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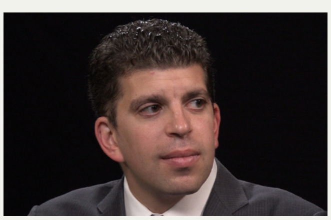
VIDEO SERIES

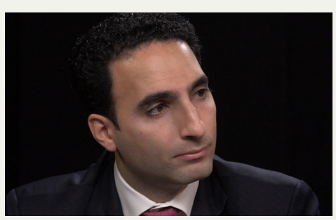
Briefing

Private Equity Fund Formation

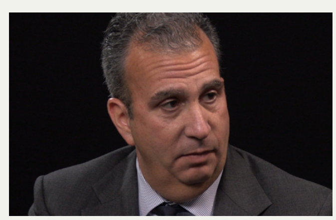
How GPs and LPs discuss fees associated with fund formation



Robert Blaustein
Kirkland & Ellis LLP



Raed Elkhatib
Credit Suisse Private Fund Group



Steven Millner
Gen II Fund Services

Private Equity Fund Formation

Key Findings

1. There is room for negotiation on deal fees (but not much)
2. Meanwhile, operating expenses at firms are increasing
3. The rising cost of being a GP may play out in fee negotiations
4. Some fees generated from a firm's portfolio fall outside the "offset paradigm"
5. The pressure to add value is influencing fee-structure arrangements

The Panelists

Robert Blaustein
Partner,
Kirkland & Ellis LLP

Raed Elkhatib
Managing Director,
Head of Due Diligence
Credit Suisse Private Fund Group

Steven Millner
Managing Principal,
Gen II Fund Services

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1 THERE IS ROOM FOR NEGOTIATION ON DEAL FEES (BUT NOT MUCH)

The balance of power between LPs and GPs is always shifting. And lately, where deal fees are concerned, it has been shifting toward LPs.

"There's a well-defined set of fees that GPs can charge to generate ancillary income," says Raed Elkhatib, head of due diligence at Credit Suisse Private Fund Group. "These include transaction fees, monitoring fees, things of that nature, and they're offset against management fees. Years ago the offset was undefined and was an important source of income for general partners. But it moved to a 50-50 offset eight to 10 years ago, then 80 percent. Today, most commonly, it's a 100 percent offset."

There is still space for GPs to negotiate. They may be able to arrange an exception to the prevailing 100 percent offset if they can demonstrate a level of performance that supports a lower rate. Such arrangements are particularly important to small funds, where fees are still a vital source of revenue to support the investment program.

"For smaller funds and even some midsize funds, it's a pretty significant source of income," says Robert Blaustein, a partner at law firm Kirkland & Ellis LLP. "As pressure on fees or delays in the waterfall distributions, this real-time income is really helpful to sponsors in competing for talent and making sure they can pay bonuses to people out of the carry."

But exceptions to the 100 percent rule are now uncommon. Gen II Fund Services recently surveyed two dozen of its clients raising money and found that all but one were at 100 percent offset. "Nearly all of the recent funds we've seen start off with a 100 percent offset. It's not even a negotiating point for many funds now," says Steven Millner, managing principal at Gen II.

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2 MEANWHILE, OPERATING EXPENSES AT FIRMS ARE INCREASING.

GPs are in a tight spot these days. Their abilities to take fees is getting squeezed by LPs, while inside the office their operating expenses are steadily rising.

"Post-regulation, once private equity firms needed to register [with the SEC], the costs associated with running a private equity fund went up," says Millner. "They went up because of the legal costs, the compliance costs, the costs of dealing with cybersecurity, and greater LP due diligence during fundraising."

Going Overboard?

Robert Blaustein
Kirkland & Ellis LLP

When a GP comes to an arrangement with limited partners, it's vital to get the details in black and white. That's what the limited-partnership agreement is for. But is there such a thing as too much information?

"The SEC has clearly shown a preference for more detail and more specificity, and LPs are, to a degree, accepting of that," Blaustein says. "They realize that a specifically listed basket of fees is just more and better disclosure."

But some GPs feel compelled to protect themselves by overloading the LPA with details, explaining why they might need to take this fee or that fee. Blaustein thinks GPs should not go overboard with their lists of fees.

"I went snorkeling recently, and I signed a disclosure saying, 'This is dangerous activity,' and I might be killed or injured. But it didn't list every way that I might be killed or injured," he says. "There is a risk that the more specificity you provide, the more it impacts the spirit of the agreement. When you get to the point when you're trading off real points and trading off real flexibility in order to keep something, there is certainly a downside there."

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Plus Expenses

Steven Millner
Gen II Fund Services

The amount of disclosure in limited-partnership agreements has increased dramatically— disclosure not only regarding the sharing of fees, but the definition of what constitutes fund expenses, as well. Who should pay for unforeseen expenses that pop up over the life of a PE fund? The LP or the GP?

"The bright line is: Does the fund sponsor pay for these expenses, or do the LPs pay?" Millner says. "The definition of fund expenses has become much more robust, so the LPA now contains a long list with lots of semicolons."

Take, for example, the new Foreign Accounts Tax Compliance Act [FATCA], which requires managers to supply details of their American investors to the IRS. This new rule is proving to be an operational challenge and added expense for PE firms.

"Four years ago, there was no such thing as FATCA, so what do you do now?" Millner says. "There has to be some language in the document that protects both parties with an understanding of how these types of expenses are going to be handled and who is going to bear them."

And there's the ever-growing cost of keeping LPs happy. Limited partners are increasingly sophisticated, and as a result, they're demanding more information. Recent surveys by Big Four accounting firms show evidence across the board that LPs are asking for much more information, more frequently and in more detail.

The cost of delivering this information adds up. "Back-office administrative costs certainly have ballooned over time," Blaustein says, adding that the resources devoted to the improvement of portfolio companies have never been more important or costly. "There is also a greater expectation from investors, from limited partners, that GPs do more to add value. I think the days of leverage driving returns are long past us. So there is operating talent, larger teams, more complicated sourcing mechanisms within these firms that drive up the cost of running a partnership."

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3 THE RISING COST OF BEING A GP MAY PLAY OUT IN FEE NEGOTIATIONS

As their expenses rise, some PE firms are pushing back on fees. But they must present a solid case to get LPs to walk back from a 100 percent offset.

"Some LPs are requiring firms to build up a budget," Elkhatib notes. "They're saying, 'Prove to me that if you're a $250M fund, you require additional fees to operate your business. Put it on a piece of paper and prove it out to me. Help me understand the cost of running your business, and I'll be okay supporting that.'"

Smaller firms will generally work harder to realize higher fees, because they need them more.

"When I look at clients, there's a correlation between the size of the management fee and the size of the fund," Blaustein says. "The bigger funds are taking a little bit more of a haircut. So you can see 150 [basis points] on a billion-dollar fund, whereas you might see 200 bps at a $500M fund. That's where the economics are coming back to the smaller sponsors to be able to absorb some of their costs—that's one of their mechanisms."

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4 SOME FEES GENERATED FROM A FIRM'S PORTFOLIO FALL OUTSIDE THE "OFFSET PARADIGM."

Deal fees generated from portfolio companies that fall outside of the traditional "offset paradigm" are getting a lot of attention today. In the most typical case, a private equity firm will charge its portfolio company for the services of an operating partner, but that expense, because it is paid to a professional who is not a direct employee of the private equity firm, will not be offset against the management fee.

"There are several baskets [that fall outside of the offset paradigm]," Blaustein says. "The first is firms that have some sort of value-add service-provider group—maybe it's an operations group, maybe it's bundling services, things

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that the portfolio company otherwise would be getting outside the sponsor. Second, there is that group of semi-affiliated—but not permanently employed—operating partners, people who are brought in to add value to portfolio companies in the same way that a public company might hire an independent director to come in. Then the last basket is just sort of a negotiated basket, a grab bag."

These outside-the-paradigm fees make their way to GPs by various avenues—and they are attracting scrutiny, primarily because disclosure is an issue.

"With these ancillary fees, there is less transparency," Elkhatib says. "One example is, back to the operational point, if you have an employee who's a full-time executive within the firm and he's seconded to a portfolio company—to a position that exists, a CEO, a CFO—if there is additional compensation for that employee and he's still getting compensated from the funds, some investors worry if they're double-paying."

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5 THE PRESSURE TO ADD VALUE IS INFLUENCING FEE-STRUCTURE ARRANGEMENTS.

Adding value isn't cheap. There are administrative costs, there is the price of attracting management talent—and a lot of PE firms are finding it a challenge to locate the revenue necessary to pay for it all.

Then, piled on top, there are the increasing costs of regulation. Firms have always had CFOs. Now they have a chief compliance officer and a compliance consultant. They work more closely with their law firms. A Gen II survey shows that, where many firms once capped organizational costs at $1M, they've now pushed it up to $1.5M and even $2M—and they're breaching their caps more often than ever.

"And then LPs want to know what you're bringing to the table to create value, in terms of an operating team," Millner says. "How do you create value beyond financial engineering? That's a whole new set of costs into the mix. And ultimately someone is going to have to pay for it."

These pressures are putting a strain on PE firm budgets, and the consequence is often more intensive negotiation of fees. "What we see more and more in LP documents is a lot more specificity regarding this fee paradigm, about what's included and what's excluded," Millner says. "Where is there an offset, as opposed to where is there not an offset?"

LPs recognize the importance of value-add services, and they appreciate the fact that costs are rising. But a firm can help its case for more fees if they do a better job of illustrating cost and value-add effect.

Keep It Simple

Raed Elkhatib
Credit Suisse Private Fund Group

As limited-partnership agreements get lengthier and more complex, it's essential to maintain focus on the document's core implications.

"The interpretation, the simplification, that's what critical," Elkhatib said. "You have to break it down in terms of getting more transparency, more disclosure, and really understanding what this means for me. What are the implications to me as an LP or a GP?"

One area where transparency blurs is fee disclosures, often because there is still no standard language to describe fees. There may never be.

"There are a lot of different organizations—by size, by strategy, by geography—and a lot of complexity," Elkhatib says. "It has to be a very nuanced, specific conversation about who the GP is, what they do, and how they deliver returns for their investors. Because of that, there is not one homogeneous set of terms that works for all situations."

"The more direct the link that fund managers can identify, the better," Elkhatib says. "'Here is the cost, and here is the associated value.' That's critical, going forward. There is a cost to all these services to generate outsized returns in what's becoming a more mature, more competitive market. Let's make a more direct link." ■

Expert Q&A

With Steven Millner
Managing Principal
Gen II Fund Services

What measures can be taken by sponsors to keep costs in check during fund formation?

When a sponsor is looking at the costs of running its business, it's analogous to running any business. You look at your assets under management, and then figure out what resources are needed to properly manage those assets. The largest component of a private equity sponsor's operating costs is human capital. Crucially, how do costs scale as more funds are raised, and is the firm's operating model optimized? Each fund has its own accounting and reporting requirements, and with each new fund comes a requirement to invest more in human capital and administration functions. As a fund administrator, we can drive those costs way down so new funds that are raised don't overwhelm the business. We've also seen many GPs outsource HR functions to a professional employer organization (PEO). PEOs have been very popular among PE funds, providing an additional means to reduce operating costs and risk.

What expenses associated with fund formation have risen in recent years?

One of the recent significant changes we have seen is an increase in regulatory compliance costs. Its effects are felt at the fund level, and with the sponsor. LPs expect their GPs to operate in a fully compliant manner and, as such, we are seeing fairly substantial increases in the ongoing cost of compliance. Organizational costs to set up a fund, to negotiate the LP agreement are also trending up. In past cycles, we would see organizational costs of about $1M, but now we're often seeing it go to $1.5M, and even to $2M. That is a reflection, in part, of enhanced fund legal complexity, increased compliance requirements, and much more due diligence being performed by LPs.

How are these expenses affecting fee negotiations with LPs?

One area of intense focus by the SEC and LPs is on the fees that may be charged to portfolio companies, and how these are shared between the sponsor and LPs. That shift has been fairly substantial. We have seen it move from 50-50, to 80-20, then to 100 percent allocated to investors. That's now the norm in most of the funds we review. The impact for sponsors is less revenue to run their business and a need to be more operationally efficient. The other negotiation between GPs and LPs is the verbiage that deals with what expenses will be borne by the fund. We've seen a far greater degree of clarity in LPAs on expense responsibility and allocation. Ongoing regulation and SEC oversight means that there's a fairly fluid situation with fees and expenses in LPAs. The smart legal advisor will assist the sponsor with future-proofing the LPA—putting in added language that protects both parties regarding new rules, regulations, and costs, and deciding who bears those costs. ■

Contact: Steven Millner at smillner@gen2fund.com

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