doubling down on its ability to achieve stronger returns, Silveira pointed out. And funds that are oversubscribed are not under pressure to alter their fee models, he added.

Management fees continue to be a major point of friction between investors and their managers, as PEI's LP Perspectives 2021 survey – published in December – examines. Still, initiatives such as Hamilton Lane's appear for the time being to be rare. ■