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CONVERSATIONS

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Scrutinizing Deal-Related Expenses

Two experts discuss changes in how deal-related expenses are handled, and walk through some hypothetical scenarios

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–Julia Corelli, Pepper Hamilton

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-Anne Anquillare, PEF Services

WITH EXPERT COMMENTARY FROM: Pepper Hamilton LLP / PEF Services LLC

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➜Times Have Changed for Deal Expenses

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Dealmakers need to know that the treatment of deal-related expenses is now subject to much greater scrutiny. Anne Anquillare of PEF Services and Julia Corelli of Pepper Hamilton talk through a series of hypothetical expense scenarios and sort out who pays for what. They also share key findings from a recent survey on the topic.

Anne Anquillare
Co-founder, CEO,
PEF Services LLC

Julia Corelli
Partner,
Pepper Hamilton LLP

➜ BIO

Anquillare has been in the private equity industry since 1993. Previously, she was a general partner at Walden Capital Partners, worked in the investment business unit of Prudential Insurance Company of America, and has served on the board of governors of the National Association of Small Business Investment Companies. A CFA, she received a B.S. from Lehigh University and an M.B.A. from NYU's Stern School of Business.

➜ BIO

Corelli joined Pepper Hamilton in 1984 and is a partner in the firm's Corporate and Securities Practice Group and co-chair of its Fund Services Group. She was previously a member of the firm's tax group and served on the firm's executive committee. She received a B.A. from Yale University, a J.D. from Villanova University School of Law, and an LL.M. from the Villanova University Graduate Tax Program.

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Privcap: We're talking about a topic in private equity that's getting a lot more attention, which is how expenses are dealt with in a private equity firm and which entity pays for them. The dealmakers, which tend to be the founders of the firm and the people driving the business activity, are not often as aware as they should be about how times have changed with regard to expenses. What, historically, has been the practice of private equity firms by way of expenses, and how has that changed?

Julia Corelli, Pepper Hamilton: Well, "loosey-goosey" might be a way you'd describe that, for sure. It's changed over the last four or five years because of the introduction of Dodd-Frank, the registration of more advisers, the scrutiny the SEC is putting on things, and now the results of examinations and speeches talking about those things. And you see people having a heightened awareness of all the expenses of what they do and how it affects the returns to a limited partner.

The returns have always been a focus. A dealmaker will definitely focus on the returns of the fund, particularly the returns from deals that they do. But there's a growing consciousness of expenses along the way, at the same time as you have a lot of the deal processing becoming quite different. It's much more competitive, and it's more expensive. So the confluence of all of those things is to focus on expenses and to be more aware and trained within your organization about how they get dealt with.

Anne, from your perspective, what has changed in the market as far as the need for dealmakers to be more aware of how expenses get treated?

Anne Anquillare, PEF: There's been a maturing of the industry. We deal with a lot of first-time or small emerging fund managers. If they want to go from fund two to fund three or fund three to fund four, they do need to be more sophisticated in the conversations with their investors, because their investors will be more sophisticated in their questions.

What are some of the typical expenses that we're talking about? Where do they start, and through what period of the life cycle do they extend?

Corelli: In the beginning, there are fundraising expenses that involve travel, meals with prospective or existing LPs, with CEOs of portfolio companies, with CEOs of prospective portfolio companies. There's a focus on the travel and entertainment expenses.

In addition, you have the normal deal expenses. There's legal. There's accounting. There's consulting, environmental, IP—all of the people who you use to put a deal together. People complain that those expenses are getting higher these days, and they're incurred earlier, as the deal process is changing. If you move from a straightforward letter of intent to closing, and to a deal where there's an auction and a letter of intent never comes, and you actually go from auction to definitive documentation, you've front-loaded a lot of the deal expenses before you know you have a deal. Broken deal expenses have come under a high level of scrutiny, by LPs as well as by the regulators.

And in the mind of, let's say, a dealmaker, why shouldn't he or she just say, "An expense is an expense. I'll just incur this expense, and we'll let the accountants figure it out later."?

Anquillare: As a fund manager or GP, you want to be ahead of the problem. So to the extent you take a more laissez-faire attitude, something that's relatively small and could have been addressed sooner can blow up into a problem that could affect the trust of your investors and certainly could cause a lot of pain and anguish and legal time, due to an SEC issue.

So in a nutshell, what is your advice to a firm as far as setting up this culture and a system for getting ahead of how expenses are treated?

Corelli: Number one would be knowing your LP agreement (LPA)—knowing how you've configured the expenses and having a say in that LPA as it's being developed so that you, the deal person, can confer with the CCO and counsel to say, "We need these kinds of expenses because this is what's happening in the deals that we're seeing."

Number two, make sure there's a real connection between what you disclose in your PPM to everything that you can anticipate happening. That's really hard to do, because in the next 10 years, who can say what's going to happen? But if you are talking to everybody in the firm—the dealmaker, the CCO, the counsel, the accounting group, the CFO—all of those people have a say in what expenses should or should not be borne by the fund.

Let's talk a bit more about documentation. What does this look like from a GP's perspective?

Corelli: When reporting expenses, done on the firm's form for reporting expenses, there should be a policy and procedure in the compliance manual that addresses which need prior approval and which don't. There should be constant checking by the CCO with the deal people as to whether they're complying with that manual. If you have expenses being put through which are not consistent with that policy, you have to remediate that and educate and train and document what you've done to address that.

If there are expenses like legal bills, have your lawyer set it up in a way that

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it's broken down by them. Give them instruction. Break down what should be charged to the management fee and what should be charged to the fund, because then you're not in the process of highlighting the line entries and saying, "That's a fund expense, and that's a management expense."

Let's get to our first scenario. There's a PE firm that's holding an annual meeting at a resort, and on the same trip as that annual meeting, one of the partners decides to visit a local CEO and take him to dinner in conjunction with a potential deal. Which entity should pay for the annual meeting, the GP management company or the fund? And which entity should pay for the CEO dinner?

Anquillare: The annual meeting is typically a fund expense, although it's interesting to see the granularity that the SEC and, in some cases, investors are getting into with regard to what constitutes an annual meeting. Is it just the meeting? Is it the dinner before? What about the golf and tennis? So getting back to Julia's point, you have to have a policy, and we're starting to see the industry continue to evolve in being able to handle this in a more proactive and organized manner.

The CEO dinner is part of deal sourcing, and you need a bright line as to when it's just general prospecting versus you've targeted a company and you've started the diligence process.

So it sounds like you're saying, in general, taking the CEO to dinner should be a separate expense that goes to the management company?

Anquillare: It's hard to generalize, but it also depends on whether the CEO is from an existing portfolio company or a target company, and how far you've gone down the pipe to target them. And there is a whole continuum of sourcing a deal, getting to know the portfolio company, doing due diligence on it, documenting your deal with it, closing, and going forward. So somewhere in that continuum, the expenses shift from management company to fund.

The next scenario is: An LP wants to see how the sausage is made and is coming along with a GP on a deal due diligence trip. The trip requires travel, entertainment expenses, as well as some legal fees. The deal ends up not happening, but the LP was so impressed with the whole process that they end up investing in the next fund.

Corelli: So the LP was not an LP in the fund that the GP is visiting this portfolio company for?

That's an important distinction?

Corelli: It is, because it wouldn't be a fund syndication expense of the fund that has the portfolio company.

On the other hand, you're marketing the firm, and it's going to benefit fund two. I would say that that LP's travel expense is not a fund expense. It's a management company expense.

Another scenario: A GP conducts due diligence on a portfolio company up until a letter of intent is signed, but then the firm secures financing for the deal. Who pays the legal fees associated with the financing?

Anquillare: We go back and forth about this, because this is actually a third party providing the financing, and as a fund, you're either paying for that—hopefully getting the portfolio company to pay for it—or it becomes management company expense. So if structured in the best light, you would already have a definitive agreement with the portfolio company so that they would be responsible for reimbursement.

Corelli: If the deal closes, the portfolio company pays it, and if the deal doesn't close and you have an arrangement with the lender, the fund pays it.

Anquillare: This is one of the common drawbacks in a partnership agreement. You cannot envision all the nuances that are going to happen over the next 10 to 12 years of a fund's life. These partnership agreements now have to blossom from 50 pages to 500 pages, and I think that would be a real problem.

Let's talk briefly about the survey that your firms conducted into practices around expenses. Can you give us an executive summary?

Corelli: Well, it was tri-party among PEI, PEF, and Pepper Hamilton. We came up with scenarios of everything from doing a deal to being examined by regulators and building your firm. We started with two people, adding principals, adding operating partners, etc., and came up with a number of questions, and then sent the survey out to 104 participants across growth equity, private, real estate, debt, and other.

The most interesting finding to me was on some of the regulatory expenses like registration and routine exams, which are, according to the survey, standardly the management company's expense. And as you moved into exam findings and fixing deficiencies and into something that grew out of it that was a subject of some investigation, you saw more and more of the survey answers shifting to the fund. And I'm not sure LPs are really anticipating that that is happening.

Anquillare: It was a great first step, and I want to emphasize first step, we had more than a hundred respondents, typically CFOs, CCOs of these funds. And there was consistency in the responses to the tried and true industry practices—things like the deal expenses.

What came across clearly is that there was no consensus with regard to the newer issues facing the industry, like regulatory and new scrutiny. Nobody really talked about annual meetings until about a year ago. It behooves us as an industry to really keep this conversation going, because the SEC, while they're coming up to speed, they're not as well versed in the private capital industry. ■

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