# Squeezed in the middle

As pressure from both regulators and investors builds, **Julia Corelli**, a partner with law firm Pepper Hamilton, asks whether fees and expenses are burying the PE model for smaller funds

**Corelli:** Mid-market managers are facing a trifecta of pressures

Fund managers are getting squeezed from all directions. Absent raising a larger fund next time, GPs cannot realistically expect to grow top line revenue. At the same time, they bear variable and often unpredictable expenses. The only true lifeline for the middle market manager is a positive track record that can sustain the firm over several funds until carry kicks in. As a result, new managers have a precarious business path for the first 10 years or more.

As in 2014, over 80 percent of participants in the 2016 *pfm Fees and Expenses Benchmarking Survey* are managers with less than $1 billion under management. Around 20 percent have AUM of less than $100 million. The group comprises the lower, middle and maybe some of the upper end of the middle market. The survey shows how difficult the current private equity business model has become for smaller funds.

Internally, GPs often need to manage a talent pool where compensation is a constant source of pressure. Junior professionals are expecting more, sooner. Limited partners are pushing to reduce their fee burden. Completing the trifecta, regulators are triggering unforeseeable – and at times uncontrollable – examination costs. Technology, space and utility costs look predictable by comparison. Combine that with the ever-growing interest in patient capital and one wonders why any new manager would willingly enter the fray.

Predictably, the survey shows that managers have not been shifting expenses to their funds and continue to bear variable costs – like marketing, travel, research, accounting and communication. Two exceptions seem to be broken deal expenses and co-investment costs. Meanwhile, fee offsets are more often 100 percent, so other forms of fee income are less available to bolster top line revenue.

When asked who pays the legal, accounting or consulting costs during diligence before a letter of intent is signed, 57 percent of respondents agreed that the fund should pay if the deal ultimately closes. If the deal doesn't close, close to 80 percent said the fund pays. By contrast, the figure was 29 percent and 53 percent, respectively, in 2014. The number of responses indicating the portfolio company pays pre-LOI costs in a deal that closes dropped from 61 percent to 38 percent between the two surveys.

There has been a similar shift when it comes to attributing post-LOI deal expenses. If the deal is closed, 42 percent agreed in 2016 that post-LOI expenses should be reimbursed by portfolio companies, compared with 65 percent in 2014.

The net result: the fund is picking up more. Perhaps there are more minority or co-investment transactions occurring where it is more common that the portfolio company does not bear all of the fund's transaction costs. The more likely driver is competition for deals.

## Catch 22

How co-investors should share in deal costs remains controversial. When the co-investment entity is expense-free, the best practice is to have a pre-disclosed policy making fund investors aware of

this. Without this, regulators complain. But pre-set policies are by their nature inflexible, and managers usually prefer an approach based on fairness. As the legal structuring necessary to accommodate co-investments has grown more complex, the debate over who bears the cost of the co-investment vehicles has escalated. Costs include not only organizational expenses but the ongoing costs of tax returns, audits, bookkeeping, LP transfers, etc. Co-investment vehicles are increasingly management fee and carry free, especially when populated by existing LPs, leaving many wondering whether separate co-investment investment vehicles are worth it.

In the 2016 survey, over 83 percent of respondents said that the organizational costs of co-investment vehicles were borne by the co-investors, while only 9 percent treated them as transaction expenses. While the GP could try to negotiate for the portfolio company to cover them (which means the fund is effectively bearing its percentage ownership share of those costs), that is not always successful. Yet, having the portfolio company pay them would seem to be a fair outcome as the deal would not happen without the co-investment entity being organized and funded and all participants in the deal benefit from the co-investment.

If a fund manager cannot negotiate a management fee from the co-investment entity; or does not have a policy making it a fund expense; or is unable to negotiate for the entity's costs to be covered by its investors or the portfolio company, it has to absorb those costs within the firm's budget. It is one of those unpredictable expenses – the fund manager cannot know in advance what kind of deals will present themselves during the fund's life which will require co-investment capital.

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At the risk of increasing operating costs, fund managers are succumbing to LP pressure to deploy their capital through co-investments. By doing larger deals, the manager may hope to raise a larger fund next time, facilitating revenue growth and supporting a bigger team. The danger is they may wander from their original investment mandate: the lower end of the middle market PE deals. It's a catch-22.

## The cost of compliance

A third large variable cost for mid-market managers is regulatory costs. These come in many shapes and sizes: registration costs, the cost of having a chief compliance officer, ongoing compliance maintenance costs, examination costs and investigation costs, ie, the costs of interactions with regulators beyond the routine examination. The 2014 and 2016 surveys were fairly consistent in their treatment of examination costs – the majority are manager-borne. In 2014, about 67 percent of survey respondents said managers should bear the legal costs incurred in connection with a routine examination, while 20 percent said the fund pays that expense.

Both surveys asked whether the GP or fund should bear the costs associated with the restatement of financials should an examination show valuation deficiencies. In both, about 57 percent said the management company paid the costs of the restatement and just under 30 percent said the fund would pay it. The sample size may not be significant enough to call this an industry practice, but this may indicate that, in some cases, fund managers can require the one who benefits from the regulator's remedial action to bear the associated costs. It will depend on the circumstances.

Broken deal expenses, co-investment costs, regulatory examination costs are three areas where mid-market fund managers have been able to advance a bit against the trifecta of cost pressures. Their solutions are often creative and heavily scrutinized by investors, resulting in longer, more negotiated LPAs and side letters, which increases organizational costs. It is only by industry surveys such as the *pfm Fees and Expenses Survey* that we can see, at a macro level, some of the pressures that middle market managers face and understand how much it takes a special kind of manager to maneuver their way through the first 10 years necessary for a sustainable business model. ■

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