Institutional Investor Insights: Avoiding Minefields in Limited Partnership Agreements

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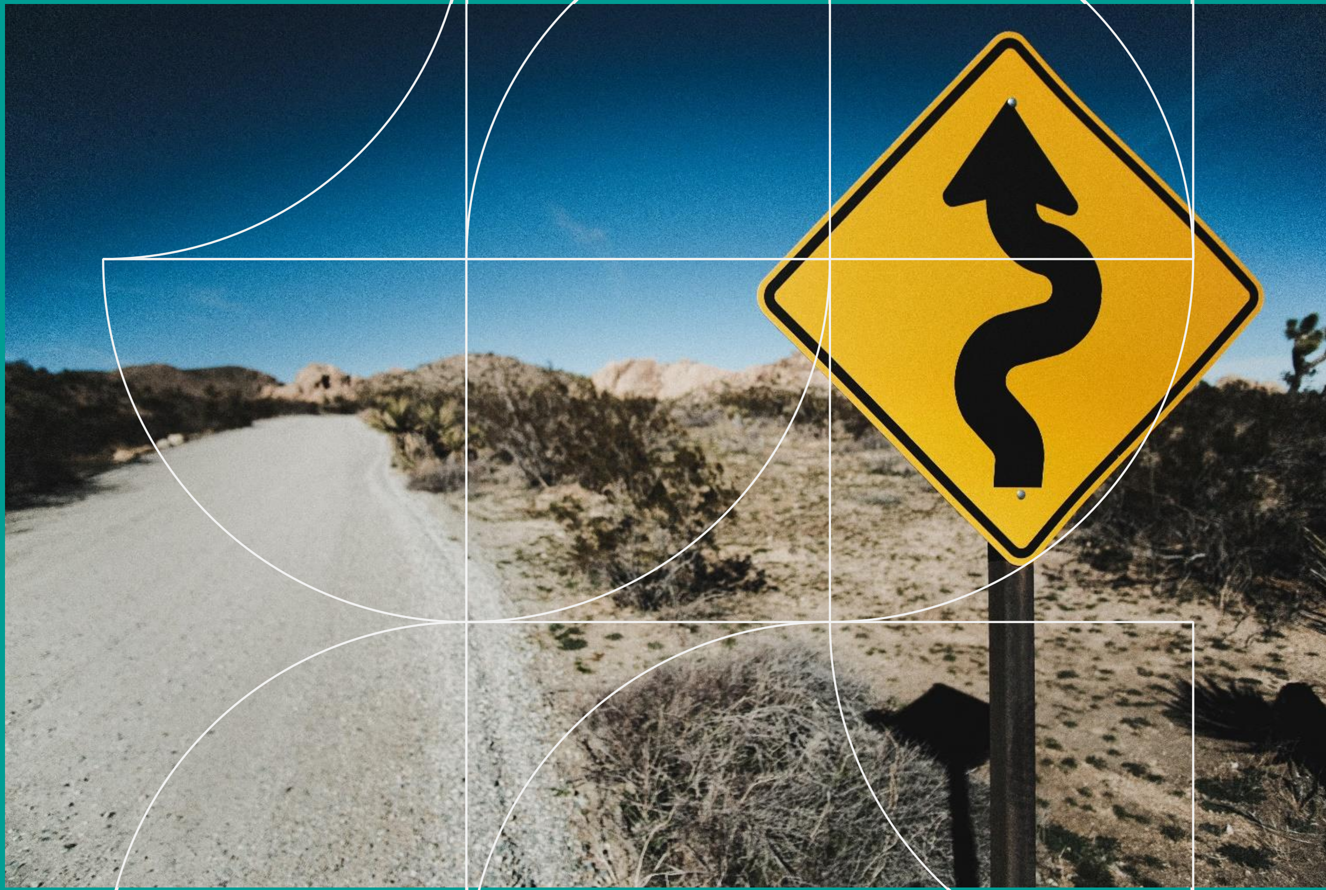

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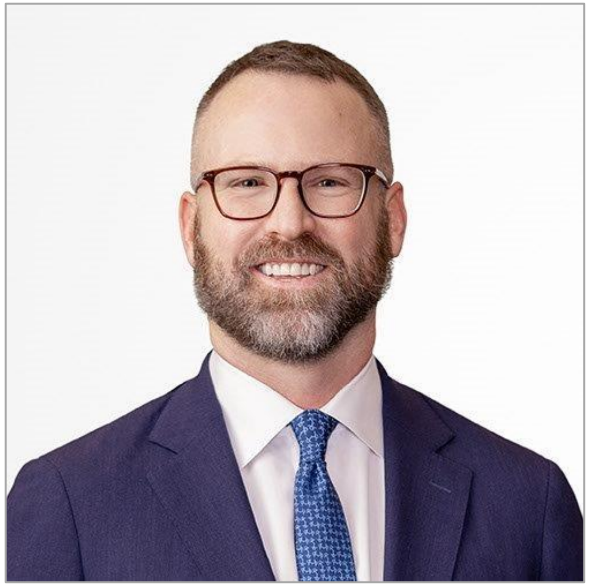
Presenters



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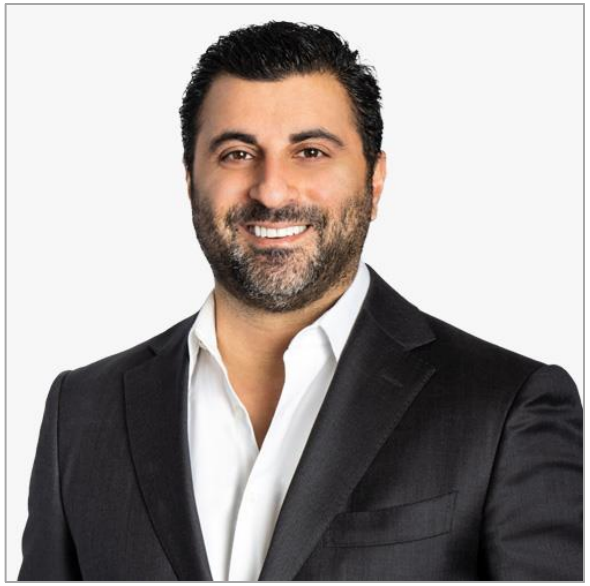

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Agenda

1 | Preferred Returns

2 | Management Fee Calculations

3 | Net Asset Value (NAV) Facilities

4 | Key Takeaways

5 | Q&A

Preferred Returns

Preferred Returns

Overview

Typical European Style Waterfall [Whole of Fund]

1. Return of capital
2. Preferred return (expressed as a fixed percentage)
3. GP catch-up (% of total distributions in 2+3)
4. Carried interest

Typical American Style Waterfall [Deal by Deal / Hybrid]

1. Return of capital from a disposed investment
    - Can also return expenses and losses on prior realizations.
2. Preferred return on the disposed investment
3. GP catch-up (% of total distributions in 2+3)
4. Carried interest

With a "claw-back" feature both models should result in the same aggregate sharing of profits over the life of the Fund, with the only variable being the timing of receipt of such profits by the manager – earlier for a deal-by-deal model and later for a whole fund model, with taxes advanced.

Preferred Returns

Notes on Preferred Returns

- The principal feature of the LP structure is the compensation contract – GPs receive an annual management fee, but the bulk of their compensation comes from sharing the profits of the investments.
- Preferred returns mitigate unobservable GP effort problems, not rewarding GP for low returns. Preferred returns may entice general partners to exit their investments more quickly or delay an exit.

Preferred Returns

Key Factors Affecting Returns

- Timing: When does the calculation begin and end accrue?
- Base: On what amounts is the preferred return charged on?
- Compounding: Is the preferred return compounded or non-compounded?

Preferred Returns

Definitions - European

“**Preferred Return**” means, with respect to any Limited Partner and as of any time, an amount equal to a cumulative return of 8% per annum, compounded annually, on such Limited Partner’s unreturned Contributions as determined from time to time, treating all distributions to such Partner as a return of such Partner’s Contribution. For purposes of this calculation, (a) Contributions made by a Limited Partner shall be taken into account on the date that such Contributions are due as set forth in the applicable Call Notice, and (b) distributions shall be taken into account on the date they are made to such Limited Partner.

ILPA: “**Preferred Return**” means, with respect to each Partner (other than an Affiliated Partner), as of any date of determination, such amount as is equal to an annual rate of return of [8]%, compounded annually and calculated daily on the Capital Contributions made by such Limited Partner, calculated from the date of receipt of each such Capital Contribution by the Fund and accrual of the Preferred Return, and ceasing on the date of distribution or deemed distribution by the Fund to such Limited Partner.

Preferred Returns

Definitions – American (Hybrid)

"**Preferred Return**" means, with respect to each Partner (other than an Affiliated Partner), as of any date of determination, the excess, if any, of (i) the aggregate amount of Partnership distributions (regardless of the source or character thereof) required to cause the annually compounded internal rate of return from the Effective Date through the date of determination on the aggregate Capital Contributions made by such Partner on or prior to such date to fund Realized Investments and Cost Contributions to equal 8% per annum, over (ii) the aggregate amount of Capital Contributions made by such Partner on or prior to such date to fund Realized Investments and Cost Contributions. For purposes of calculations of Preferred Return pursuant to this paragraph, (x) each Capital Contribution shall be treated as having been made on the date on which such Capital Contribution was required to be paid to the Partnership or, at the discretion of the General Partner if later, the date on which such Capital Contribution was actually made to the Partnership, and (y) each distribution shall be taken into account as of the date made by the Partnership.

Preferred Returns

Definitions – American (Hybrid)

“**Realized Investments**” means, as of any date of determination, the portion of each investment in each Portfolio Company (excluding Bridge Financings) that has been disposed of (including distributions in kind to the Partners, or written down or written off by the Partnership)

“**Cost Contributions**” means Capital Contributions (other than Investment Contributions and Bridge Financing Contributions) that are used to pay an expense of the Partnership (including Partnership Expenses); provided that upon the liquidation of the Partnership, any Capital Contribution that is not an Investment Contribution or Bridge Financing Contribution shall be a Cost Contribution..

ILPA: “**Preferred Return**” means, with respect to each Partner (other than an Affiliated Partner), as of any date of determination, such amount as is equal to an annual rate of return of 8%, compounded annually and calculated daily on the Capital Contributions made by such Limited Partner [used to fund the cost of (i) such Portfolio Investment, (ii) each Realized Investment, and (iii) aggregate Unrealized Losses], calculated from the date of receipt of each such Capital Contribution by the Fund and accrual of the Preferred Return, and ceasing on the date of distribution or deemed distribution by the Fund to such Limited Partner.

Preferred Returns

Less Common Variations

- Waterfall Variation: Sometimes unpaid and accrued preferred return is paid first, followed by a return of capital (steps 1 and 2 are switched). The result is a slightly higher preferred return since outstanding accrued are paid *before* capital is returned so the base amount is larger for longer. There is less compounding, however.
- Preferred Return Based on IRR:
  - IRR Hurdle that reads: “First, the investor gets a 10% IRR and then, of the promotable proceeds in excess of the IRR hurdle, the investor gets a 70% share (as excess investor profits) with the manager getting a 30% share (as promote).” IRR usually is defined by the Excel XIRR function. The XIRR function has a unique compounding feature that is rigid and cannot be modified. The XIRR function uses daily compounding to arrive at an effective annual rate of return
- There is a real difference between a standard preferred return and IRR formation in a small number of instances.

Preferred Returns

IRR - Continued

- Differences between the two formulations arise in investment portfolios when new equity capital is called late (i.e., capital is being contributed by the investor after some promotable proceeds have already been split between the investor and the manager). When applied to a portfolio of assets the likelihood of a discrepancy increases substantially where the manager is receiving promote when it would not have under a traditional preferred return formation.
- This phenomenon occurs because, with the mechanics of IRR, cashflows are, in essence, fungible. In the IRR Hurdle formulation, the prior period excess profits paid to the investor are algebraically ‘‘reclassified’’ to cover the next equity capital outlays, as well as their accrued preferred return over the past year it remained outstanding. Essentially, some or all of the investor’s profit is reclassified into return of capital and return on capital, as contrasted with the manager’s portion that remains untouched. The intended carry split is then compromised retroactively. An additional compromise will occur each time there is a subsequent equity contribution, until all prior excess profits of the investor have been exhausted: the profits are reclassified.
- For many single asset investments, as well as many portfolios, promotes to the manager (and excess profits to the investor) will not be generated until sometime after all equity has been invested. In those cases, the preferred return formulation and the IRR Hurdle formulation will generate identical results.
- In some cashflow scenarios, there is a marked difference between the incentive fee results of these two formulations, due to reclassified profits.

Preferred Returns

- WHEN IN DOUBT ASK FOR A MODEL!!!!

Management Fee Calculations

Management Fee Calculations

Typical Fee Structure

(i) Percentage Rate multiplied by (ii) Fee Base

Percentage Rate

Fluctuates between .75% and 2%, before the Step Down Date

Sample Fee Base

- The entire Commitment of the LP.
- Capital Contributions made by LP to fund the Acquisition Cost of Portfolio Investments other than Temporary Investments, less an amount equal to the Acquisition Cost of Portfolio Investments, other than Temporary Investments, that have been realized (in whole or in part), written off or Permanently Written Down as of the end of the most recent financial quarter.

Management Fee Calculations

Step Downs in Management Fees

- Management Fees step down after the Investment Period.
- A second Step Down may occur after assets are not being actively managed (i.e. at the end of the Fund Term (prior to extension that may be permissible under the LPA)).
- Step Downs can impact the Percentage Rate or the Fee Base. For example, the Percentage Rate is reduced by 30-50%, or the Fee Base may be reduced to only reflect the NAV of Investments still outstanding (less any write-downs).

Management Fee Calculations

Credits/Offsets

- Certain Fee Income payable to the GP is income generally redundant to Management Fees. These include monitoring fees, advisory fees, board fees, and beyond. <u>To the extent a fee is payable by an Investment company to the GP or Manager because of the GP or Managers general investment management obligations, we insist these fees are offset against the Management Fee 100%</u>.
- Credits and Offsets are paid in one of three ways:
  i. as a direct reimbursement/distribution to the LPs in the same amount payable by the LPs;
  ii. as a credit to Management Fees payable to the GP or Investment Manager by the Fund at large; or
  iii. at the end of the Fund term via the waterfall (the least favorite).

Management Fee Calculations

Credits/Offsets (continued)

- The most significant drivers of our advice relate to whether the LP will get the full value of the offset through credit against Management Fees payable and timing of when such amounts will come back to the LP.
- Consider when certain offsetable amounts (options, warrants, etc.) are valued. Usually at the end of the Fund’s term.
- Consider if management fee is calculated based on the appropriate asset value under management.

Management Fee Calculations

Catch-up Payments

- At the time of an investment on the part of any LP following the Initial Closing of a Fund, the LP is generally expected to catch-up on Management Fee amounts payable since the Initial Closing. In addition to amounts due as Management Fees, LP are generally expected to interest on those catch-up amounts. As of late we have begun to consistently request waivers of interest payments. For a variety of reasons, we are seeing increased success in doing so and depending on the size and timing of LP commitments, this amount can be meaningful.

Separate Vehicles

- Co-invest vehicles and non-core strategy funds (such as annex funds, warehousing funds, etc.) do not pay full-freight Management Fees, but rather a much lower rate.

Net Asset Value (NAV) Facilities

NAV Facilities

What Are They?

- NAV facilities are credit facilities secured by the Net Asset Value of the Fund. Unlike a subscription credit facility, which is generally secured by the ability of the GP to call capital to satisfy partnership expenses, a NAV facility includes in its collateral package proceeds of fund investments, pledges on fund accounts, and equity interests in portfolio companies.
- Used to create liquidity at the Fund level to be used for general fund purposes (ex. expanding investment capacity, creating liquidity for LPs), usually when there is no longer uncalled capital to secure the credit facility.

NAV Facilities

Concerns

- Create opportunity enhancements in Fund performance with increased risk to capital commitments of LPs.
- Depending on the NAV lender, a LP may have exposure to the same underlying asset in multiple facilities. For example, a single LP may be invested in a PE-strategy which directly invests in an asset, but also be invested in a credit strategy (or two) which have exposure to the same asset in the sub-line and NAV facility.

NAV Facilities

Key Terms to Consider

- Are NAV facilities included in the definition of borrowing more generally and thereby subject to overall leverage caps, limits on total days outstanding?
- What rights does the GP have to pledge collateral in connection with a NAV facility, is the GP's interest part of the collateral package?
- If a NAV facility is cross-collateralized, is it a condition of such borrowing to enter into an intercreditor agreement allocating risk among the creditors?

Key Takeaways

Key Takeaways

1. Read the LPA Carefully
2. Ask Questions
3. Request Models and Examples
4. Nothing Ventured Nothing Gained

Q&A

thank you

contact information

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