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THE MODERN FUNDRAISER

A guide to the choices, vehicles and structures available for private alternative asset fund managers and their investors

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Reading the fee leaves

Despite fee transparency having become a top priority in the LP community, a buoyant fundraising market is keeping many terms around fees and expenses firmly put. How long that lasts, however, appears to be an open question

by CLAIRE COE SMITH

On the face of it, it would seem that managers are under immense pressure to concede more favorable fund terms for LPs in the partnership agreement.

As regular readers of *pfm* are aware, fees have become a hot issue in the press, which has caught the eye of the public sector. In July, a letter signed by 13 state treasurers and elected city officials was sent to the US Securities and Exchange Commission (SEC) urging the regulator to require standardized private equity fee disclosures from GPs.

Meanwhile, the California Public Employees' Retirement System (CalPERS) and other LPs have been under intense media pressure to justify performance fees. Amid the controversy, the Institutional Limited Partners Association (ILPA), which CalPERS is a member of, launched a fee transparency initiative last year that included a standardized fee reporting template for managers to use.

If the court of public opinion determines private equity to be too opaque, or too expensive, LPs will have a more difficult time justifying their private equity portfolios to outside stakeholders, even when their alternative assets deliver superior returns – which investors could use as leverage during fund negotiations.

But by far the biggest trend explaining this perception is the SEC and other regulators taking a more aggressive approach to enforcement when it comes to fees. Last year, Kohlberg Kravis Roberts and The Blackstone Group became the

two most recent high-profile examples of this trend, with both GPs agreeing to eight-figure settlements for SEC charges related to broken deal expenses and accelerating monitoring fees respectively.

But here's the thing: despite these trends, today's bullish fundraising market is limiting investors' ability to move terms on fees, expenses and carry models.

Sean Hill, a Boston-based partner with Proskauer, who is also co-head of the law firm's private investment funds group, says that when it comes to GP compensation, investors are not focusing on any one issue, which may decrease their leverage to significantly move any one term in their favor.

"Smarter and more experienced institutional investors are looking at it more holistically, focusing more broadly on alignment of interests. Investors certainly want to pay less, but for managers with a strong track record and a good reputation, to the extent that they have in place the so-called US waterfall, they have been able to retain that."

The US waterfall, or deal-by-deal waterfall, is more favorable to GPs than the alternative "fund as a whole" European approach. Hill says he has not seen a US manager having to switch to a European waterfall in quite some time, and indeed some larger high-performing European managers have been able to agree deal-by-deal waterfall arrangements that are cross-collateralized.

Hill: watching waterfalls

Others agree that, despite all the recent attention on fees, LPs are not necessarily pushing back harder on the issue during fund negotiations.

"The bigger funds are all getting whatever they want when it comes to GP compensation at the moment, and that is the standard 2 percent annual management fee and 20 percent carry over an 8 percent preferred return," says David Waxman, managing director at Azla Advisers, a fundraising and secondaries advisory firm.

"Even for the smaller or newer funds in the US, who most likely have to go with the European waterfall, they are still also pushing for 2-and-20," Waxman continues.

At that smaller end of the market, or for first-time funds, he says he has seen GPs more willing to negotiate on fees and carry in order to attract LPs, and a tiered carry structure is not uncommon, where carry increases once certain performance criteria are met.

"We have seen models with 17.5 percent, 20 percent and then 22.5 percent carry, depending on performance. GPs are interested in doing that kind of thing to align interests and introduce LPs to their funds."

More disclosures

Although greater regulatory scrutiny hasn't necessarily moved fund terms, the SEC and other agencies are certainly prompting GPs to include more disclosures in their marketing materials and fund documents.

Hill says it is in the expenses provisions that GPs are seeing the real impact of the conversation going on between regulators and investors, and the enormous drive for transparency and clarity.

"The 'partnership expenses' section used to be a small paragraph; now it's a full page in the fund agreement, listing out every single thing that will be borne by the partnership in fine detail, so that there is no doubt about it."

But will greater regulatory oversight start to move certain terms in the time ahead?

"I expect to see GP compensation certainly becoming more efficient –and a desperate need for more alignment coming from investors. The money will talk, and in the end the market will move in the direction that the LPs want it to go," predicts Mounir Guen, founder and chief executive of MVision, a placement agency.

That's a view shared by Waxman, who argues that longer term, investors will be able to get much more bespoke arrangements on GP compensation by focusing their attention on separately managed accounts, which are rapidly growing in popularity.

He says: "Managed accounts are a huge trend and are something the large managers are doing a lot of with their biggest investors, and there everything is negotiated – fees, carry, everything. Those are fully negotiated on all terms, regardless of who the manager is. That's where everything is headed, because the very large LPs would rather do that than be in a pooled vehicle where they are subject to standard terms."

He adds that the bulk of large buyout firms' assets under management used to be in pooled vehicles, but things are beginning to move to the opposite end of the spectrum. "By 2020 we will see a major shift to a much larger percentage of assets being in managed accounts, and that's a function of negotiation, because LPs will then be able to get the terms they want."

WPPILOT

SEC: pushing disclosures, not terms

Skin in the game

While compensation-related terms may not experience significant movement for some time, if at all, investors are experiencing success in certain other areas.

For instance, investors see the amount of management team commitments as a key element in aligning GPs interests with their own, and so while 1 percent used to be standard, there are signs of this moving higher, and closer to 2 percent. In a recent speech, Terra Firma boss Guy Hands picked up on this sentiment.

"If an investment team has a substantial portion of their liquid net worth invested in a fund, you know that they are not motivated just by fees – their main objective will be to protect and grow their own capital alongside that of investors."

Remarkably, he went on to say that, at Terra Firma, that meant "not sponsoring any fund, or any deal, unless we can put at least 10 percent of our own money into it. We are not going to make our money on fees – we are going to make it through carry, and we are only going to get paid if our investors make money."

Tailored approach

It is a sentiment that many LPs find especially welcoming as they look for ways to tailor their views on GP compensation to the specifics of the team involved.

"The first thing that LPs are looking at is being fair," says Guen. According to him, this involves looking at a firm's finances, with leeway given to smaller groups who may need limited transaction fees, or higher management fees, in return for better alignment in the profit share. The idea is that smaller groups, who are raising a couple of hundred million dollars or less, tend to tighter on their internal budgets.

"The first thing investors do is try to understand the budget of the fund, and then they try to assess how much money those at the senior level of the partnership have made for themselves, which drives GP commitments. From that, they come back with recommendations, suggestions and ideas," says Guen.

Waxman says he has also seen examples of smaller managers able to secure an agreement that they can charge due diligence fees to the fund, where the management fee would not be sizeable enough to cover such expenses.

Meanwhile, at the larger end of the market, LPs committing hundreds of millions to a fund expect this tailored approach to result in savings.

"That recognition can be made by a GP giving them some form of co-investment confirmation relative to their contribution, which allows them to blend their fees. That may not be a straight-up discount, but it is a reduction because of the blend – we see models where investors commit €500 million to a fund and may then have the same amount of co-invest, which means they can deploy €1 billion at 0.75-and-10 rather than 1.5-and-20," observes Guen.

All told, the fee transparency debate and other recent trends may not being significantly changing GP compensation models at the moment, but as investors' increasingly tailored approach to fund negotiations indicates, things rarely stand still for long. ■