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Current Developments in Fund Terms of Private Equity Funds

“On the path to a two-class society” – a bold summary of the international private equity market, if one reviews the last 12-18 months of international fundraising for private equity funds. As mainly observed by English-language trade publications, fund managers are increasingly divided into the few “*haves*” as compared to the many “*have-nots*”. One must take this into account when reading about the new records in fundraising. With this in mind, it is worth taking a closer look at current trends in contractual *fund terms* of private equity (PE) funds and other closed-end alternative investment funds for institutional investors.

The current fundraising situation is characterized by very competitive efforts of fund managers to attract institutional investors. This wooing of investors has recently expressed itself in positive fundraising numbers. Given its promise of “*excess*” returns, private equity as an asset class is in high demand in the existing low-interest environment. If one takes a step back and looks at the background for fundraising, it’s almost astonishing that the fundraising numbers have recently developed so positively and at times exceeded former record levels.

Fundraising background and numbers

The general fundraising climate is a source of concern for many fund managers: politically, economically, as well as with regard to taxes and regulatory issues. The complex situation of international politics has become even more challenging in recent years. Headlines were made by the recent UK Brexit decision as the latest spectacular highlight of the ongoing EU and Euro crisis, the latent political conflict with Russia, as well as the refugee crisis and the U.S. presidential

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election campaign between Hillary Clinton and Donald Trump. Taxes also continue to be an explosive topic. The key words BEPS, FATCA/CRS, Investment Tax Reform Act (*Investmentsteuerreformgesetz*), value added tax on management fees and international pressure on carried interest taxation all illustrate the fact that the merry-go-round continues to turn with regard to taxes. Important *regulatory* aspects for managers and investors have not yet been adequately clarified and are exacerbated by new requirements.

In addition to ongoing changes in the laws and planned legislation (EU Capital Market Union, AIFM Directive II, EU Market Abuse Regulation, MiFID II), the topic of *enforcement* of existing legislation by regulatory authorities is also a source of stress for fund managers. In particular, the SEC recently subjected U.S. fund managers to stricter requirements and auditing.

However, there have been a few glimmers of hope. For example, the UCITS V Implementation Act and the German Federal Financial Supervisory Authority's (BaFin) practices have eased the regulations on credit funds. Yet, the *economic* environment – with high market volatility on stock exchanges, low prices of commodities, low interest rates and the Central Banks' *quantitative easing programs*, along with the downgrading of the valuation of non-listed "*unicorns*" in the USA – has somewhat clouded the situation.

Nonetheless, the fundraising numbers in recent months have been promising. Investors in PE funds have high expectations for returns by this asset class. According to surveys, more than 40% of investors expect an increase of 4.1 percentage points as compared to the return on public capital markets. These high expectations have recently been met. 2014 and 2015 saw the highest net payments (i.e. more distributions than capital calls) to fund investors since the financial crisis. The average holding period of funds decreased in 2015 to 5.5 years (2014: 5.9 years). As a result, investors received back their invested capital (and hopefully also profits!) more quickly, in turn making the asset class private equity even more attractive to investors than before.

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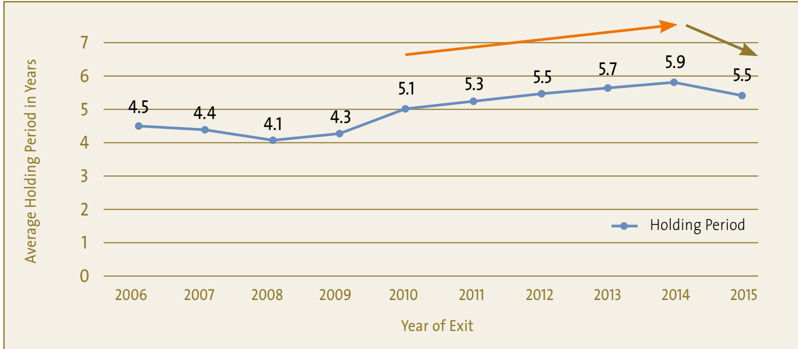
Global buyout holding periods: getting shorter since 2015 Fig. 1



Source: Preqin Buyout Deals Analyst

More than 30% of investors stated that the private equity asset class most recently exceeded their expectations. Therefore, more than 35% of investors want to increase their shares in PE funds. In addition, 45% of investors are still below their target allocation for private equity. The great demand of investors accelerates fundraising and actually leads to oversubscriptions of some funds. Internationally, the 2015 fundraising volume was slightly larger than the already high levels of the previous year. The average fund size increased to USD 578 million, a new record high. First-time funds achieved an average fund volume of USD 237 million, whereas experienced managers actually raised an average fund volume of USD 657 million, also a new record high. In Europe, the fundraising volume remained stable around the level of the previous year, despite a reduction in the number of funds raised. Only in Germany, the numbers were a bit weaker than in 2014. In 2016, the international growth trend continues, also in Europe and Germany, and promises new record levels.

"*Haves*" and "*Have-nots*" – recipe for a successful fundraising

As it did last year, the gap has again widened between the "*haves*" and the "*have-nots*" among fund managers. The successful managers have amassed in-

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vestors' capital in a short period of time by utilizing their good track records, established brand names, clearly defined investment strategies, large commitments to invest their own money in the funds, stable teams and well-organized succession planning. These successful fund managers are often able to complete a fundraising within six months (in some exceptional cases, even within three months) – while most of the fund managers, in particular those with younger or less successful teams, are "on the road" for approximately 12 (or even 18) months, in order to conclude their fundraising efforts. The trend for the fundraising by successful managers is to have only one single closing ("*one and done*"). Though in practice, this sometimes merely is a good "sales pitch" by the wordy placement agent handling the fundraising. These agents come up with creative designations for the second or third closing: "closing 1B or 1C". What is meant by this "*window dressing*", however, is that subsequent closings take place in close succession after the first closing. In any case, the work that goes into a successful fundraising (not least on the legal, regulatory and tax aspects of the fund structuring), is often not entirely transparent to those on the outside.

Success in fundraising is not only expressed by the speed at which it takes place, but also by the amount of the capital raised. According to industry statistics, 10% of all funds collect 60% of all capital in international fundraisings. This must be taken into consideration when assessing new fundraising records. By contrast, less successful fund managers (the "*have-nots*") feel investors' declining loyalty and the increasing importance of popular fund brands. Nevertheless, from the investors' point of view, the distinguishable qualities of the fund managers decreased (in particular with respect to large buyout firms). Statistically, based on the length and the amount of capital raised, the first closing already indicates whether fundraising will be a success. This emphasizes the importance of a successful first closing. In addition to those aspects that are critical from an investor's perspective, such as team, track record and investment strategy, there are financial and other incentives (early bird discounts, co-investment rights, seats on the advisory board, etc.) that can be particularly attractive for first closing investors. In particular, investors are increasingly requesting co-investment rights often resulting in extended negotiations for corresponding side letter clauses and detailed co-investment policies for the funds.

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Big picture trends in fundraising

Some of the big picture trends in fundraising include various legislative initiatives in countries that endeavor to be attractive locations for fund managers. *Luxembourg* is a prime example: In the summer of 2016, the law on the new legal form, reserved alternative investment fund (RAIF), took effect. To date in *France*, the most common legal structures for PE funds are contractual type fund arrangements (FCPR, FPCI). Now, the *société de libre partenariat* is newly introduced as an alternative structure to the German KG and the U.S./UK limited partnership structures. In the *UK*, the long-overdue reform of the limited partnership is still pending, but expected to be completed in the near future. By contrast, *Germany*'s lawmakers have recently been inactive (with the exception of new rules on credit funds) in order to make Germany more attractive as a domicile for funds and fund managers.

In general, there is a recognizable trend towards more complex fund structures. Nowadays, master-feeder structures are the rule. Historically, *tax* aspects were the primary driving force for fund structures. As a rather recent development, *marketing* aspects are now also gaining significance in fund structuring, for only a structure that incorporates a coherent marketing concept allows for a successful fundraising. More complex fund structures have recently led to increases of the establishment costs of funds.

So-called "*core*" PE funds represent a new development modeled on Berkshire Hathaway. These have a longer investment period and term, as well as lower expected returns than traditional PE funds and, up to now, were only launched by mega buyout firms for very long-term oriented investors (pension funds, insurance companies). It remains to be seen whether this is just the flavor *du jour* or a permanent development. The secondaries sector has recently shown slightly decreased transaction volumes, although these remain at high levels. Fund restructurings (including "tender offer"-like transactions), *stapled* transactions and an increased use of leverage took center stage. At the same time, secondary funds have recently been very successful in fundraising. Due to the large amount of "*dry powder*" that was amassed, one can expect that the volume of secondary transactions will increase again in the future.

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Since the publication of the so-called *Panama Papers*, some institutional investors fear damage to their reputation. There is a rethinking of the use of offshore vehicles, because no one wants to see their name connected with a "*tax haven*" – certainly not in undifferentiated headlines on the first page of a newspaper. However, participating in a fund structured as a tax-neutral Cayman Islands *exempted limited partnership* is no different for tax purposes than the participation in an equally tax-neutral German *Kommanditgesellschaft* (limited partnership). Furthermore, from the fund manager's perspective, there are regulatory reasons due to the marketing rules under the German Capital Investment Act (*KAGB*) to give, for example, priority to a Jersey or Guernsey feeder vehicle over an "onshore" vehicle. It remains to be seen, whether the question of reputation will eventually lead to a substantial shift from offshore to onshore funds.

Fund economics – the core of every fund agreement

The focus of every analysis of fund terms is on *economics*. They make up the core of every fund agreement. In this regard, even successful managers are still subject to pressure from investors. The alignment of interests of management and investors is guaranteed by the management's own capital participation; they have "*skin in the game*". The "traditional" participation of 1% of the fund volume continues to be the general standard. However, established funds with a larger team increasingly have participations of 2% or more. This *alignment of interests* is important for the long-term success of private equity and is the reason why the fundamental economic parameters for PE funds have not changed since the financial crisis.

The investors now demand more transparency in funds. They often request disclosure of budgets and detailed expenses reports. The U.S. regulatory authority, the SEC, requires disclosure of costs and fees. The latter demands detailed documentation in the fund agreement and placement prospectus. Regarding the other *fees* (transaction fees, advisory fees and other compensation, which the fund managers receive from portfolio companies and third parties), a 100% *fee offset* against the management fee has meanwhile become the market standard. Only in individual cases does one still see a mere partial fee off-set (e.g. only

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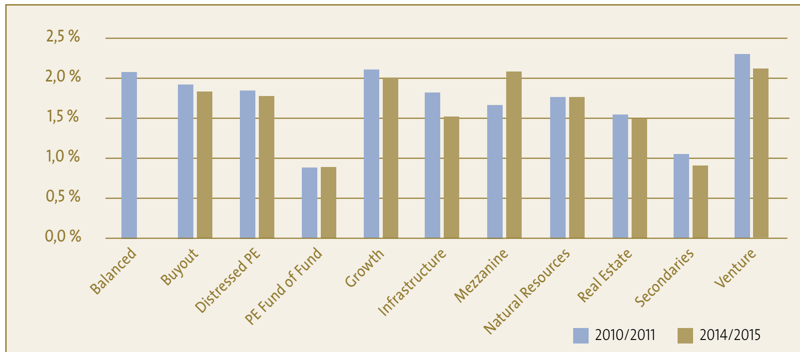
80% offset or exclusions of certain fees). The amount of the management fee has been constant at approximately 2% for quite some time (dependent upon the size and strategy of the fund, the usual fees are 1.75%-2.25% of the fund volume).

Management fee (2010/11 vs 2014/15): Pressure from investors Fig. 2



Source: Preqin Private Equity Fund Terms Advisor 2011 and 2015 (instead of: 2011)

However, there has recently been a slight downward trend, which primarily affects funds with a fund volume of more than USD 1 billion. In a few cases, some funds have conceded to pressure from the investors to switch from capital commitment to invested capital prior to the expiration of the investment period. In general, the trend in management fees is to tailor them according to strategy, market sector and team size. From the manager's point of view, disclosing the budget can also present an opportunity, because certain investment strategies, particularly those requiring greater manpower (e.g. turnaround funds), can achieve even higher fees in certain cases as a result of such disclosure. There is also a movement towards more transparency regarding ongoing fund expenses.

The trend observed within the last year of *voting rights* on the economic parameters continues – even if this has only happened in a few cases to date. Some international funds offer investors the choice between alternative models for *management fees* and *carried interest*. Thereby, the options are structured so that a lower management fee is combined with a higher carried interest and, potentially, with the elimination of the *hurdle rate*. For example, a US me-

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ga-buyout fund offered investors the following three options: (a) 1.5% fee + 20% carry + 7% hurdle, (b) 1% fee + 30% carry + 7% hurdle or (c) 0.5 % fee + 30% carry + no hurdle.

Examples of economic voting rights (no coherent picture) Fig. 3

Special Situations Funds: 2 Options
1 % Fee + 30 % Carry vs. 1.75 % Fee + 25 % Carry

US Mega Buyout Funds: 3 Options
1.5 % Fee + 20 % Carry + 7 % Hurdle
1.0 % Fee + 30 % Carry + 7 % Hurdle
0.5 % Fee + 30 % Carry + no Hurdle

Secondary Fund of Funds: 2 Options
1.5 % Fee + 10 % Carry vs. 0.85 % Fee + 20 % Carry

EU Big Buyout Funds: 2 Options
Whole-of-Fund Waterfall vs. Deal-by-Deal Waterfall + 7.5 bps less Fee

However, such models are only appropriate for established managers who do not necessarily have to rely on management fees to cover all of their overhead expenses. One should also carefully consider accounting and tax implications of offering economic voting rights. Increasing *individualization* is also reflected in more frequent negotiations of individual modalities of the management fee (such as the beginning or date and scope of reduction after the investment period). Here, managers must continue to expect requests from investors for *early bird and loyalty discounts* and deductions due to high subscription amounts.

Meanwhile, the *whole-of-fund* calculation method for *carried interest* has become an international standard. Its current percentage in the USA, Europe and the rest of the world is approximately 80%. Just a few years ago, this was unimaginable in the U.S., because traditionally the *deal-by-deal* calculation method was used there. By comparison: five years ago (2011), the percentage of *deal-by-deal* structures was still at 49% – a paradigm shift in the otherwise rather slowly changing world of *fund terms*.

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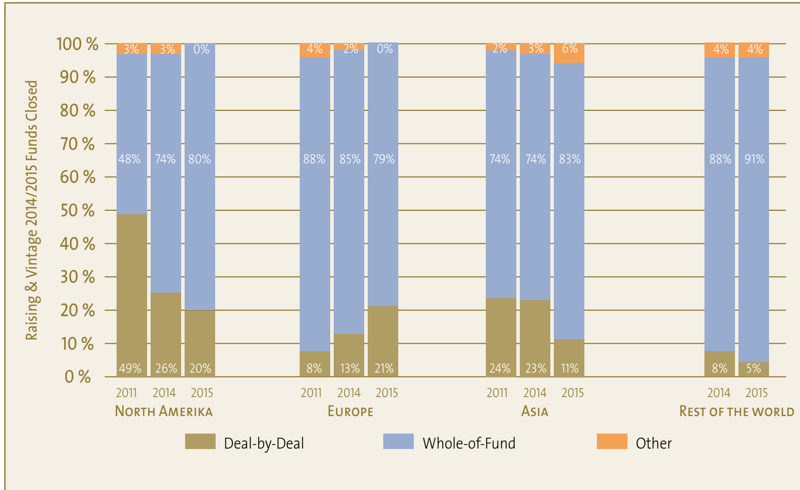
Whole-of-Fund is gaining upperhand Fig. 4



Source: The 2015 Preqin Private Equity Fund Terms Advisor (versus prior editions of 2011 and 2014)

Concurrently, the discussion of securing the *general partner clawback* obligation has been eased by the move to *whole-of-fund* structures, because there a situation of overpayment of carry is, by its nature, less likely compared to *deal-by-deal* calculations. For securing the carried interest clawback, *personal guarantees* provided by the carry recipients are more common than *escrow accounts*. The carry rate for most funds is 20%. Certain funds managed by particularly successful fund managers provide for a *super carry* (25% or 30%) upon meeting of certain thresholds (for example a 2.5x *net money multiple*).

With all the pressure on fixed fees, this demonstrates the willingness of the investors to reward exceptional performance. The *hurdle rate* is still mostly at 8%, though managers increasingly attempt to implement lower rates to reflect the low-interest environment. However, to date, this does not often succeed: in 2010/11 65% of all funds had a 8% hurdle rate, in 2014/15 this number was only at 56%. At the same time, the number of funds with a *hurdle rate* of 6% or 7% has gone up slightly.

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Fund governance – protecting investors in tumultuous times

In *fund governance*, the professionalization of investors can be observed. During the financial crisis, investors learned (or, to be more precise, had to learn) that the rules on *fund governance*, i.e. the legal framework of the fund, including investors' rights, is especially important for a fund in times of crisis for a fund. The *ILPA principles* still serve as guidelines for many investors. The *Institutional Limited Partner Association* (ILPA), an international organization of institutional investors, strives for further standardization of PE funds. There are various recommendations (*ILPA templates*) on capital calls, distribution notices and reporting. At the beginning of 2016, ILPA added a new *fee reporting template*. Though one has to admit, that, until now, these templates are still not yet fully accepted by the market. In June 2016, ILPA started an ambitious initiative to standardize *non-economic terms* in fund agreements.

Furthermore, the focus of *governance* negotiations is still on *key person* clauses. There, dependent upon the size of the team, one can increasingly observe multi-tiered and differentiated LPA provisions. In addition, the technical details of *change of control, investor giveback obligations* and *no-fault* rights are increasingly being negotiated.

Fund documentation and ESG issues – side letters and no end in sight

The ESG (*Environmental, Social, Governance*) issue is becoming increasingly important within the scope of the operations and fund documentation and has established itself as a core value creation strategy. The question of *how* ESG programs can be implemented at the level of funds and portfolio companies is paramount. As the ESG issue has only come up in the last few years, it continues to evolve. Thus, the approach of fund managers to address this in side letters and fund documents is also evolving. The scope of side letters and subscription documentation continues to grow due to greater regulatory requirements and more complex fund structures. Negotiations are time-consuming, so that fund managers increasingly limit voting rights regarding the "*most favored nation*" clause and make election rights dependent upon the respective investor's subscription amount.

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Summary – where does this journey lead?

The trend leading to a two-class society for fund managers continues. The most successful managers were able to modify the contractual parameters within the last 12 to 18 months, in part to their own advantage. It is important to note, though, that in many respects, the fund terms were not scaled back to the very manager-friendly standards that existed before the financial crisis. Even the phenomenon of oversubscribed funds does not significantly change that fact. Instead, adjustments to individual clauses can be observed: differentiated key person provisions, some experiments regarding election rights with respect to economics and super carry in selected cases. Hence, the trend of "*evolution not revolution*" continues for another year. *Panta rhei* – everything flows!

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