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PRIVATE EQUITY FEES REQUIRE DYNAMIC DUE DILIGENCE

An examination of private equity fees and expenses

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Overview

As a category, private equity funds are known to have some of the highest and most complex fee structures in the investment world.

Their complexity is magnified by the distribution mechanics within private equity funds that specify the order and amount of fees to be charged and returned to the various parties during the life of the agreement. While the relative level of fees charged on a percentage basis has declined over the last several decades, the absolute level has increased dramatically driven by the significant increase in fund sizes. As a result, we have increased our focus on fees and expenses, particularly given the importance of transparency for investors and the greater scrutiny surrounding the Securities and Exchange Commission's ("SEC") investigations over the past 18 to 24 months.

The main categories of fees and expenses we examine during our due diligence efforts are management fees, carried interest, preferred return, organizational expenses, transaction fees and fee offset provisions. For the purposes of this article, we are excluding the carried interest and preferred return provisions and focusing on the other categories as these tend to have greater variability and have attracted more attention from the SEC of late.

Management fees

The most common fees seen in private equity fund agreements are management fees. They are usually structured as a percentage of an investor's commitment to the fund during the investment period (ranging from 1% to 2%) declining to a lower percentage of remaining invested capital thereafter depending on the fund's specific strategy. The original concept behind management fees was to cover the manager's ongoing staffing and overhead costs while it sources, screens and executes investments and was not intended to be a profit center. However, as fund sizes increased over the last several decades, management fee income has grown significantly and now generates substantial profits for larger firms.

In evaluating the reasonableness of the management fees, investors should consider the size of the manager in terms of the number and size of prior funds, whether prior vehicles are generating fees and the number of professionals and offices. Investors also should consider projected growth of the team. Compensation is typically the single largest use of management fees and is a key driver of behavior for the manager's investment professionals. Thus, it is important for investors to understand all sources of compensation across the team and how this drives incentives for the investment professionals.

In order to best assess the reasonableness of the management fees being charged, whether the fees cover reasonable operating expenses and salaries, and appropriately take into account the lower levels of incremental expenses associated with the formation of a follow-on fund, investors should request a three-year operating budget from managers. We note that, while we regularly make this request, very few firms are willing to disclose their operating budgets. For those that do not, the request may then drive a detailed discussion that generates enough information on which to make an assessment.

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Additionally, in certain situations, managers may offer more than one management fee/carried interest combination. In order to determine which option works best, investors must assess the fund's expected return characteristics and overlay their own specific preferences regarding fees and cash flow patterns.

We have found generally that for most high performing managers, choosing the option that results in a higher management fee/lower carried interest (profit sharing) component generates the optimal long-term return for the client.

Organizational expenses

Organizational expenses are designed to help offset the cost of creating, structuring and raising the limited partnerships. It is important to assess both the absolute dollar amount of these expenses and the cap, and determine how this compares to prior funds and other funds in the market. Given organizational expenses are intended to support fund formation efforts, it is important to request specifics around how placement agent fees are treated to ensure these fees are not charged to investors who are precluded from using placement agents and, more broadly, are not charged to the fund, which may include investors that did not initiate their commitments by way of a placement agent relationship. Specific to European funds, organizational expenses have increased over the past couple of years as a result of an increasingly complex regulatory and tax environment. In these cases, it is important to understand the magnitude of the increase and the expectations around the extent to which incremental fees over the fund's cap will be borne by the manager.

Transaction and other fees

In this broad category, it is important to assess the specific provisions around these fees, which in addition to transaction fees may include directors' fees, monitoring fees, consulting fees and break-up fees. We find the best approach to determine what is included in this category is not to work from the definitions, but have the managers describe all the possible fees that are charged to companies and ask that definitions in the limited partnership agreement simply refer to "all fees charged". The goal is to determine if, effectively, these fees are providing another source of income to the manager in a way that undermines alignment with the limited partners, given some of these fees may not be tied to how well the manager's investments ultimately perform.

A key component of the analysis is to determine how relevant these fees are to the manager's strategy, given consulting fees would be more important to a strategy with an operational improvement focus versus a non-control distressed strategy. Importantly, if it is determined that transaction and other fees are a viable component of the manager's strategy, one should assess what portion is offset against management fees (discussed more below), understand if fees are expensed pro rata across all fund vehicles including separately managed accounts and other side-by-side vehicles, and assess the organizational structure of the manager, including any affiliates.

Fee offset provisions

These provisions are designed to recapture the fees charged by managers to their portfolios and offset some or all of those fees against the management fees paid by the limited partners. Without such provisions, the managers can create (and have created) a new revenue stream outside the base management fees that weakened the alignment with limited partners.

We recently completed an analysis of our universe of buyout funds and found that 84% of 2014 and 2015 vintage funds offer a 100% fee offset provision compared to 7% of 2006 and 2007 vintage funds. While this appears to be a trend demonstrating greater alignment with investors, the complexity of the offset provision has increased materially and all offset provisions are not created equal.

During due diligence, investors should focus on what is most relevant to each strategy. For many funds, the greatest variability occurs in how fees associated with the manager's operational or strategic involvement are offset. The investor's primary focus should be on assessing if the fee structure incents performance in a manner that aligns the manager with the investors. For example, in one case we found that the compensation paid by the portfolio companies to the operating professionals was not offset against management fees; however, in our reference calls, we found that the majority of these professionals' compensation on an overall basis is tied to a successful exit of the portfolio company, which ensures greater alignment with the fund's investors.

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SEC focus

As you may have seen in the news recently, the SEC has been reviewing fees and expenses of a large number of private equity firms over the last couple of years and, in particular, has focused on transaction fees and fee offset provisions. Transaction fees, similar to those charged by investment banks, are typically charged by the managers based on a percentage of the deal's total enterprise value. Because firms typically invest 25% to 40% in equity and the balance comes from third-party debt, the transaction fees have the potential to represent a meaningful portion of the capital invested by the manager. The SEC has questioned whether certain firms should be able to charge such fees if they are not registered to serve in such a capacity.

In addition, the SEC has taken a closer look at how operating partners should be viewed (affiliates or full-time employees versus outside consultants), how operating partners are compensated and how compensation is disclosed. Typically,

operating partners are experienced industry executives who provide their expertise to a private equity firm across the investment process.

They may help source and research new investments and, most commonly, serve on boards of portfolio companies and assist with operational improvements. Operating partners may or may not be exclusive to a private equity firm. In May 2014, the then Director of the SEC's Office of Compliance Inspections and Examinations, Drew Bowden, remarked that many firms do not treat operating partners as affiliates, or full-time employees, when in many cases they act as full-time employees.

Conclusion

Fees in private equity funds are complex and can have a significant impact on returns over the life of a fund. As a result, the due diligence procedures applied to analyze fees must be dynamic and evolve to adequately assess the various structures different managers employ.

The Institutional Limited Partners Association[1] ("ILPA", www.ilpa.org), an industry group designed to provide education and resources to limited partners investing in private equity, released its ILPA Principles in 2009 with an update in 2011. While the broad goal of the Principles is to improve transparency and communication between limited partners and managers, they include specific sections with regards to best practices for fee structures, amounts and disclosures.

[1] Pavilion Alternatives Group has worked closely with the ILPA since its inception and was involved in the development of the Principles as well as ILPA's Standardized Reporting Templates which were released in 2011.

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