PODCAST: Fund Fees and Expenses Trends

8/20/2019
Categories: Funds

[Brian Dolan]
Hello and welcome to this Pepper Podcast.

I am joined today by Julie Corelli, a Pepper partner and co-chair of the firm's Private Funds Services practice.

From 2014 to 2018, Julie has spearheaded for Pepper three surveys published by PFM in which fund managers shared how they deal with fees and expenses. We have also worked with PF Services and with them on their surveys. In addition, in 2015 Pepper and MergerMarket partnered up to take a closer look at the co-investment environment.

Taking collectively, these surveys offer unique insight into the approach that funds, CFO's and CCO's approach ordinary and extraordinary fees and expenses that occur in the life of a private equity fund. These fees and expenses need to be appropriately allocated to investors, co-investors and/or managers, but what is appropriate?

Julie recently wrote an article for the *Journal of Private Equity* where she gives her thoughts on the guidance that the surveys offer and how to address unanswered questions when industry guidance is lacking.

I asked Julie to join us today on this Pepper Podcast to share what she learned from the process of writing the article.

Julie, welcome and thanks for joining us today.

To give our listeners a little background, can you tell us who made up the PFM and MergerMarket Survey respondents?

[Julia D. Corelli]
The PFM MergerMarket respondents were in the three different surveys growing in number to 157 in 2018. In 2016 it was a little bit lighter, there were 80 respondents in 2014 that was in the middle of that at 128. Predominately there growth equity and buyout private equity strategies but there were also respondents who fit into the real estate, mezzanine senior debt, other private debt, infrastructure, fund of funds and other diversified platforms. So those were all in declining percentages. The roughly 2/3 of each survey was in the growth equity and buyout private equity space.

The geographic region in which the respondents for the PFM Survey were located was predominately in the Northeast. They were 55%, 54% and 49% in '18, '16 and '14 respectively, in the Northeast. The other areas Midwest and West took up a third of them in most of the years and in terms of size of the funds, the vast majority were under 1 billion, breaking down between less than 100 million at about 20% in the last two surveys, a little bit shy of that in 2014 and the 100 to 500 range being roughly a third to 40% of each survey. And then 18% to 20% in the 500 to a billion range.

[Brian Dolan]
Well thanks for the background. Let's jump into the numbers a little bit.

Let's start with the consummated deal expenses. Where along the deal timeline do expenses cease to be included under management fees and become deal costs?

[Julia D. Corelli]
In consummated deals the timeline varies and it's a judgment call from the fund managers. There's certain things that are really clear, that they are not deal expenses and there's certain things that are really clear that they should be deal expenses. They're really clear that they should be management company, i.e., not deal expenses, are things like marketing of the firm, joining a trade association, engaging strategic advisors about industry developments on the industry in which the strategy of the fund is focused. Hosting or sponsoring an industry event to build brand awareness. Those are things that are clearly in the management company expense and all survey respondents are very uniform in that approach.

On the other end of the spectrum, when a fund manager engages counsel and accountants to assist in preparing an auction bid or the deal is under an LOI and substantive due diligence has begun, third parties are engaged to assist, quality of earnings consultants and the like. Those are clearly deal expenses when the deal is consummated, but what's murky is what's in the middle, and there's a lot that happens after a potential target company is identified and before the pure LOI and documentation is generated. There's a lot about developing the investment thesis, there's a lot of research and analytics that go on internally at the manager to determine if that's something where you want to develop the indication of interest.

So is an indication of interest enough for the fund to bear the expense of using, perhaps, outside counsel to develop the indication of interest and submit it? That's a very good question. Most firms I think would take the position that they are, in fact, deal expenses, if the deal does get consummated. Broken deal expenses, I know we're going to get into and those might be a little bit different on how you would treat this murky category and broken deal expenses. But the firm should certainly have a policy and procedure in place which identifies who is responsible for making these decisions of expense allocation in that murky territory.

There's also a growing cottage industry of experts out there that market their services as expense allocators and there are more firms who are taking up that approach of finding a third party to verify their internal allocations.

Certainly firms should look at their LPAs and their policies and procedures on expense allocation and make sure that however an expense is allocated, it fits within a category that is listed in the fund document as something to be borne by the fund.

Regulators these days are less inclined favorably towards catch all provisions. They really want to see express provisions about what kind of expenses are to be borne by the investors in the fund. Of course managers don't have a crystal ball so it's hard to see what the expenses are going to be, that the fund incurs so you have to really think carefully about that long list of expenses which go into the fund document and a catch all is always going to be there, but think about using it narrowly given the regulatory response we've seen in examinations to those catch all provisions.

[Brian Dolan]
Now you did refer to broken deal expenses. Let's talk about them because that is a whole different world. Based on your experience with these surveys over the years, what did you learn about how those expenses are treated over time?

[Julia D. Corelli]
Well that is an interesting one because it has changed over the three surveys that we've done in '14, '16 and '18, but to limit, perhaps the dialogue here, I'll just focus really on the '16 and '18 one.

We are actually seeing a growing trend between '16 and '18 of more expenses before a letter of intent from a broken deal, before the letter of intent is signed, more is going to the management company and less to the fund than there were in the 2016 survey.

In 2018, 24% of the respondents said the management company bears that kind of expense, 69% said it would go the fund, whereas in '16 it was 12% management company and 80% fund. So that's where the deal busts during due diligence before formal LOI is signed, before the firm really hires a lot of outside lawyers and consultants. So it's pretty early in the process.

If you move onto the next stage, if you will, of the process, which is after the LOI is signed, perhaps the firm has already hired lawyers, consultants, accountants, other service providers to work on that transaction and then the transaction busts, who bears the expenses there. And there you see declining percentages born by the management company. So in '18 it was 14% versus the earlier stage of the deal when 24% would have gone to the management company and a much higher percentage this time 78% of the later stage bust going to the fund.

Interestingly still, that is a decline in 2016 of what goes to the fund. 2016 reported the respondents reported 87% going to the fund, that declined, as I said, to 78%, so it's a small, but somewhat meaningful decline. In that category of transaction which breaks, there's also a 6% or 7% group of the respondents that said it is still reimbursed by the targeted portfolio company.

So that is one of the binding provisions that is often in an LOI, something that says how expenses are treated. I'd say the majority of LOIs still say that each party bears their own expenses, but certainly there's a trend towards trying to push those onto the target company if that's possible.

Then lastly in the final stage after a definitive agreement is signed, in that last category of when does that the portfolio company bears it or the targeted portfolio company bears it, that is a little bit higher. Now 11 or 12% of the respondents in 2018 and 2016, respectively, are saying the portfolio company bears it. The fund still bears a lot more than the management company but interestingly, even after a definitive agreement is signed, the management company will actually bear some of those expenses.

There is also a push to get some of them borne by a lender if there's a lender involved in the transaction. But the interesting thing to me is actually from 2016 to 2018 a slight growth in the number of respondents who said that the management company will even bear the broken deal expenses at that stage. I think that is a product of desiring to not burden the fund with broken deal expenses. Which raises a question of even if you're allowed to, should you be putting expenses onto the fund. Even if your LPA says that it's possible, should those expenses still be borne by the fund and some managers will say I choose not to. If they do that and later change their mind and start imposing those kind of costs on the fund, our experience has been that that will draw some regulatory scrutiny later on. Even though you've disclosed early on that you could charge them to the fund and then didn't until a later date when you started to again, that does create a problem, or at least something that's noticed on a regulatory exam.

[Brian Dolan]
Let's talk co-investing. This is a major tactic in the private equity industry and the topic actually flowed between the MergerMarket and the PFM studies so we have some good data around that. Where were the major drivers for co-investing based on the survey respondents of the 2015 Pepper MergerMarket Survey in particular?

[Julia D. Corelli]
So MergerMarket and Pepper did the survey in 2015 on co-investments. It was strictly focused on funds that do, in fact, engage in co-investments, so you're looking at consummated deals where co-investments actually happened. The MergerMarket Survey asks a question around what are the drivers behind why people want to do co-investments.

Interesting, some of the answers were risk sharing, 26% of the respondents said that sharing the risks of the potential investment was a reason to as a driver behind the co-investment. Facilitating fundraising was 22%, the strategic support of the portfolio company was 16% and building good will with investors was close behind that at 12%. Gaining operating partners was 8%, establishing relationships with other PE firms was 8% and competitive differentiation was 8%.

So the interesting thing to me as a lawyer is that risk sharing was one of the biggest drivers behind it. And certainly facilitating fundraising is not a surprise and relationship building not a surprise to see that that's a driver behind co-investment. To offer co-investments, there has to be a lot of thought in advance in how you position the opportunity. Whether it's going to be offered to all your investors in the fund or whether it's going to be offered to a select few is an area that is targeted by a CC upon examination. So you need to have a policy and procedure in place for how that's going to be, how the opportunity is going to be allocated to the various investor groups.

Offering co-investment in order to induce an investor to invest in a new fund or next successor fund than that is something that also needs to be disclosed. Often, at least in the SEC's view, it should be disclosed to your existing limited partners. The inducement aspect of that particularly is important if you are going to use that LPs investment commitment to the newer successor fund in order to market to other investors. The obvious reasons being if they were given the co-investment opportunity and that's why they came into the second fund, it's not strictly because of the terrific investment opportunity that the newer second fund offered.

[Brian Dolan]
Same co-investment topic, but let's cross over to the PFM surveys. Who bears the cost associated with investments with co-investors?

[Julia D. Corelli]
So both the '16 and '18 PFM surveys asked questions about the mechanics of charging costs to co-investors. In looking at the outcome of the data from the respondents, the thing that jumps out as significant is the growth in the number of respondents who answered, yes, co-investors bear broken deal costs.

If the co-investment entity has been formed and the growing percentage of people who indicated that co-investment entities being formed earlier in the process. So what that tells us is, and our experience tells us, is that there is a growing trend towards making sure that co-investors actually do bear the pro rata share of the broken deal costs.

The fact that half as many funds, which was 13% in '18 versus 26% in '16 said the sharing obligation is set forth in the indication of interest from the co-investor is also interesting because people are dealing with the question earlier in the process. Perhaps even before the co-investment vehicle is signed. And that's where I would say, based on experience, there is the clear trend if you're going to have co-investors that are signing on in an earlier stage, they are expected to bear the fees, the pro rata share of the fees, if the deal should bust.

Certainly co-investment funds will have a policy in place on bearing these and generally do expect to bear their share of them. Some co-investment funds will say that they're not going to participate in those transaction costs unless the deal closes. As I said, the majority, I would say, do expect to bear the broken deal costs.

So lining these statistics up with some of the earlier comments on when managers expect their fund to bear broken deal costs. Which is clearly that it's later in the process that they impose those on the fund, except for those situations where they might choose not to. And co-investment vehicles tend to be formed later in the transaction process as the management team gets closer to closing. So it makes sense to see in the data that co-investment vehicles being formed later and managers pushing broken deal expenses onto the fund at the later stage, it makes sense to see that co-investment vehicles bear their pro rata share.

I think that I'd also add one comment here about the ILPA 3.0 Principles. Those principles provide that the general partner should not invest in opportunities or appropriate through the fund through other investment vehicles unless the investment is made on a pro rata basis under pre-disclosed co-investment agreements established prior to the close of the fund.

Interesting comment, because a lot of fund managers will locate their co-investors on a deal by deal basis, so there isn't opportunity prior to an LP's investment decision into a fund to actually know what the likelihood of co-investors is going to be in a particular deal. Certainly if the fund manager has a track record of using co-investments to supplement its fundraising in multiple deals, one could expect it going forward. And, therefore, it should be disclosed in part of the PPM as part of the strategy for the next fund.

If the fund manager is an emerging manager, hasn't raised a prior fund, then it's harder to know how that's going to play out. It would be better if the emerging manager's PPM included disclosure about the potential for co-investment and how that was going to be used, potentially, with respect to certain deals. And if it can't be that precise, then certainly, naming that you could have co-investors in your discretion should be something that is in the PPM disclosures.

Behind the scenes, the managers should have a policy and procedure for how investments are going to be allocated between co-investment and the fund and certainly deal with the conflict of interest of whether principles can invest in a co-investment side, or only through their commitment to the fund.

[Brian Dolan]
Thanks for that Julie. Let's take a few minutes to talk about another big category of expenses. Those are regulatory expenses. It's a category that has clearly grown since the Dodd-Frank Act in 2010 and what have you learned about these regulatory expenses based on reviewing both the MergerMarket and PFM survey respondents over the years?

[Julia D. Corelli]
The 2015 MergerMarket survey had an overwhelming number of respondents. 76% that said regulatory concerns was one of the biggest challenges in structuring co-investments and managing their co-investment activity. 30% said it was the biggest challenge, so it's clearly regulatory issues around co-investments is clearly an issue for managers.

Just in the general world, even without co-investments, managers have concerns over regulatory expenses because they've grown a lot. A number of examinations continues from the SEC. The examiners are more educated about the private equity industry, and they are diving deeper and deeper into every nuance of the business, even upon a routine examination. The PFM surveys asked a number of questions of respondents on what they would charge to the fund in a situation where the SEC found a deficiency.

So the reason I focus on deficiencies here is because routine regulatory expenses are still very well accepted as the cost of doing business of the manger. They rarely are pushed onto the fund, only in extraordinary circumstances and with clear and concrete disclosure would you be able to push those, I think onto the fund. But when it comes to corrective action. Something that is highlighted in a deficiency letter, there's a couple of questions that we've asked in the PFM surveys which are very interesting: (1) do you disclose the deficiency letters to investors? and (2) the corrective action from the deficiencies that are highlighted are the expenses of those corrected actions, and (2) with respective to corrective actions, undertaken because there was something highlighted in the deficiency letter, are the costs of those corrective actions borne by the fund or by the manager?

In all three of the PFM surveys, '14, '16 and '18, respondents were asked if they would charge the fund a situation where the SEC found a deficiency around valuations and that deficiency around valuations led to a need to re-do two quarters worth of reports to investors. In '14 and '16, approximately 30% reported that the accounting and legal costs associated with those revised reports would be a fund expense and about 12% said some portion of it would be paid by the fund, in other words it was to be split between the fund and the firm. So 42% total, not so surprising since reporting expenses generally are fund expenses and revision may or may not have something the management team viewed as right or necessary, but something they agreed to with the SEC.

And that's an important distinction that we need to make when we think about corrective actions pursuant to deficiencies. There's a lot of corrective actions that managers take, not because they think they are necessarily needed, but because they want to end the examination process with the SEC. So they will agree to it. It's a cost benefit analysis. It's a decision of where the pain point might be minimized and they'll go through with actions in an agreed manner with the SEC even though they might think they would win if they argued on that point with the SEC further.

So that's often a reason why managers think it's justified to push SEC deficiency corrections onto the fund. In this situation it happened, in this example, it happened to be something around valuations which triggered a restatement of financial reports and financial reports are customarily a cost which is borne by the fund. So it wasn't surprising that you saw 42% saying that some portion or all of that would be borne by the fund.

But in 2018 this number dropped to 15% reporting it would be a fund expense and only 10% said it would be split between the fund and the firm. 75% now said it was a management expense. So what you're seeing is anything to do with the SEC corrective action on deficiencies, is now much more, according to these respondents, is much more a management company expense. So that was a big growth in the number that said the management company bore it.

The same but inverse trend seems to be happening with respect to the question of disclosure of deficiencies letters to investors, and here what we see between '16 and '18 is a decline in the number of managers who are committing to disclosure deficiency letters. The decline was from 50% in '16 to 30% in '18 who said yes in all cases they would disclosure deficiency letters to investors.

That's consistent with them saying, we're going to bear that cost of all the corrective action ourselves. They're keeping it all internal and all in-house. The number of people who said would disclose it in a side letter actually increased from '16 to '18. So remember the first decline from 50% to 30% were those who said they would just disclose it in all cases. In other words, that something in the LPA or a policy and procedure, they disclose it in all cases. More frequently now you use that there's a side letter request form an investor to see any deficiency letters and that percentage of respondents between those two years increased from 16% in 2016 to 27% in 2018.

There's about the same number of people 23% and 24% in those two years said they would disclose the deficiency letter only if it resulted in some costs to the fund. So you can almost add those percentages to the 50% and 30% in the beginning about all cases because they only do it if they disclose if it's a fund expense. And then there was a growing percentage that said "we tried very hard not to have to make any disclosure" and that was increasing from 11% to 18% in '16 to '18.

So these data points, I think, are indicative of people's evolving treatment of regulatory expenses. How they treat them is often going to depend on what is the nature of the underlying deficiency and whether that does have an impact on the fund or not. So it's very difficult to develop a policy and procedure around this. It has to be dealt with sui generis on a case-by-case basis. But there should be consistency across funds within a firm's platform on how regulatory expenses are treated.

[Brian Dolan]
Thanks, Julie, for your insights today. A lot of data here. I'm sure it was a bear of a process to put together this article and going through all the conclusions and the data points that you were looking at for these surveys.

Can you give our listeners maybe one or two conclusions that you learned as we finish this podcast from the article writing process?

[Julia D. Corelli]
It's very difficult to discern trends and data across different surveys. We tried in each of the surveys to have a set of comments or questions that are repeated across the surveys so that over '14, '16 and '18 and on the co-investment part that came in in '15, we could compare that data with other questions that we asked.

Respondents they had a different day, they ate something different for breakfast that day, you always have that human factor in responses to surveys. So we don't make a lot of distinction when there's a one, two, three or even five percent difference in a number, but in a lot of situations we see a 15 or 20 or 30 percent change in a number and that's where we definitely think that there is a trend that is happening just from the data.

Then we illuminate that with our own experience in working with fund managers and almost 100% of the time come out consistently with where those big jumps are occurring, things are changing. And I think fund managers have a lot to deal with in the regulatory environment these days that is evolving on a day-to-day basis.

We had Mary Jo White who was a different leader from the SEC, then Jay Clayton is. The environment is a little different today. There is some growing interest in less regulation for fund manager which I think would be a welcome relief. But you don't see that actually playing out in the SEC. So people are still very focused on things like regulatory expenses and concerned that it can disrupt their business, and it is disrupted because the revenue stream for most fund managers is finite. It comes from managing the funds and it's a management fee and there's very little transaction fee revenue that's coming in these days. So it's challenging to suddenly have an expense like that that you have to bear inside the fund manager.

So, overall, I'd say the data's really interesting. We are looking forward to doing this survey again in 2020. The idea is to get it every two years so that we can see where the big changes are occurring. One of the things we pay attention to is the impact of ILPA 3.0 which recently came out. The taking up of the ILPA expense reporting formats is certainly something that is occurring and will help to deal with all of these expense issues.

We don't see that in the smaller funds. It's a very complicated report and it takes a lot of internal resources to put that together for investors. But in the mid-market funds, 100 million to a billion, you are definitely seeing the expense reporting being taken out more and it's probably becoming the norm in the over $1 billion fund.

So, as I said, we're looking forward to doing this again in 2020 and coming out with more trends and examples for you in the future.

[Brian Dolan]
Thanks again, Julie.

For our listeners, we are going to have links to all of the surveys that Julie referenced during our podcast today. Also, the description of this podcast which is on Pepper's Insight Center at www.pepperlaw.com. Thank you.
