PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

FUND FORMATION AND INCENTIVES REPORT

A Research Study

April 2014

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Commentary from Schulte Roth & Zabel

Welcome to Schulte Roth & Zabel and *Private Equity International*'s Fund Formation and Incentives Report. In light of our extensive experience as legal counsel to managers and investors, we were pleased to partner with PEI on the design of the questionnaire, to review the results and to provide commentary based on our experience in the market.

Carefully crafted private equity fund terms and conditions portray well run negotiations and developed relationships between GPs and their investors. These relationships thrive through precise alignment of interests. GPs must be receptive to changing dynamics and therefore increasingly make decisions on fund terms and conditions with an eye toward attracting LPs, who want to see managers sharing in both risk and reward.

For instance, GPs face increasing pressure to assume a meaningful risk of capital alongside investors and to demonstrate personal confidence in their fund's ability to perform by making a greater dollar contribution to their own fund. The survey reveals that this trend looks certain to continue. Similarly, GPs increasingly agree that they should only begin to reap the benefits of carried interest once investors have received a total return of their invested capital plus the agreed hurdle rate, as opposed to on a deal-by-deal basis. This European-style model, seen as more investor-friendly, is now dominant.

It is well understood that GPs must exploit their proven track record to attract new LPs. While a firm's stature plays a large role, track record comes down, in the end, to individual talent. Indeed, the study reveals that many GPs cite the treatment of key persons as an important bargaining tool during fundraising.

Reputation also plays an important role in human resources. The survey's results show that private equity remains an attractive industry, with few firms short of talented applicants. Furthermore, individual firm reputation ranks as a high draw for investment professionals, second only to compensation.

We hope that this study will assist private equity firms to benchmark their procedures and structures, with the hopes of maintaining their position as industry leaders.

If you have any questions about the findings in this report, or would like to explore how SRZ can assist your firm, please feel free to contact us. Our contact details are listed at the end of this report.

Kind regards,

Stephanie R. Breslow

Omoz Osayimwese

Phyllis A. Schwartz

Joseph A. Smith

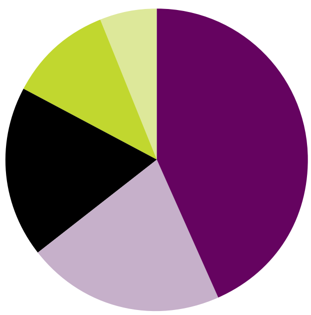
Methodology

Private Equity International, in association with Schulte Roth & Zabel, carried out a survey of senior private equity managers in October and November 2013. The survey, which was followed by several in-depth interviews, was designed to provide a deeper understanding into how managers structure funds in a manner that is designed to ensure alignment of interests with their limited partners, and how investment professionals are incentivized to achieve top performance.

Over 130 people took part in the survey, representing institutions of different sizes and managing funds with various strategies in all parts of the world.

Figure 1

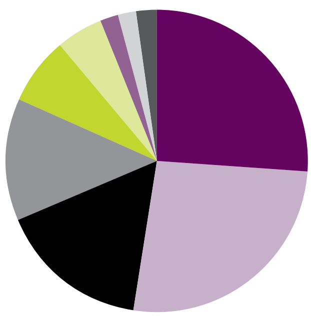
Where is your firm headquartered?



- 44% North America
- 21% Europe
- 18% Asia-Pacific
- 11% Latin America
- 6% Middle East/Africa

Figure 2

What fund strategy does your firm specialize in?



- 26% Growth/expansion capital
- 26% Real estate
- 17% Buyout
- 13% Venture capital
- 7% Turnaround/distressed
- 5% Fund of funds/co-investments
- 2% Infrastructure
- 2% Mezzanine/debt
- 2% Secondaries

Figure 3

What are the total assets under management (AUM) of your firm?

- 32% Less than $300 million
- 17% $300 – $500 million
- 19% $500 million – $1 billion
- 20% $1-$5 billion
- 12% Greater than $5 billion

GP Commitment: How much do GPs commit to their own funds, how, and why?

Although private equity fund managers agree that they need to have "skin in the game" to ensure alignment of interests with their investors and to keep staff incentivized, there is no industry-wide agreement on the size of contribution that firms should make to their own funds. The largest proportion of survey respondents said that their firm contributes between 1 and 2.5% of the total fund size. The majority of GPs contribute 2.5% or less of total capital commitments.

The survey also revealed that there is a discrepancy between what GPs think the industry standard should be and the size of their current contribution. Twice as many GPs commit more than 5% than those who think that they should, which shows that GPs would prefer to make a smaller commitment than they currently do.

Figure 4

What commitment has your GP made to your most recent fund?

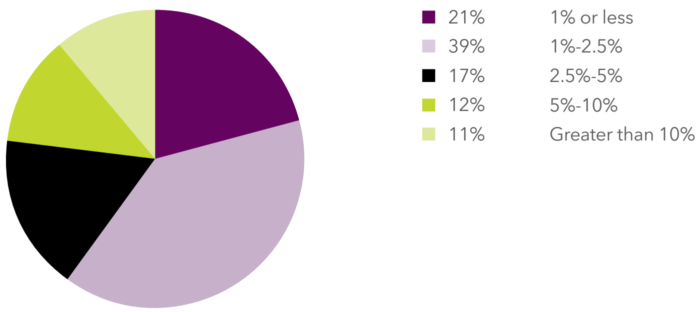
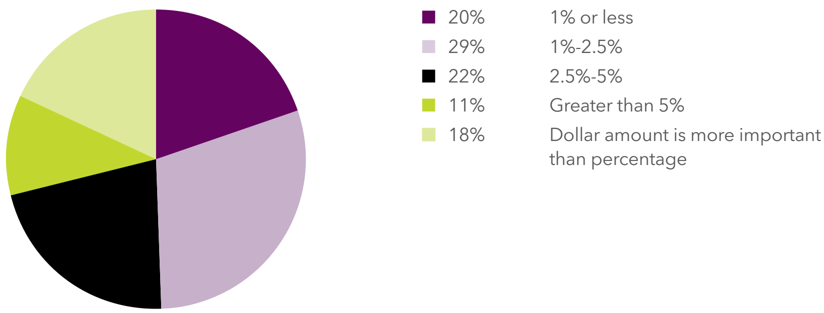


Figure 5

What commitment should GPs make to a fund?

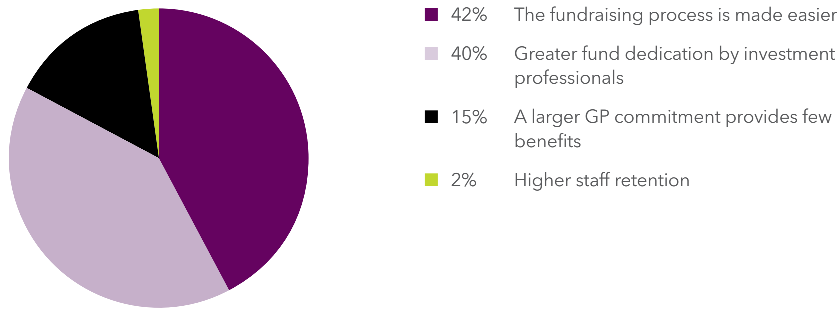


Managers think that a larger commitment demonstrates to LPs a clearer alignment of interests and so can facilitate the fundraising process. In addition, managers believe that LPs want GPs' percentage contribution to increase, with one manager emphasizing how "LPs want to see real GP commitment, direct with their own money."

Managers also feel that a larger commitment leads to greater dedication to the performance of the fund from the investment team.

Figure 6

For a private equity firm, what is the top benefit of a sizable GP commitment?

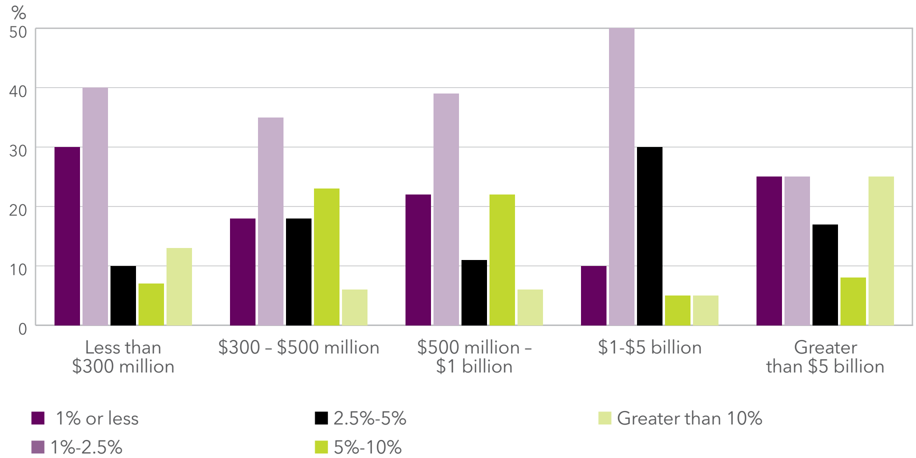


Larger firms are leading the way in making more sizable commitments in percentage terms. While stronger pressure from LPs may be a major cause, bigger GPs are typically more able to put up larger sums of money. For smaller firms, the dollar amount committed can be more motivating than the percentage of the total fund size. One US-based fund manager explained that "your interests are much more aligned with the guy who's putting up less but for whom the dollars are more important."

Figure 7

What commitment has your GP made to your most recent fund?

By AUM

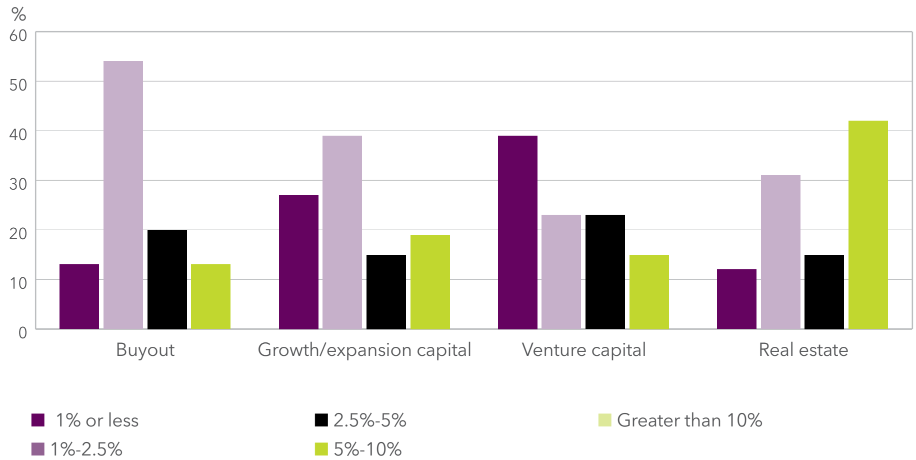


Real estate managers tend to make larger GP commitments. Indeed, the survey revealed that real estate firms have more LP-friendly terms across the board which is likely due to real estate's crowded market space and greater competition for LP capital.

Figure 8

What commitment has your GP made to your most recent fund?

By strategy

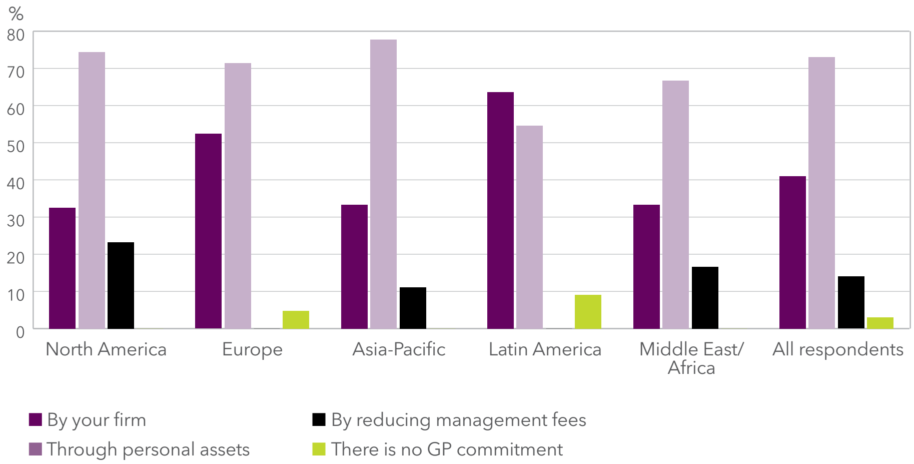


> **from the LP's perspective, they feel more comfortable if members of the GP firm are putting their own hard assets into the investments, so if things don't go right they feel some pain**

The method used by the GP to fund the commitment is a contentious issue which can alter the alignment of interests with LPs. Another US-based fund manager noted how "from the LP's perspective, they feel more comfortable if members of the GP firm are putting their own hard assets into the investments, so if things don't go right they feel some pain." Accordingly, the survey showed that almost three quarters of GPs use investment professionals' personal assets to finance commitments while less than half employ assets of the firm.

Figure 9

How is the GP commitment funded?

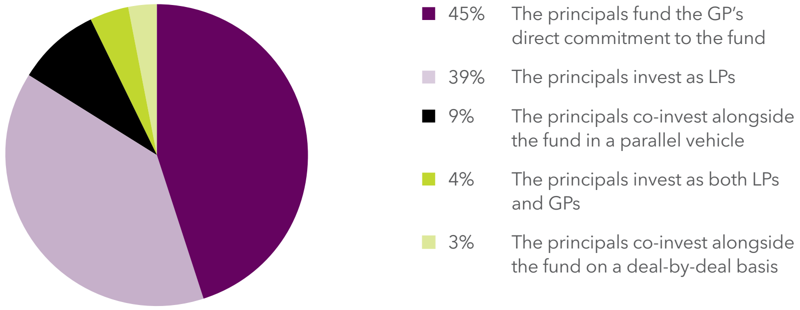


Managers in North America, Asia, the Middle East and Africa most commonly make commitments through personal assets while commitments tend to be made at a firm level in Latin America and Europe. Management fees are rarely reduced to fund a commitment. One fund manager noted that, "LPs would rather that we write a check than to use the waiver."

Most GP commitments are structured so that the principals fund the GP's direct commitment to the fund or the principals invest as LPs.

Figure 10

How is the GP commitment structured?



Carry, Hurdle, Catch Up and Clawback: How are fund structures set up to demonstrate alignment of interests?

Funds overwhelmingly utilize the European carry model over the American style, further underlining the shift towards more LP-friendly terms in recent years. In the European, or whole-of-fund model, a GP receives carry after investors have received a distribution of their entire capital contributions to the fund, typically with a preferred return (a "hurdle rate"). In the American model, or deal-by-deal model, the GP receives carry after investors have been paid back their capital and returns for only those investments that have been sold (or more rarely, on a deal-by-deal basis without recoupment of prior realized losses). Many funds employ an end of term clawback to repay investors if later losses cause excess carry to have been paid to the GP. Some firms also employ an interim clawback.

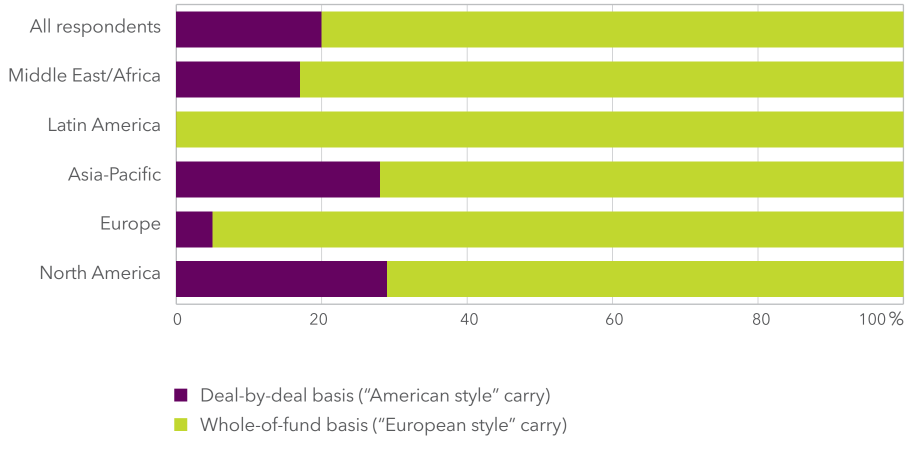
The most differentiation is found by geography, suggesting that regional norms have a significant influence over the approach of fund managers. The American model is most common in North America and Asia where almost a third of GPs use the structure, while elsewhere the model is almost obsolete.

One US-based fund manager commented that the American model is advantageous as it helps to retain and incentivize younger professionals with fewer personal assets. Another added that "I don't see anybody arguing for a European formula." On the other hand, a fund manager based in Latin America noted that "the European waterfall is the [structure] to stand, now at least, from what we're seeing in Latin America and [other] emerging markets."

Figure 11

How is carried interest distributed to your firm?

By region



GPs cite alignment of interests with investors as the primary rationale for adopting the European model. The LP sees the returns of the fund more quickly in the European model, bringing the added benefit of a higher net IRR.

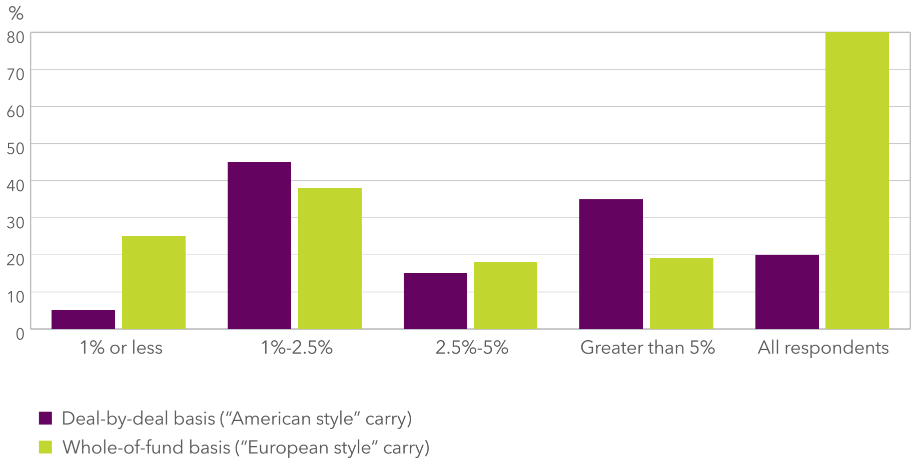
The American-style form of carry without a clawback, says its critics, incentivizes GPs to focus only on their more successful deals and abandon those that are not doing as well. Since an unsuccessful deal affects the GP less than one of its investors, some claim that there is too little incentive for GPs to manage the entire portfolio of the fund. Although this form of the American-style carry is less common, its negative perceptions also affect how the American-style carry with clawback is perceived. Most funds, however, provide investors with clawback protection, only 3% of survey respondents did not include clawback protection in their most recent fund.

GPs perhaps compensate for a less favored carry model by demonstrating alignment of interests through a larger seed commitment: GPs using the American model are more likely to provide a commitment of greater than 5%. By contrast, those using the European model are more inclined to make a commitment of 1% or less.

Figure 12

How is carried interest distributed to your firm?

By size of GP commitment



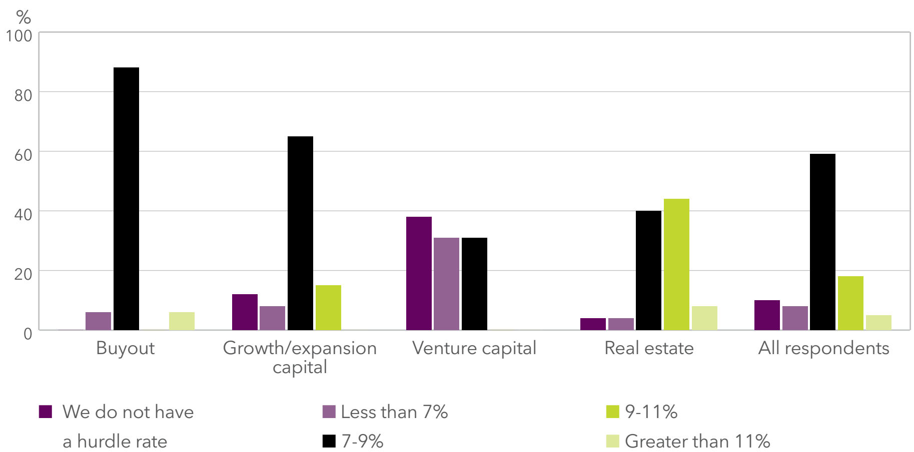
The clear industry-standard hurdle-rate is 7-9% – the rate of return when managers start to earn carried interest. However, not all GPs are satisfied with the status quo: a number of fund managers declared that they would prefer a lower hurdle rate. One said "we think that it's too high, especially as management fees are coming down."

Venture capital funds are most likely to have no hurdle rate, while real estate funds have the highest hurdle.

Figure 13

In the case of a hurdle rate, what percentage does your fund use?

By strategy

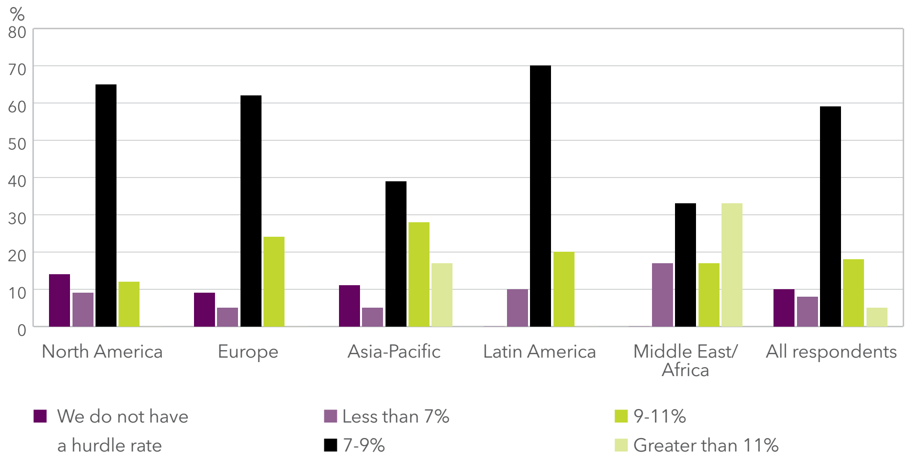


Managers based in Asia, the Middle East, and Africa have the highest hurdle rates, pointing to expected higher returns in these emerging markets. Surprisingly, such hurdle rates are not found in Latin America according to survey participants.

Figure 14

In the case of a hurdle rate, what percentage does your fund use?

By region

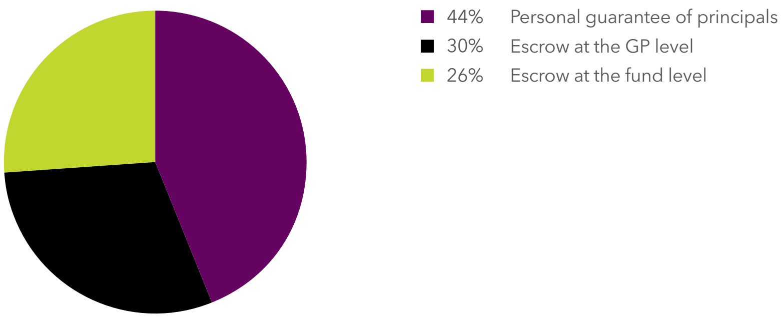


There is no single preferred clawback method among GPs. So, while managers are influenced by LPs over the carry structure and the hurdle rate, they are largely not influenced by LPs when deciding how to secure a clawback. The largest proportion of GPs secures clawbacks via a personal guarantee of the fund principals.

Figure 15

In the case of a clawback provision, how is the clawback secured?

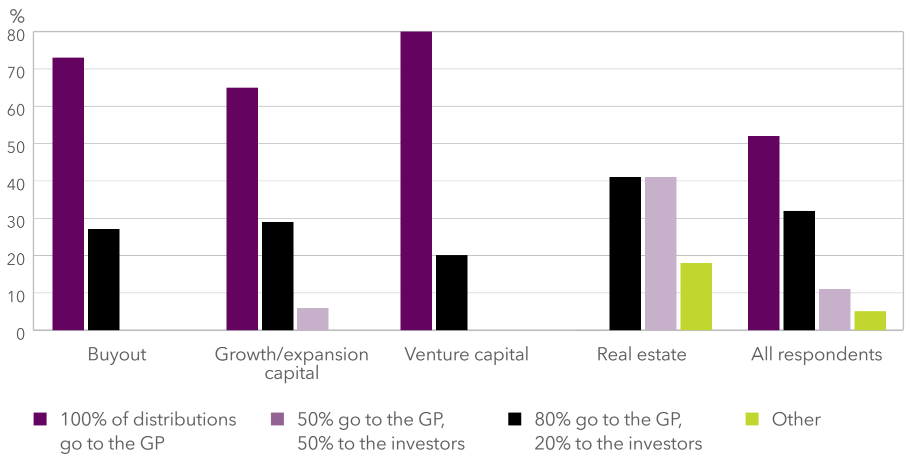
By region



The most common means to structure the catch up tranche is to give 100% of the distributions to the GP after investors have received their preferred return until the GP reaches its 20% carried interest threshold.

Figure 16

In the case of catch up tranche, how is the catch up distribution structured?



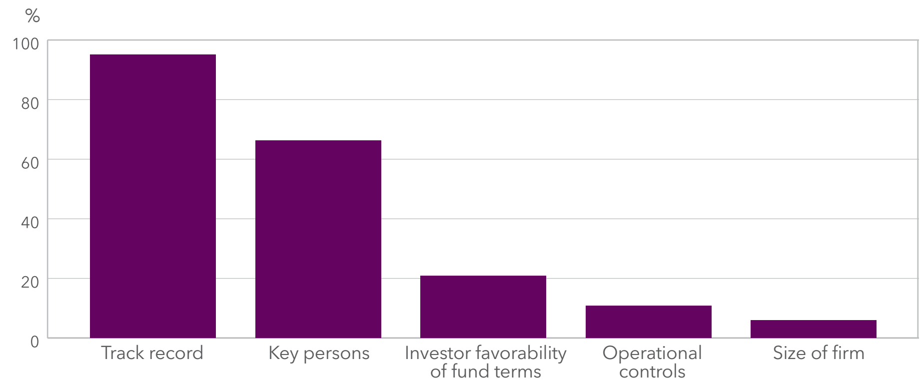
Real estate firms have the most LP-friendly terms. None of the firms surveyed have a catch up tranche where 100% of the distributions go to the GP, while real estate funds have the highest percent of respondents using a 50-50 distribution in the catch up tranche.

Key Man Clause: How are funds set up to protect against key people leaving?

While managers overwhelmingly think that track record is the most important issue for LPs when selecting a fund manager, GPs feel that an important, albeit secondary, concern for fund investors is how key people are incentivized to remain with the fund manager. One manager went as far as to say that key person provisions play the largest role as, "investors are backing people first and foremost," and noted that "track record is important as long as the people that are continuing are the people with the track record."

Figure 17

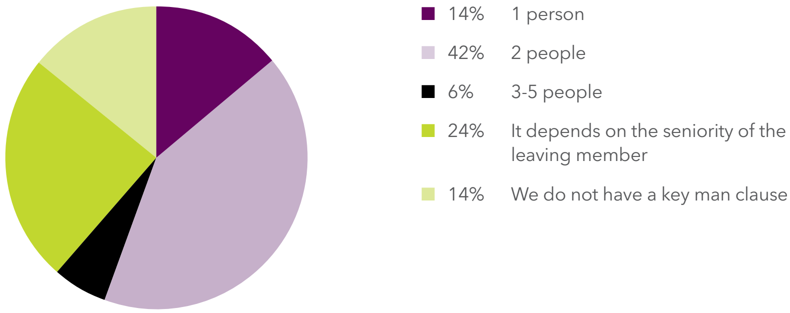
What two issues have the most importance for LPs?



The key man clause is clearly an important component of the fund terms, with 86% of GPs surveyed having used a key man clause within their latest fund. Most commonly, two people from the investment team must leave in order to trigger the key man clause, although one assumes that if the key man group numbers greater than six, the number of leavers typically exceeds two.

Figure 18

How many investment professionals must leave in order to trigger the key man clause in your fund?



Survey respondents revealed that LPs are somewhat flexible about other key man provisions. About 70% of firms with a key man clause have a provision to replace a key executive, of which a slight majority suspends new fund investments before a replacement is found. The most common time given to find a replacement is three to six months.

Figure 19

Does your key man clause have the option of installing a replacement key person?

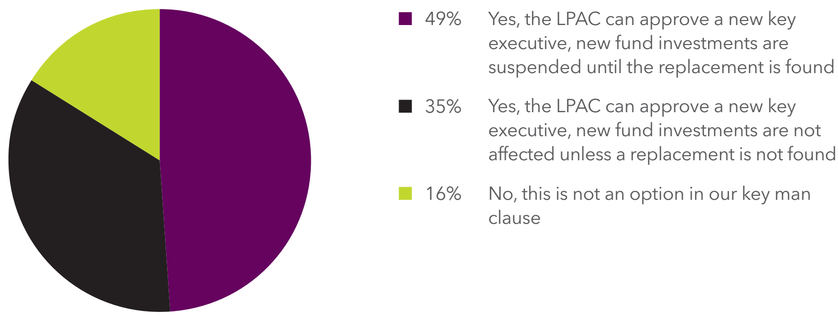
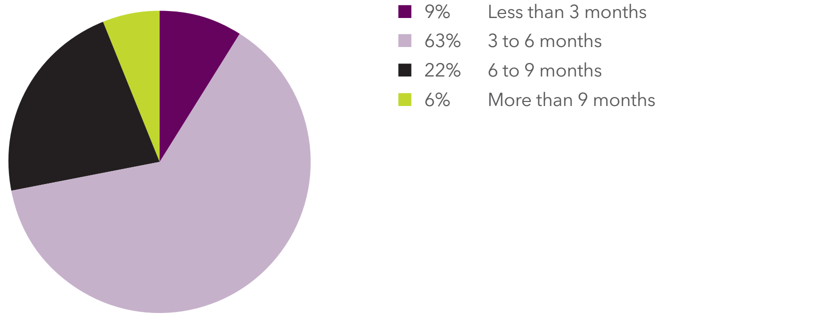


Figure 20

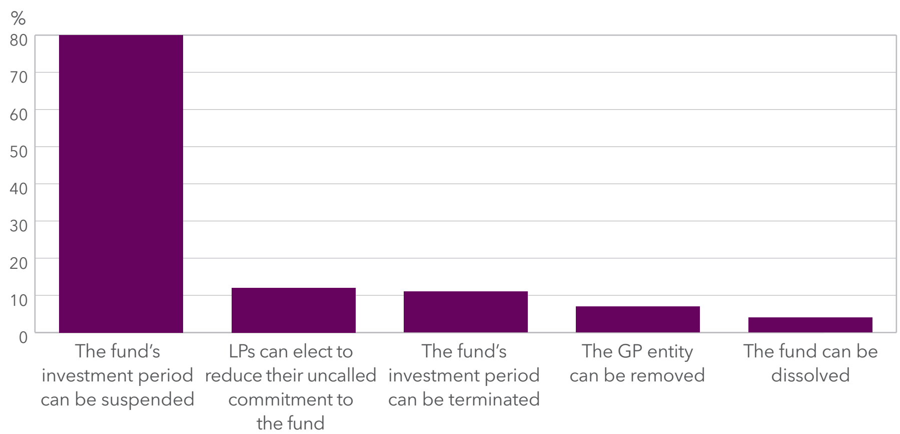
In case a key person needs to be replaced, how long does your firm have to find a suitable replacement?



Also pointing to the flexibility of LPs, the most common result of the key man provision is the most lenient – that the fund's investment period is suspended.

Figure 21

How can your fund be affected when the key man clause is triggered?



The size of a firm has the largest impact on the key man clause: each key person perhaps matters proportionately more in a smaller firm. One smaller fund manager noted that during fundraising due diligence, LPs had a keen interest in the key man clause. "[LPs were] highly focused, that would be the single item that was most negotiated. Who, how many, what the terms are, all aspects of that."

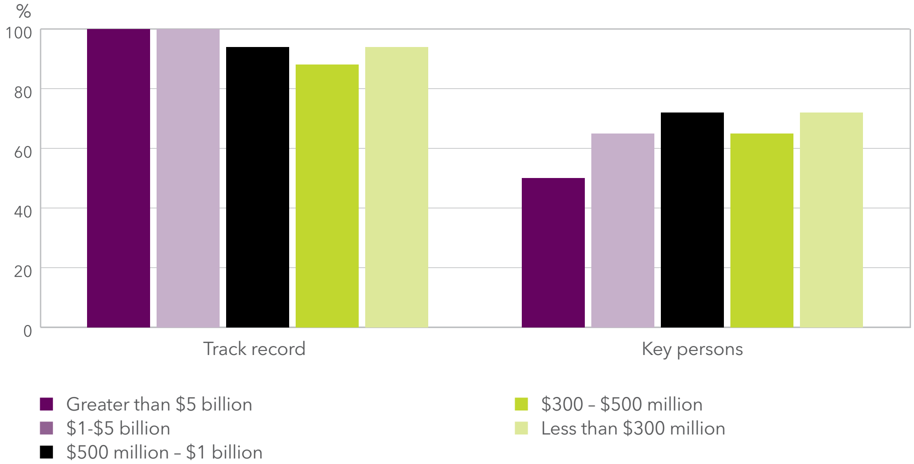
For larger firms, key persons matter a little less, and firm reputation matters more. A full 100% of firms with assets under management of $5 billion or more cite track record as a key issue for LPs, while only 50% cite key person provisions.

> ***Investors are backing people first and foremost***

Figure 22

Top two issues of importance for LPs

By AUM



The survey revealed that the trigger of the key man clause leads potentially to the most drastic consequences in smaller firms. GPs with lower assets under management are more likely to have the right to see the GP entity removed, have the right to the fund dissolved and have the right to reduce their uncalled commitments when the key man clause is set off.

Figure 23

How can your fund be affected when the key man clause is triggered?

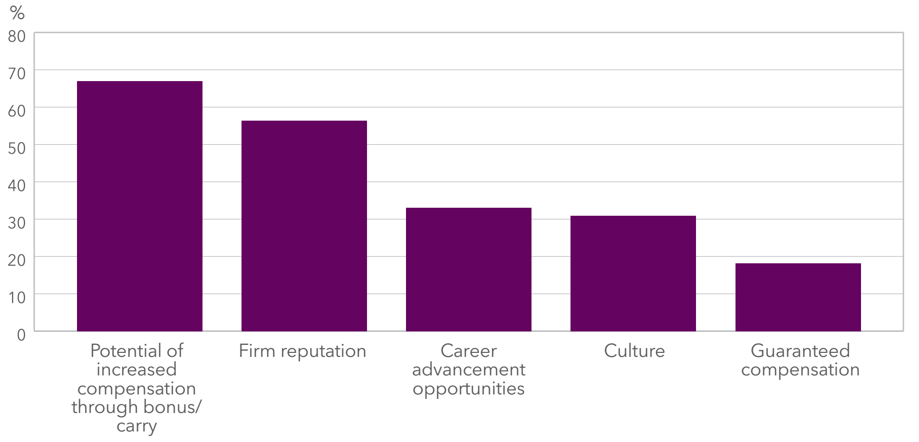
By AUM

Compensation: How are professionals paid?

The potential for increased compensation through bonus and carry is the most important factor in attracting investment professionals, according to GPs.

Figure 24

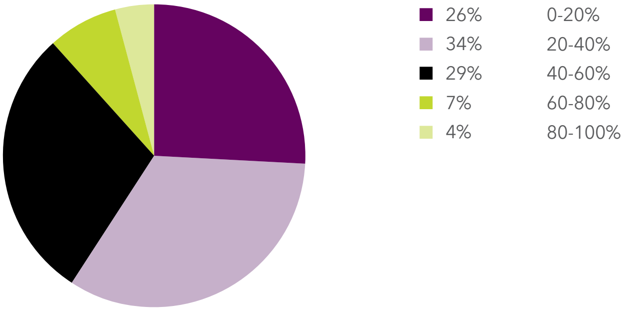
What are the top two issues attracting investment professionals?



In addition, many fund managers noted how a more discretionary form of compensation also provides better motivation for staff, with one fund manager remarking "if it's all base and it's contractual, human nature being what it is, I think you have people coasting." For three quarters of the GPs surveyed, more than 20% of staff compensation is discretionary.

Figure 25

What percentage of your professional employees' compensation is discretionary?

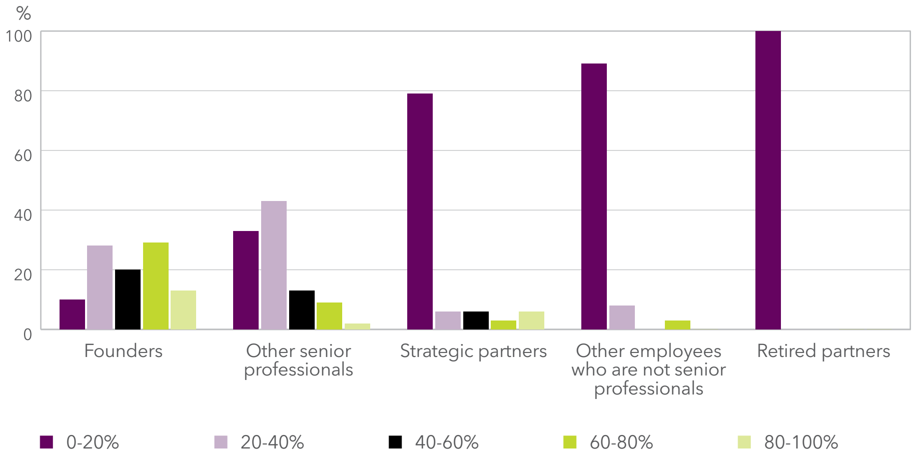


That said, the distribution of the carry tends to weigh heavily towards the founders of a firm, with other senior professionals also receiving a substantial portion of the carry.

The majority of carry should be well defined in an equitable split so the LPs can be comfortable that the partnership can endure and [that] it's not just a bunch of junior people working to make one partner rich

Figure 26

What percent of the carried interest goes to each of the following?



The founders of smaller firms tend to receive a larger portion of the carry. However, other senior professionals play an important role at firms with lower assets under management. One smaller fund manager noted how LPs were highly interested in how his firm distributed carry saying that, "the majority of carry should be well defined in an equitable split so the LPs can be comfortable that the partnership can endure and [that] it's not just a bunch of junior people working to make one partner rich."

Figure 27

What percent of the carried interest goes to the founders?

By AUM

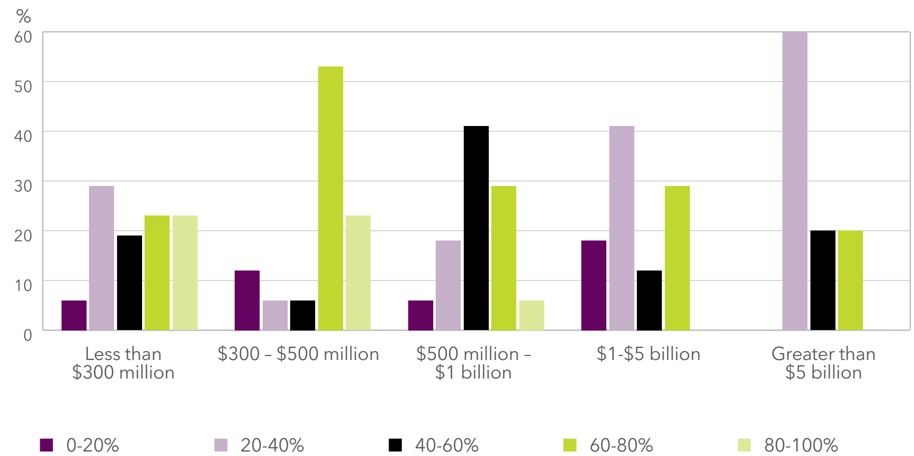
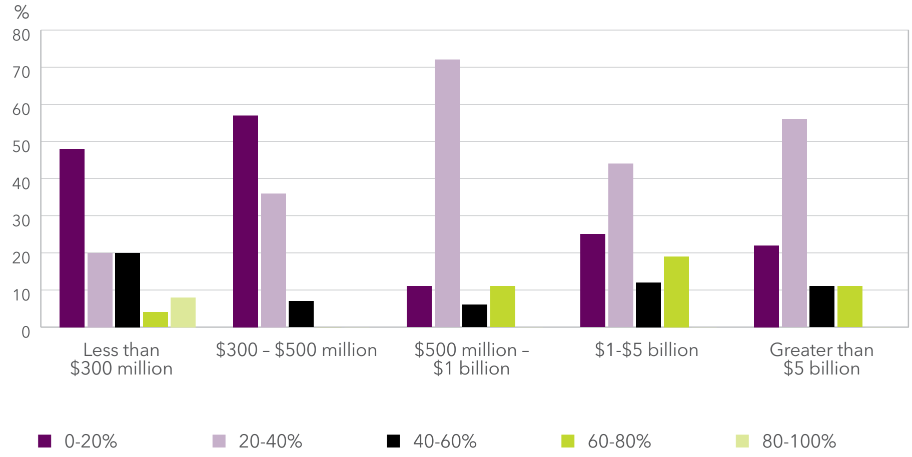


Figure 28

What percent of the carried interest goes to senior professionals (other than founders)?

By AUM

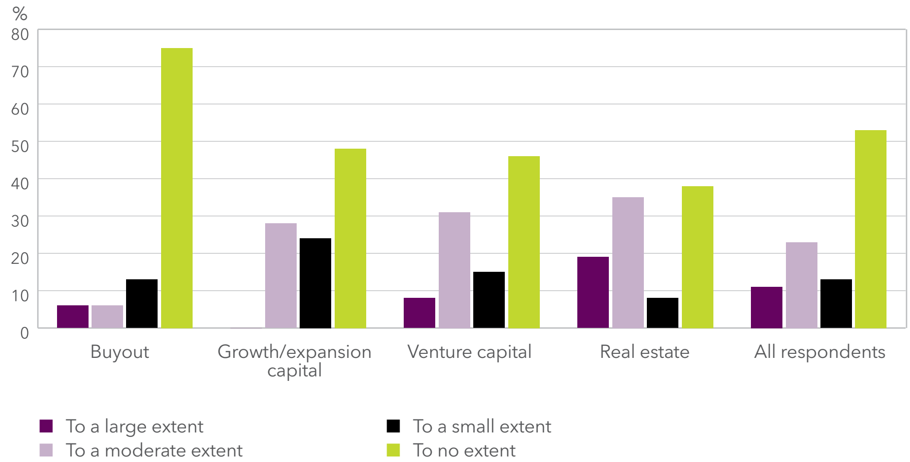


Direct involvement in individual deals tends to not matter to the majority of GPs when distributing carried interest. Personal involvement matters most for real estate firms and least for buyout firms, suggesting that buyout houses place a larger emphasis on overall portfolio management.

Figure 29

To what extent does the distribution of carried interest among the investment professionals depend upon contributions to specific deals?

By strategy

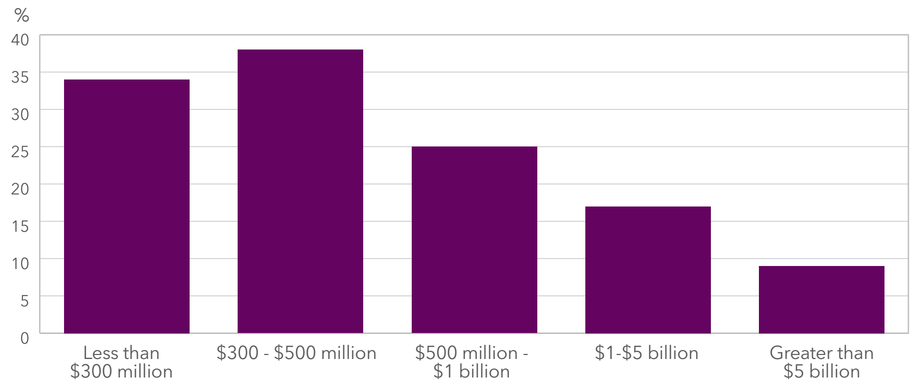


Over two thirds of GPs have vesting arrangements; however, such provisions are most likely to be found in larger firms. A firm's level of resources has a significant impact on the inclusion of vesting arrangements.

Figure 30

Funds without vesting arrangements

By AUM



Of those with vesting arrangements, most GPs prefer a straight-line structure. Vesting is most often varied by the date an individual joins a GP firm or is based on his or her seniority. It is most likely accelerated for death and disability and it is least likely brought forward for retirement.

Figure 31

What forms of vesting arrangements are included in the fund terms?

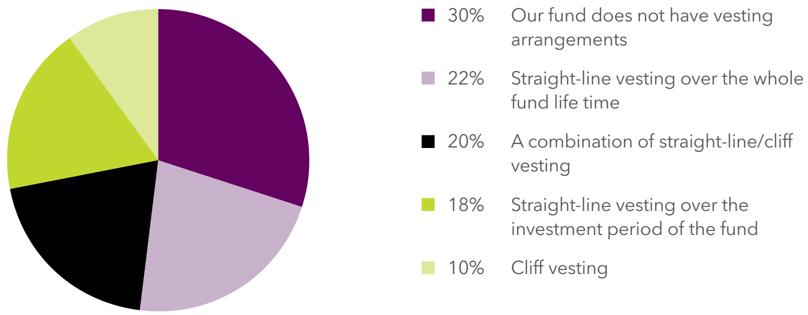


Figure 32

How can vesting arrangements differ between various investment professionals at your firm?

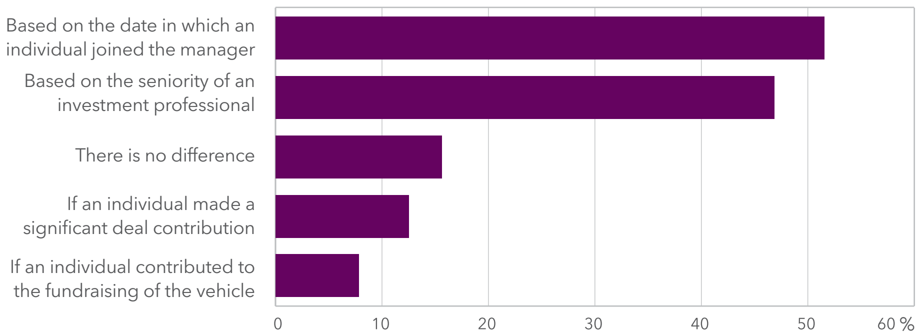
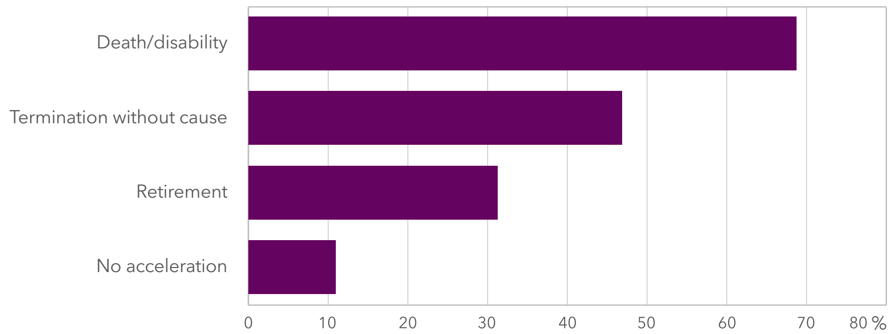


Figure 33

In what cases is vesting accelerated?



Hiring and Retaining: How can the industry continue to attract and retain talent?

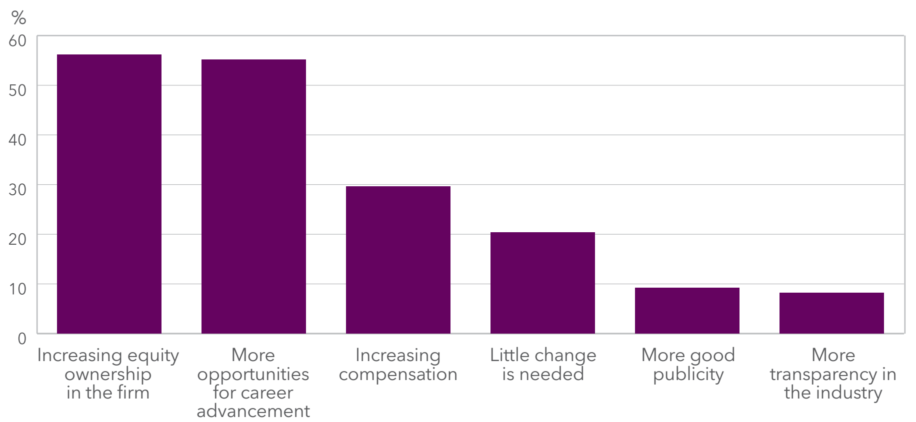
The survey revealed that the private equity industry is convinced it can continue to attract talented individuals. One manager showed strong confidence in the industry, describing how the job on its own is enough to entice new hires, “It’s an extremely attractive job. It’s not like you’ve got to dress it up and parade it and try to let people know that it’s something that they might want to do. What can we do to make it better? I don’t know.”

Another manager pointed to the novelty of the industry saying how “because the industry is pretty young, we don’t have a problem attracting talent, it’s a new industry, it’s a sexy industry, and a lot of people want to come in.”

In order to continue to retain talented people, survey respondents recommended that GPs develop opportunities for career advancement and make available more individual equity ownership in the firm. This signals that while the private equity industry may be thriving, which in turn is enticing talent, it remains difficult to move up in the ranks, particularly in smaller firms. One fund manager highlighted how “a lot of the firms are where you don’t have a lot of people, the people knew each other on the way in, or knew a lot of people.”

Figure 34

What are the top two measures the private equity industry should take to remain attractive to talented individuals?



On the positive side, few firms said that the private equity industry needed more good publicity to appeal to potential staff. Many fund managers pointed to their own firms and judged that, with a strong track record, little publicity was needed. Another fund manager noted that “the best way to attract top professionals is to create wealth for your investors and have top level returns, and that feeds on itself because people want to work in a successful environment.”

Schulte Roth & Zabel

About SRZ

Schulte Roth & Zabel's Private Equity Group is actively involved in every aspect of private equity and represents hundreds of firms, advising funds on both on- and off-shore formation and operational issues. We also represent our private equity investment fund clients, as well as institutional, hedge fund and other investors, in making, monitoring and realizing private equity investments, including founder, angel and early- through late-stage venture investments, IPO and earlier stage bridge fundings, mezzanine financings, leveraged buyouts and PIPE transactions. Where our clients hold substantial positions, we regularly provide counsel to their portfolio companies as well, particularly in connection with bank financing, capital markets and M&A transactions.

SRZ clients include private equity and venture capital funds, with a broad range of strategies, including funds which focus on middle market, leveraged buyouts, crossover, mezzanine, complex distressed investing and industry-specific funds. We also represent many of the leading private equity real estate (PERE) firms.

Our services to this broad range of funds in the formation process are enhanced by our private equity regulatory & compliance practice, which proactively works with fund managers on SEC registration and other new compliance challenges to identify and address applicable U.S. and international regulatory requirements. Additionally, our representation of funds-of-funds and of institutional investors for whom we review private equity fund investments ensures that we are always on the cutting edge of market practices. *Dow Jones Private Equity Analyst* recognizes us as one of the top law firms based upon work on private equity fund formation, as well as private equity and venture capital transactions.

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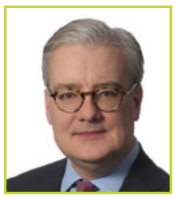

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Schulte Roth & Zabel is a premier multidisciplinary law firm focused on delivering sophisticated, leading-edge advice to its clients, which include prominent financial institutions, corporations and investors. We strive to build and maintain long-term relationships with our clients by emphasizing client service, and with expertise in a broad array of practice areas, we provide comprehensive advice to achieve our clients' objectives.

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