PERFORMANCE FEES

# Dangling a different kind of carrot

*Both investors and managers are starting to tinker with typical carried interest arrangements in search of a better long-term model, writes Dante Leone*

***Leone:** alternative reward models are emerging*

'2 and 20' has been the definitive mantra of private equity for a very long time.

The '2' portion has been moving considerably in recent years, mostly on a downward trajectory – largely as a result of the increasing sizes of private equity funds and the quest by large investors for special rebate deals, managed accounts and other customised solutions.

The '20' portion continues to remain a bastion of the industry. Nonetheless, around the margins, we see efforts by both investors and managers to tinker with typical carried interest arrangements, in the hope of finding the perfect recipe for a long-term relationship.

Often, these efforts originate because emerging or spun-off sponsors wish to differentiate themselves from the crowd. In other cases, it's because large potential investors have commanding negotiating power. In yet other cases, it's because of specific features of the underlying investment proposition.

Below, we will describe a few unconventional arrangements in respect of private equity performance fees and highlight associated rationales and drivers (although we purposefully ignore deal-by-deal arrangements, which remain quite atypical).

## PREFERRED RETURN: ALL THAT GLITTERS IS NOT GOLD

Carried interest percentage rates are normally the most pressing object of attention during any negotiations about how to reward good performance by managers. However, a major component of the reward mechanism is preferred return.

As we all know, preferred return for private equity funds is ordinarily set at an eight percent annual rate. In recent years, it has been difficult to ignore managers' gripes that a yearly preferred return of this size has become an unjustifiably high hurdle to clear. Simply put, the charge is that requiring a minimum annual gain of eight percent before payment of any performance fees is no longer fair.

From 1983 to 1990 (a fairly crisis-free period), when modern private equity came of age, the so-called 'risk-free rate' of US three-month Treasury bills rates hovered around eight percent. As a result, prospective investors quite rightly demanded that private equity professionals not receive any carried interest for annualised performances below that level. Now that the same risk-free annual rate has consistently stayed below 0.02 percent for the past 48 months, private equity professionals are arguing that the preferred return hurdle should be similarly curtailed.

Institutional investors usually counter this argument by observing that the main reason why they invest in private equity in the first place – thus accepting the associated drawbacks of illiquidity and nearly total lack of governance for a very extended period – is the hope that the premium IRR delivered by private equity funds might help add a few basis points to the average performance of their portfolio. Such targeted annual premium IRR is characteristically considered to be in the mid-teens: therefore sponsors should not be compensated for achieving annual returns below eight percent.

And given that for most institutional investors the alternative to private equity is investing more money in public equities, why should private equity be benchmarked against risk-free rates?

Furthermore, there have been suggestions in recent academic papers that private equity managers add the most value during the bust period of the economic cycle, while boom time returns tend to deviate less from the public markets.

This would reinforce the idea that the best possible incentives to, on the one hand, push private equity sponsors to do better during boom phases and, on the other hand, foster resiliency during bust phases is benchmarking private equity against liquid public markets.

But of course, that would be an ever-moving target – difficult to identify, due to the different geographies and sectors covered by any one private equity fund, and quite complex to apply for investors and sponsors alike. So there are plenty of advantages in the simplicity and immediateness of the eight percent annual rate.

And yet, as a result of the preferred return, funds often struggle to touch carry-positive territory despite having done relatively well in the face of dire overall economic conditions.

Even in situations where sponsors have created real value for investors, the flow from management fees may be low due to the post-investment period step-down and the inability to raise new funds; prospects for mid-level professionals may be grim, and the ordinary reasons for teams to remain together may have evaporated along with returns in excess of eight percent. A potentially perfect recipe for the poor management of non-realised portfolios.

These are the broad reasons why investors and sponsors sometimes endeavor to find alternatives to the ordinary preferred return model. In our experience, the two most frequent deviations from the norm are:

1. Replacing the annual rate of return with a fixed multiple on contributed capital;
2. Eliminating the catch-up.

### 1. FIXED MINIMUM MULTIPLE: MOVING THE CARROT FURTHER AWAY

In the first case, instead of an annual rate of return, sponsors are required to distribute to investors a minimum multiple on contributed capital before any carried interest becomes payable. The minimum level is often set at 20-30 percent (i.e. 1.2-1.3x on contributed capital). This structure is apparently favourable to investors, as it immediately locks in a significant entitlement to carry-free returns. But it may in fact have at least two big drawbacks.

On the one hand, sponsors may have a disproportionate incentive to make risky gambles, given that their carried interest only becomes payable when returns from investments are high not simply on an annualised basis but also on an absolute multiple basis.

On the other hand, the fact that the passing of time does not have any bearing on the carried interest entitlement of the sponsor – in other words, that the marginal cost of capital for the sponsor, after the initial drawdown, is equal to zero – is an obvious disincentive to dispose of the investment in the initial years of holding, to the extent that the sponsor believes that there is even minimal additional value to be extracted from the investment. And this may well run against the interests of investors, for whom the cost of capital not returned by the sponsor, in the hope of very limited future upside, may become more and more significant as time goes by.

However, there are two mitigating factors that can soften the impact of these issues.

The first factor has to do with dispositions: the less the power of the sponsor to influence the timing of the exit, the less the risk that this structure may actually create the aforementioned disincentives to dispose of the investment. A reduced power to influence exits may arise from the specific focus of the fund, as in the case of investments that have a fixed maturity horizon, like self-liquidating assets or credit positions. Or it may result from the investment style of the vehicle (e.g., a co-investment fund, a fund focused on minority stakes) or from the introduction in the structure of the right of limited partners to force exits after a minimum holding period.

A second mitigating factor is a sizeable commitment on the part of the sponsor, which – as always – is one of the best antidotes against excessive risk-taking and against the adverse incentive of the absence of cost of capital for the sponsor (this is not to suggest that managers with limited principal commitment are necessarily poor performers – in fact recent evidence »

**"The charge is that requiring a minimum annual gain of eight percent before payment of any performance fees is no longer fair**

> ***Large institutional LPs … are the least flexible when it comes to adopting novel carried interest terms***

**8%**
Typical return from 3-month US T-bills between 1983 and 1990, the basis for PE hurdle rates

**0.02%**
Average return from 3-month US T-bills in last 4 years

» suggests the reverse might be coincidentally true). 'Sizeable' in this context indicates not simply a large amount, but rather an amount of commitment that is particularly significant relative to the total assets of the sponsor.

Of course, there may be circumstances in which it is objectively difficult for managers to make large commitments. In this instance, it is nonetheless possible to boost the sponsor's commitment by alternative means, such as providing for the automatic reinvestment of any profits from management fees (or for a waiver of a portion of those fees); or by structuring a small, low-interest loan from the limited partners to the sponsor in order to finance the latter's principal commitment, resulting in (a small extent of) liability of the sponsor for any investment losses.

### 2. NO CATCH-UP: AN ART-NOUVEAU CARROT

In the second variation, the preferred return remains (albeit perhaps at a reduced rate), but the catch-up is eliminated.

This structure also appears immediately favourable to investors, countering their typical fears that low returns – i.e. returns with an IRR below the lower part of the range targeted by investors, likely around 12 percent – may be further decreased by carry entitlements. However, there at least two possible drawbacks here too.

On the one hand, eliminating the catch-up translates into an immediate reduction for sponsors of the total amount of performance fee potentially payable. In fact, in this arrangement, the basis for the calculation of the carried interest never includes the preferred return accrued by investors, irrespective of the level of actual IRR (or, indeed, multiple) of the fund.

On the other hand, the fact that the passing of time has such an unfavourable effect on the sponsor's economics creates a disincentive for the sponsor to continue holding the investment, to the extent that it may lock-in an immediate gain instead of risking to lose carried interest due to the accrual of preferred return, even if the investment has favorable growth prospects. (This is, if you will, the mirror image of the second drawback of fixed minimum multiples discussed above.)

But again, there are two mitigating factors.

The first has to do with the timing of exits: the less the likelihood or power for the sponsor to make a very quick exit, the less the risk that the structure may give rise to a disincentive to keep the investment. This may arise from the specific focus of the fund, for example in the case of early stage ventures, growth opportunities or buy-and-build strategies. Or it may result from constraints of the structure, such as the introduction of the right of limited partners to veto proposed exits taking place both below a minimum IRR or multiple *and* before a minimum holding period.

A second mitigating factor can be the reinstatement of the catch-up based on a minimum pre-determined IRR or multiple on contributed capital. In other words, preferred return contributions are again taken into account for the purposes of calculating carried interest distributions, for example after the IRR has reached 12 percent or the multiple has reached 1.8x. In this adjusted structure, contrary to standard practice, carried interest begins to accrue before the catch-up. As for the sponsor, investors may successfully argue that its overall carry entitlement is not reduced but rather made conditional on even better performance.

### HIGHER CARRY RATES: THE FAMOUS PYRAMID-SHAPED CARROT

The 20 percent carried interest rate has been repeatedly heralded as one of the most just mechanisms for rewarding performance on the part of the private equity managers.

Nevertheless, particularly when negotiating the terms of smaller funds, we frequently see carry rates ratcheting up based on a minimum IRR or multiple, and hitting as high as 40 or 50 percent.

As expected, large institutional limited partners with particularly stringent investment policies are the least flexible when it comes to adopting novel carried interest terms – whereas less institutional investors (such as large family offices, endowments or other opportunistic limited partners) are more likely to be receptive to this kind of requests by sponsors.

The discussion is driven by a number of considerations.

Chiefly, sponsors – especially those managing funds that have returned impressive multiples to investors or that have been successful in past deal-by-deal investments and are thinking of converting to a more permanent structure – may feel that only higher carry rates provide them with the appropriate incentives for accepting a fund arrangement. These sponsors may have the option of investing on a deal-by-deal basis with past investors that think particularly highly of them. Or they may have accumulated enough wealth to be able to focus on deals requiring only their principal capital, and providing them with 100 percent of any upside.

Increasing carry rates may, however, also be a tool in the hands of investors – for example if they are dealing with managers that have done well by concentrating on investments requiring very limited capital, and are worried that the carried interest arising out of a small fund would not constitute sufficient motivation. Creating a potentially larger pool of carried interest, after reaching higher IRRs or multiples on cash, may have the effect of keeping the overall size of the fund small and of ensuring that sponsors continue to devote their energies to the appropriate kind of investments – without the urge to change their investment style in order to maximise their performance fees.

Moreover, growing the potential carry pool may also have the effect of allowing the sponsor's team to become larger, by hiring junior resources who can take over the reins of the business once the founders have exhausted their enthusiasm.

### KEY FEATURES: DID YOU SAY "PYRAMID-SHAPED" CARROT?

First of all, catch-ups typically do not apply to the higher ratchets of carry. From another viewpoint, the distribution curve is never flat after the initial catch-up on preferred return (assuming it is present, as discussed above). No matter what the overall performance of the fund is like, sponsors will enjoy the higher carry rates only on the marginal portion of the proceeds that exceed the agreed thresholds.

Second, often precisely after early winning exits, there is a risk that sponsors may decide not to draw down additional capital from investors – or to only make investments requiring very limited capital and with the potential to yield soaring multiples – in order to minimise the risk of having to give back their already-received carried interest. Consequently, only a small portion of the fund would get deployed, to the chagrin of investors. That's why sometimes the kicking in of higher carry rates is also subject to calling or deploying most if not all of the fund commitments.

Third, these structures require strong clawback provisions. One or two early winners can have the effect of making carry distributable very soon at the higher rates, and yet money drawn after the winners have been exited could perform less exceptionally, thus requiring a downward adjustment to the carry rate applicable to the fund distributions when considered on an aggregate basis. As a result, it is quite critical that investors have confidence there is no appreciable risk of overpayment. A good way to enhance this confidence is by providing for periodic clawback tests, on an annual or other appropriate basis, as opposed to only at the time of liquidation.

Another effective way is to retain considerable portions of the carried interest to create large escrow reserves – which would be ample enough to satisfy most clawback obligations. It's the old adage: better safe than sorry (it also does apply to carrots)... ■

> ***Certain sponsors … may feel that only higher carry rates provide them with the appropriate incentives for accepting a fund arrangement***