Private Funds
CFO

Fees & Expenses Survey 2020

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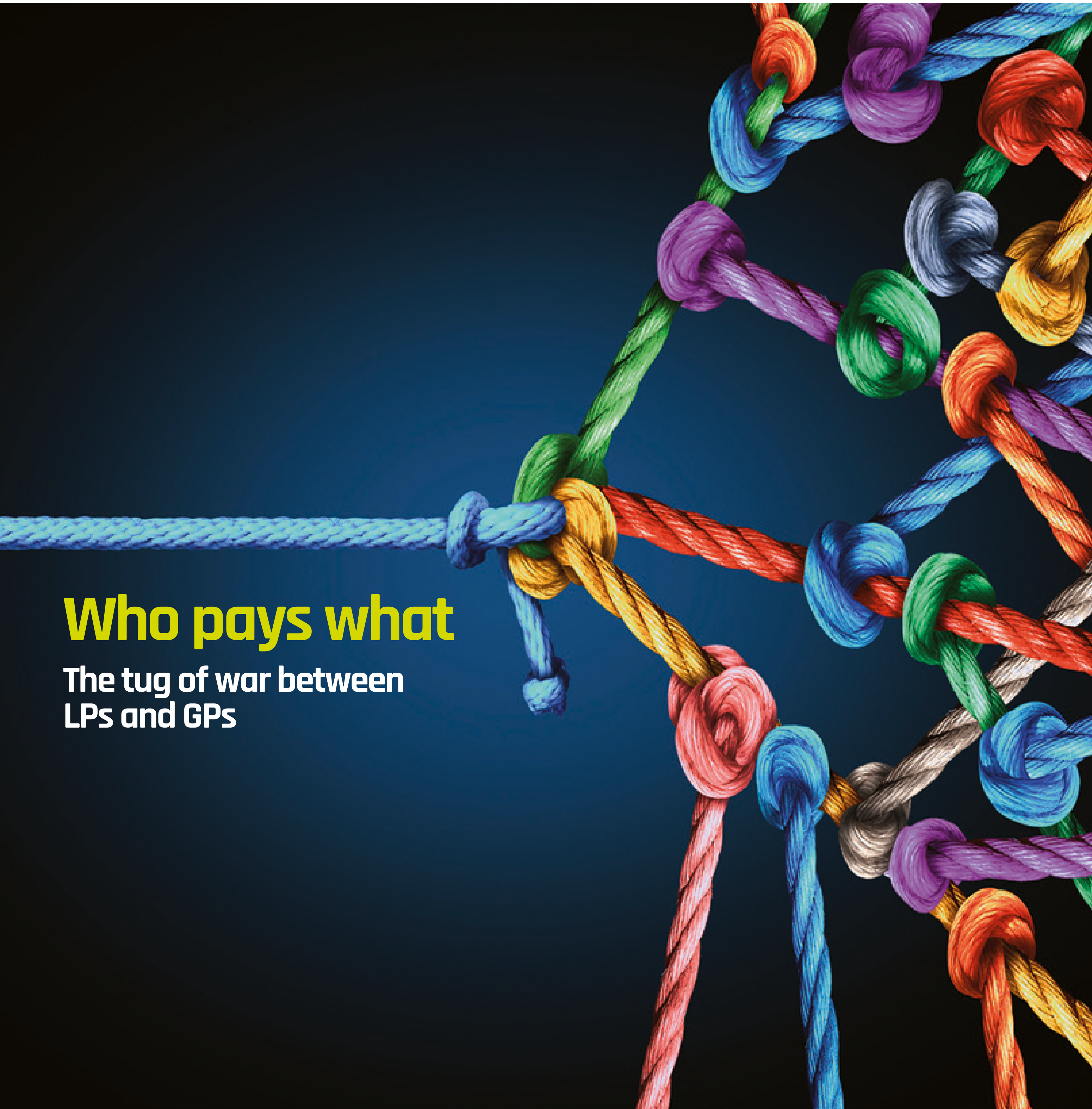

Who pays what

The tug of war between LPs and GPs

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Fees & Expenses Survey 2020

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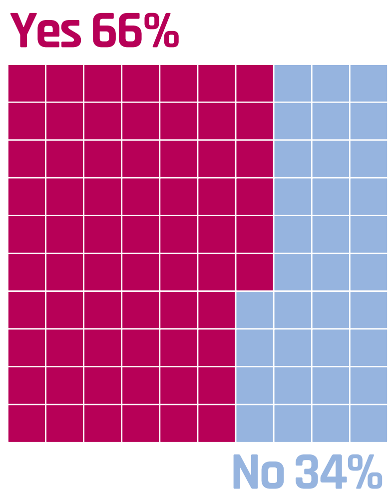
Is your firm registered with the Securities and Exchange Commission?



Insight

Eight charts that matter **Everything you need to know about changes to private equity fees and expenses in the covid era**

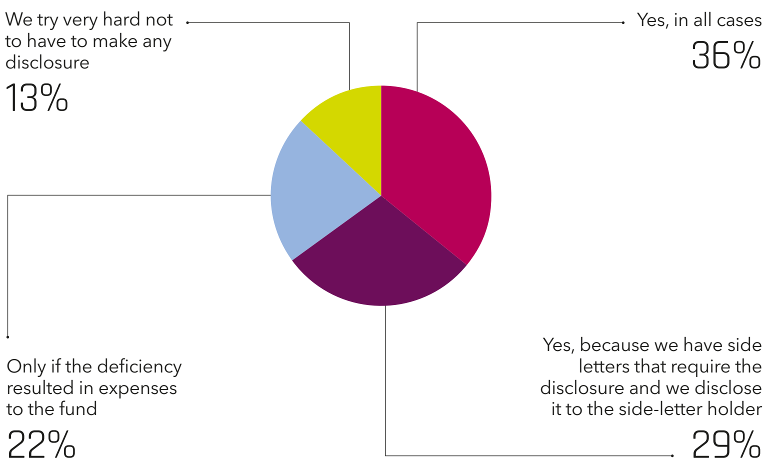
There is no doubt the combination of a punishing Securities and Exchange Commission crackdown in the wake of the financial crisis, together with LPs finally finding a common voice in ILPA, has led to a tightening of practices and procedures around the issue of private equity fees and expenses, *writes Amy Carroll*.

What began with the Dodd-Frank Act and the creation of a specialist Asset Management Enforcement Division at the SEC a decade ago led to headline-grabbing multi-million-dollar settlements with private equity giants before driving opacity out of the asset class and resolving controversial issues about who pays for what. And yet, SEC sanctions persist and tensions between investors and managers remain. It is clear there is still some way to go. Conducted biennially since 2014, the *Private Funds CFO Fees & Expenses Survey* has captured these shifts in the GP/LP relationship. Here are the most important developments identified this year. ■

On a need to know basis

There has been a fall in the proportion of managers that would automatically disclose details of deficiencies from an SEC examination report to LPs. Over a third say they would always share the information, but 29 percent would only do so if forced to by individual agreements with investors and 13 percent would avoid doing so at all costs. "Managers don't want their LPs to have that information, so they resist disclosure," says Julia Corelli, partner at Troutman Pepper. "LPs, meanwhile, are pushing for transparency and so we end up with side letters."

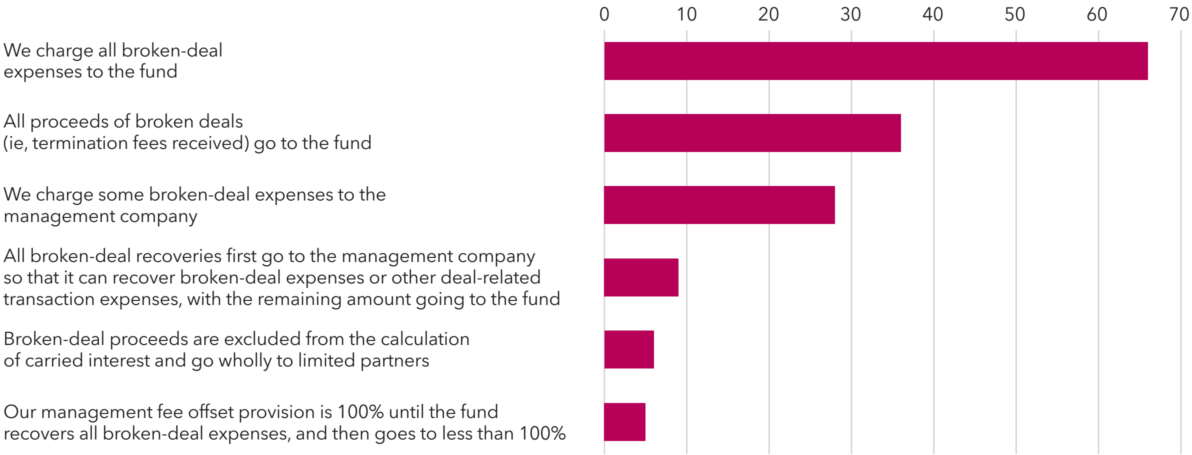
As a result of a routine examination, the SEC highlights deficiencies in the examination report. Do you disclose these deficiencies to your LPs?



Breakdown costs

The proportion of managers charging all broken-deal expenses to the fund has been steadily declining – from 85 percent in 2016, to 79 percent in 2018 and 66 percent this year. The shift is not without its critics, however, who cite potential pressure on GPs to cut back on due diligence or push on with a sub-optimal deal. Meanwhile, the proportion of managers allocating all proceeds from broken deals to LPs is edging slowly upward. But don't expect to see any significant leap anytime soon. "Why bother with the fee if you can't keep a portion of it?" asks Blinn Cirella, CFO at Saw Mill Capital.

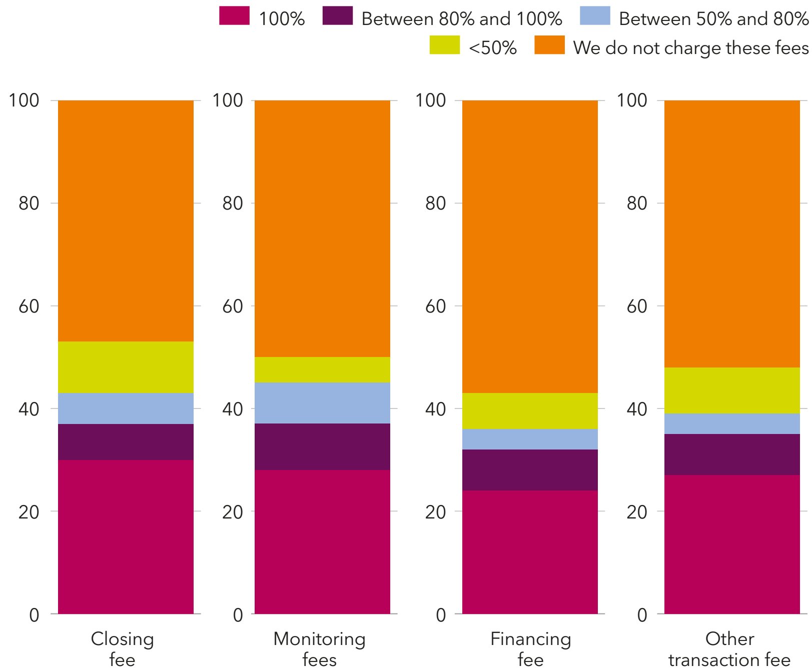
In terms of broken-deal expenses, which of the following applies to you? (Respondents were allowed multiple answers, %)



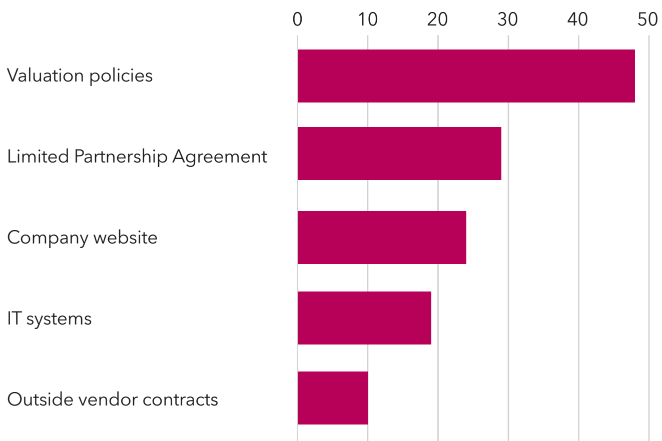
Out of favor

There has been a marked decline in the number of firms utilizing supplementary fees, such as monitoring fees, financing fees and closing fees. Where these fees are employed, they are largely offset. ILPA's director of standards and best practices Neal Prunier, says this is a welcome result of LP pressure. "These practices have largely fallen by the wayside," says PEF Service's CEO Anne Anquillare. "This is a perfect example of how the market has shifted towards a more acceptable state for investors and regulatory agents. For the most part, this hasn't resulted in a loss of capital for firms and so they have been happy to acquiesce."

What percentage of your transaction, monitoring or any type of investment-related fee received by an affiliated entity is offset against your management fees?



Have you made changes to the following documentation following an SEC visit? (Respondents were allowed multiple answers, %)



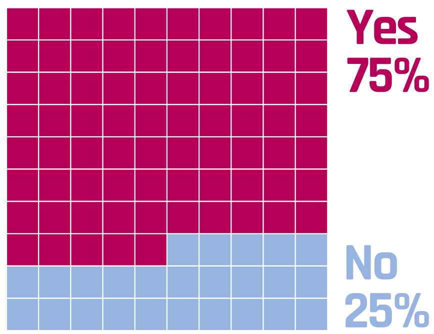
Changing values

Almost half of managers surveyed have made changes to their valuation policies as a direct result of SEC intervention – an increase of 7 percent on 2018, and a reflection of the priority that the SEC is placing on valuation methodologies. However, the proportion of managers surveyed that have made changes to their LPAs following an examination has actually fallen. This is likely to reflect progress that has already been made, as the level of detail included within the LPA continues to grow.

More trouble than it's worth

The proportion of managers offering co-investment has fallen from 87 percent two years ago to just 75 percent. This drop has taken place against ongoing appetite for co-investment from LPs, according to ILPA's Prunier. One possible explanation is that SEC scrutiny of transparency and fairness surrounding co-investment has made the practice unworkable for some GPs. "It may have become more trouble than it is worth," says practice leader at Withum's Financial Services Group Tom Angell.

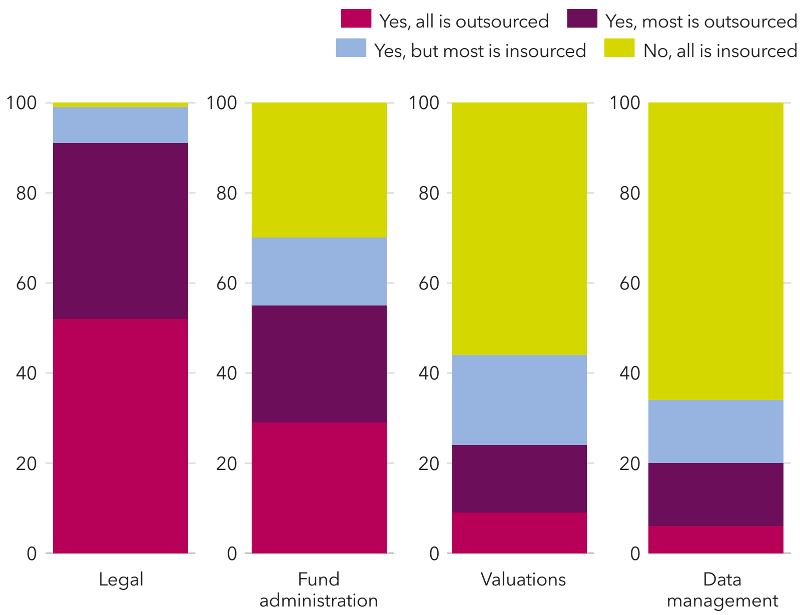
Does your firm offer co-investments?



When to keep things in-house

According to our 2020 survey, outsourcing is becoming increasingly common, particularly in areas such as fund administration, where pressure from LPs and regulators, and increasingly complex operational needs, has led to a growing number of firms favoring an independent set of eyes. One area where the trend has been reversed, however, is around valuations, which are steadily being brought back in-house. "This reflects the fact that the LPAC is increasingly being relied upon to approve changes to valuation methodologies in the wake of SEC scrutiny," says Corelli.

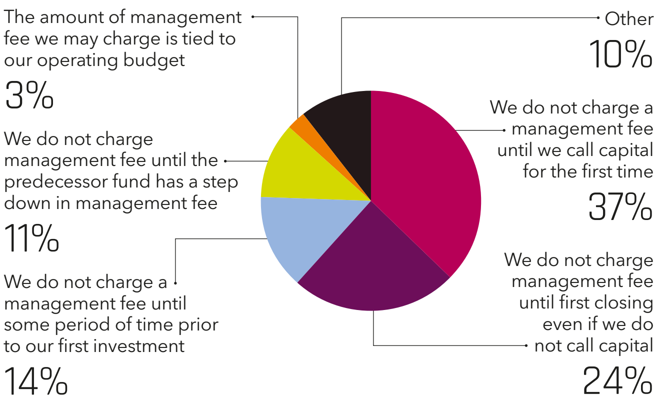
For the following services, do you outsource to third parties:



No more double charging

There has also been a significant move from managers routinely charging management fees from first close – dropping from 51 percent in 2018, to 24 percent this year. LPs are pushing back on fees for a fund that has not yet begun investing, with 37 percent of managers now introducing the management fee on the first capital call. Equally, there has been an increase in managers tying the fee of the new fund to a step down in management fee at its predecessor.

Please state which is true of your most recent fund:

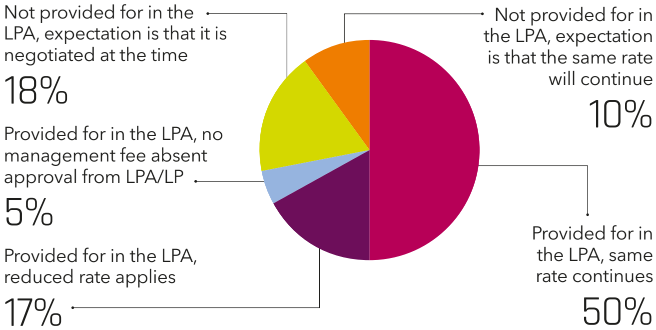


* Data may not add up to 100% due to rounding

Wishful thinking

Over a quarter of managers have made no provisions for how management fees will be adjusted in the event of a fund extension. And yet, the significant market dislocation created by covid-19 means these extensions are likely to be increasingly in demand. And, while Corelli says the rule of thumb is that anything not provided for in the LPA will be borne by the management company, 10 percent of respondents expect to be able to negotiate no change to fees as and when such negotiations take place.

What does your LPA provide about the management fee charged in an extension period?



Survey methodology

The *Private Funds CFO Fees & Expenses Survey* – formerly known as the *PFM Fees & Expenses Survey* – was launched in 2014 in response to fund managers' questions about who should pay for various fees and expenses. The resulting report, which we produce every two years, is intended as a benchmark to compare and review fee-related practices across the private markets industry.

Creating the benchmark

PEI's Research & Analytics team surveyed 131 US alternatives fund managers on their fee and expenses practices in May and June 2020. We targeted CFOs because they are the most informed of these practices. However, if the CFOs were unavailable, we asked responses from other professionals, including CCOs, COOs and IR professionals, provided they were aware of the firms' practices.

This is a benchmark covering the US, so we surveyed firms from every region across the country. The largest proportion of respondents were from the north-east, reflecting the private equity hubs of New York, Washington DC and Boston. We also received responses from across the AUM spectrum, from firms managing assets in excess of $10 billion to smaller GPs with AUMs under $500 million.

What about confidentiality?

To encourage wide participation, the survey is entirely confidential.

Why alternatives and not just private equity?

The survey's emphasis is on private equity firms – 56 percent of respondents manage buyout or growth funds – but fund managers in other illiquid alternative asset classes, such as private debt, venture capital and real estate, are included. Much of the scrutiny facing private equity firms is equally placed on other alternative classes that we cover.

Editor's letter

Tally up

Chase Collum
chase.c@peimedia.com

In the last iteration of our *Fees & Expenses Survey*, conducted in 2018, we found that the pendulum remained very much in the GPs' favor when it comes to fee negotiations. But there was also speculation that a downturn could see a swing back toward LPs.

Certainly, with the arrival of covid-19, there have been significant changes to the way LPs and GPs are doing business, and even now firms and investors continue to tweak their expectations around who should pay for what.

As this is the fourth time we've conducted this biennial survey, some interesting trends have begun to emerge. Management firms are paying a lower percentage of correction costs and penalties incurred after SEC examinations, perhaps a sign that regulatory scrutiny is being baked into fund documentation more clearly in 2020 than it had been. Another item is the cost of fund admin, which is more commonly paid for by the funds themselves than it had been in previous years. Management firms are also more likely to charge all fees that are permitted to be charged to a fund by LPAs and PPMs than they were two years ago. So perhaps LPs have not come out quite as far ahead as they'd have liked.

"Both GPs and LPs are getting some of what they want, but the tug of war continues"

But it is notable that the timing around which management fees are being charged to investors is shifting away from first close and toward the time that capital is first called. Add to that the shift to an increasingly common requirement that GPs prove they're providing market rates for investment-related fees than was the case in 2018. All in all, the 2020 *Private Funds CFO Fees & Expenses Survey* shows both GPs and LPs are getting some of what they want, but the tug of war continues.

We hope you enjoy the report.

Chase Collum

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Charged up over fees

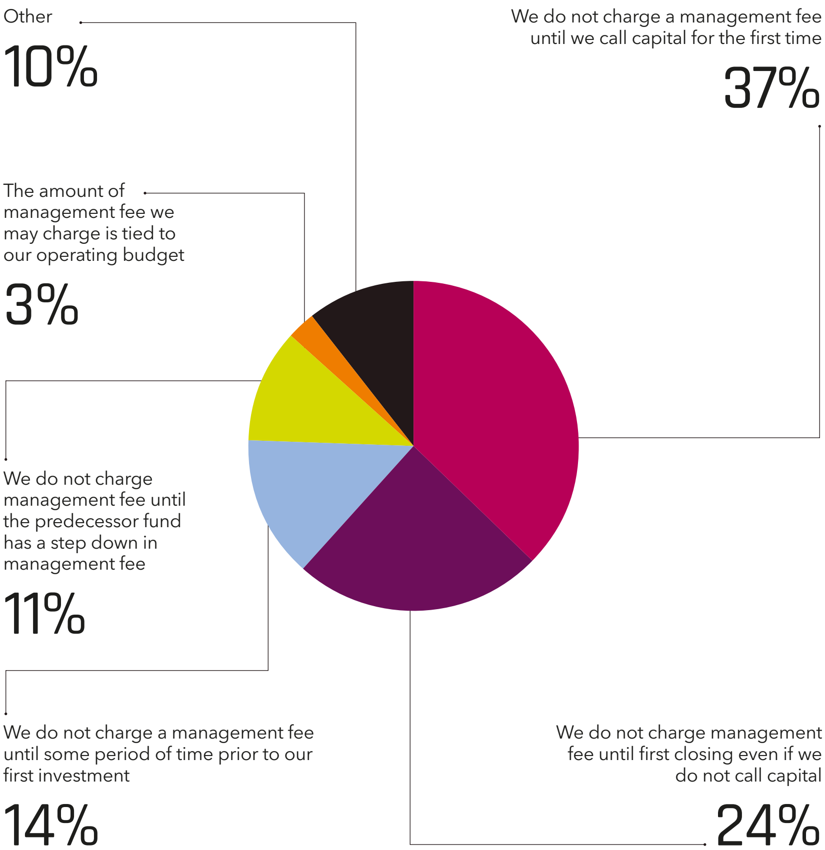
The historic two-and-20 fee model is belied by a host of idiosyncrasies

Despite dramatic increases in fund size, management fees remain stubbornly close to historic 2 percent norms, probably averaging at closer to 1.75 percent today. But as the scope and scale of private equity operations has increased, so too has the complexity of management fee calculations. The headline fee charged only tells you so much.

First up is the question of when the management fee begins to be charged. Historically, this has tended to be when a first close is reached, true of 54 percent of respondents to (then-named) *Private Funds Management Fees & Expenses Survey* in 2016 and 51 percent two years later. But there has been a marked shift in the 2020 findings, with just 24 percent starting the clock at first close. By contrast, the management fee is far more likely to be charged now at the point of the first capital call, or even some stated time after the first investment has been made.

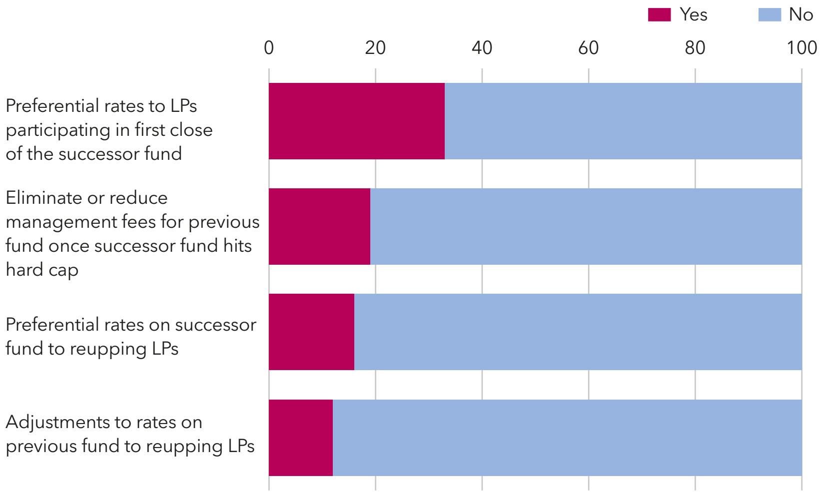
"I'm not surprised," says Saw Mill Capital CFO Blinn Cirella. "Just because a fund has held a first close, doesn't mean it is investing. Management fees are cash out of the LP's pocket and they don't want to pay the

Which is true of your most recent fund*



* Data may not add up to 100% due to rounding

How do management fees on successor funds relate to management fees in the previous fund? (%)

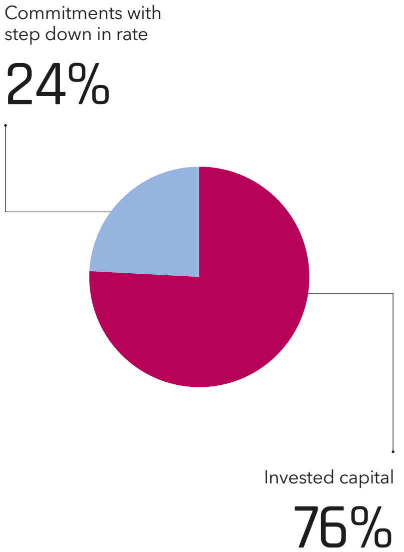


fund until they are actually making investments."

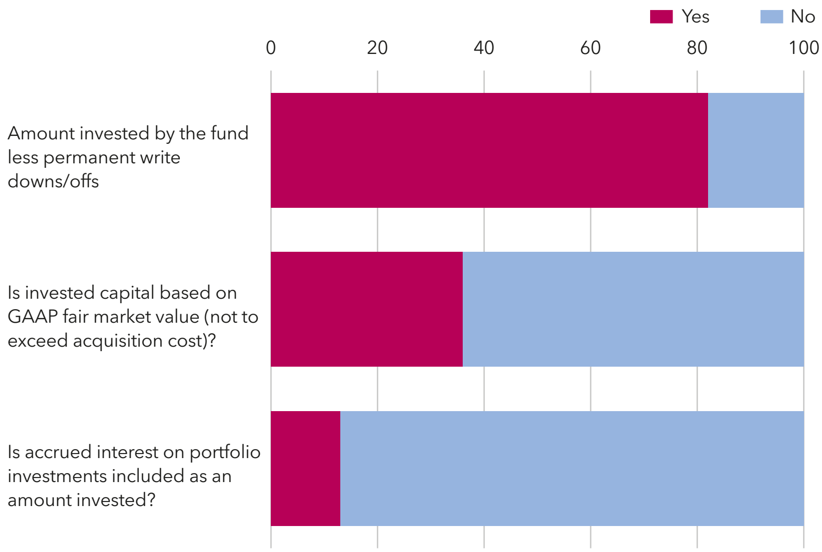
There has also been a step up in the proportion of managers kickstarting fees when the rate of the predecessor fund steps down. PEF Services CEO Anne Anquillare believes this is a logical approach to the contentious issue of bridging between two funds.

"Investors don't want to pay for the same thing twice. You are not getting two management companies," she says. "There has to be some sensitivity about how to wind down management fees in old funds and there definitely needs to be transparency during that transition period. Tying the start of the new management fee in with a step down in

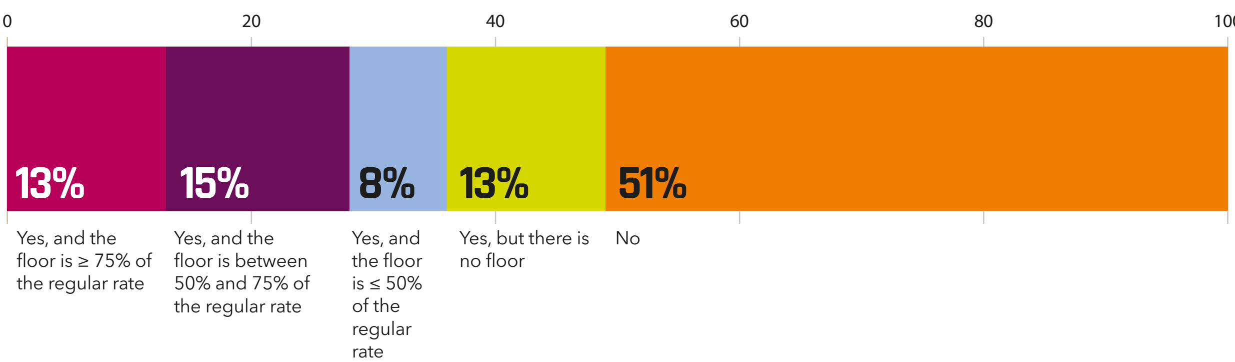
What is the base for management fee post-investment period?



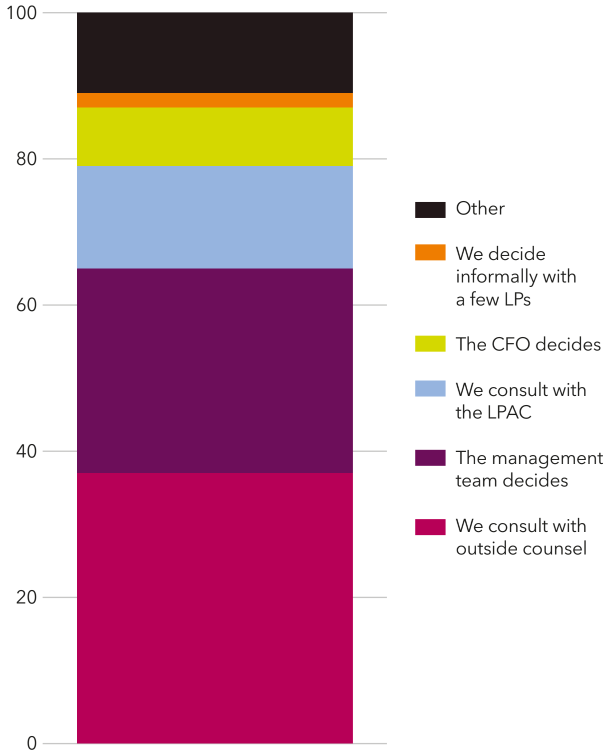
If you answered 'invested capital', how is the post-investment period fee base calculated? (%)



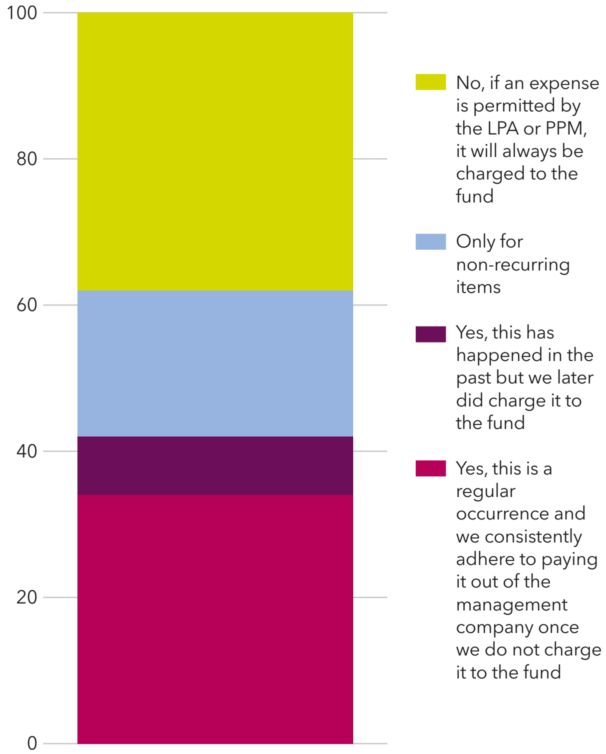
If you answered 'commitments with step down in rate,' is the percentage an annual stepdown of the pre-investment rate?



How do you decide questions about fee and expense allocations that are not addressed in the PPM, LPA or policy documents? (%)



Have you ever decided not to charge to the fund an expense that was expressly permitted in the LPA or PPM? (%)



the old management fee makes a lot of sense. There needs to be co-ordination."

Troutman Pepper partner Julia Corelli, however, finds this development surprising. "Only the biggest funds would not find this consequential to the management team. If it is happening in the mid-market, it must be as a result of lots of pressure from LPs," she says.

Another challenge associated with transitioning between an existing fund and its successor involves the extent to which the manager is prepared to offer preferential economics. The GP will want to entice incumbents to re-up, while balancing that against the need to diversify its investor pool. Striking a fair and strategic approach to inducement is therefore key.

Offering preferential rates to those prepared to come into the fund early remains the most prevalent tactic, used by a third of GPs. A further 16 percent are prepared to offer preferential rates on the new fund to re-uppers, while 12 percent approach the issue from the other direction, offering re-uppers adjustments on rates in the previous vehicle. "We definitely see economics offered to investors coming in as anchors, but it is important to be careful," says Anquillare. "You never want to give away economics in a future fund because you don't if you will still want that anchor. And you don't want to scare off other investors. It's a delicate balance."

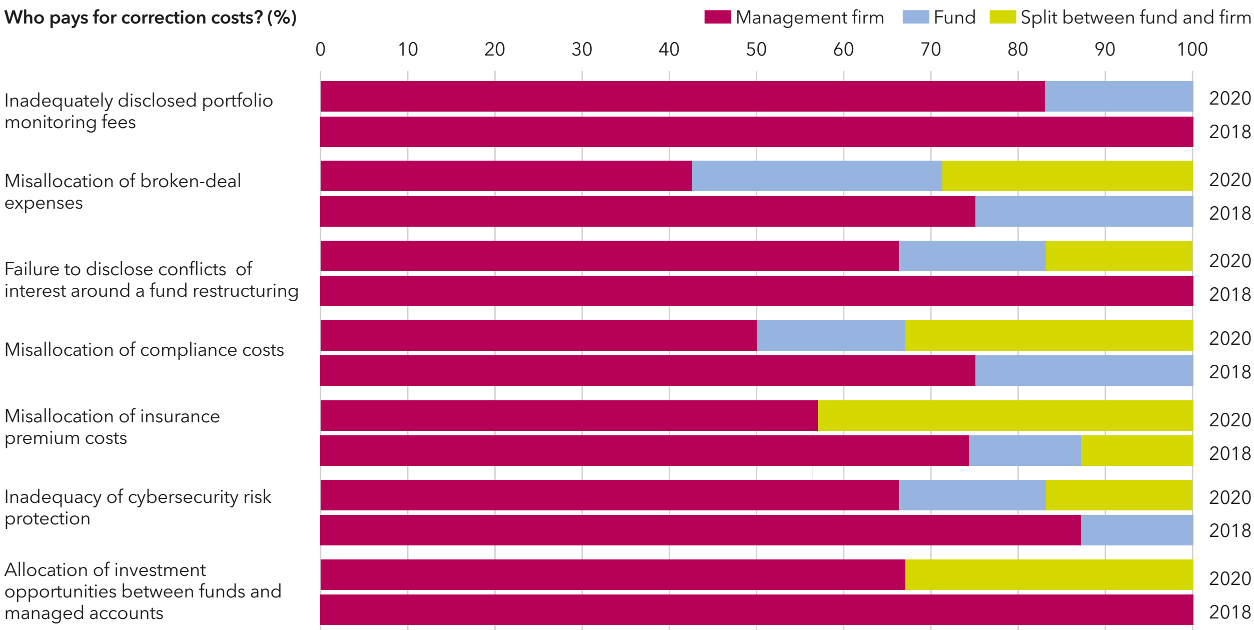
> *"Just because a fund has held a first close, doesn't mean it is investing"*
>
> **BLINN CIRELLA**
> **Saw Mill Capital**

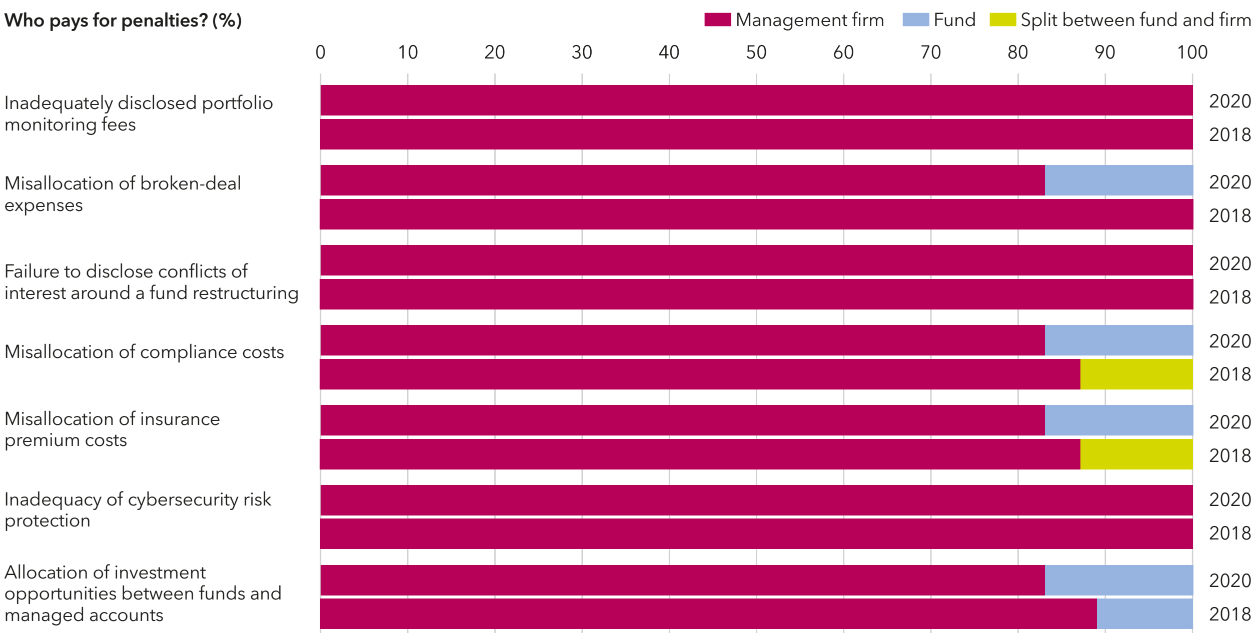
"Early closer or re-up discounts are driven principally by demand," adds Cirella. "For newer funds, or funds that typically take longer to hold a final close, LPs do not have the same sense of urgency and may find it economically disadvantageous to be an early closer. Particularly since the economic crisis, newer funds and certain funds of funds may offer one, or both, of early closer discounts and re-up discounts. For over subscribed funds holding a final close in a relatively short period of time, these discounts are less frequent." ■

Bright lines

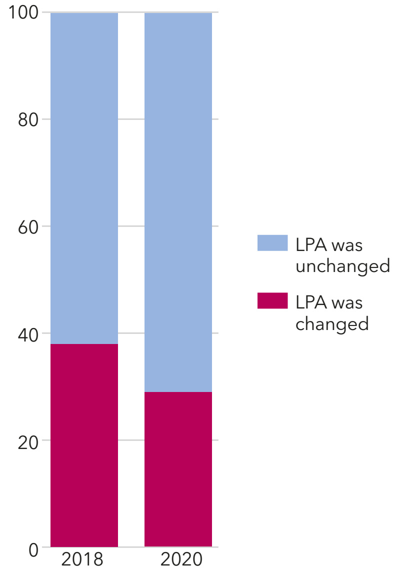
Six distinguishable trends that our biennial Private Funds CFO Fees & Expenses Survey has illuminated

Management firms are paying a lower percentage of correction costs and penalties incurred after SEC examinations

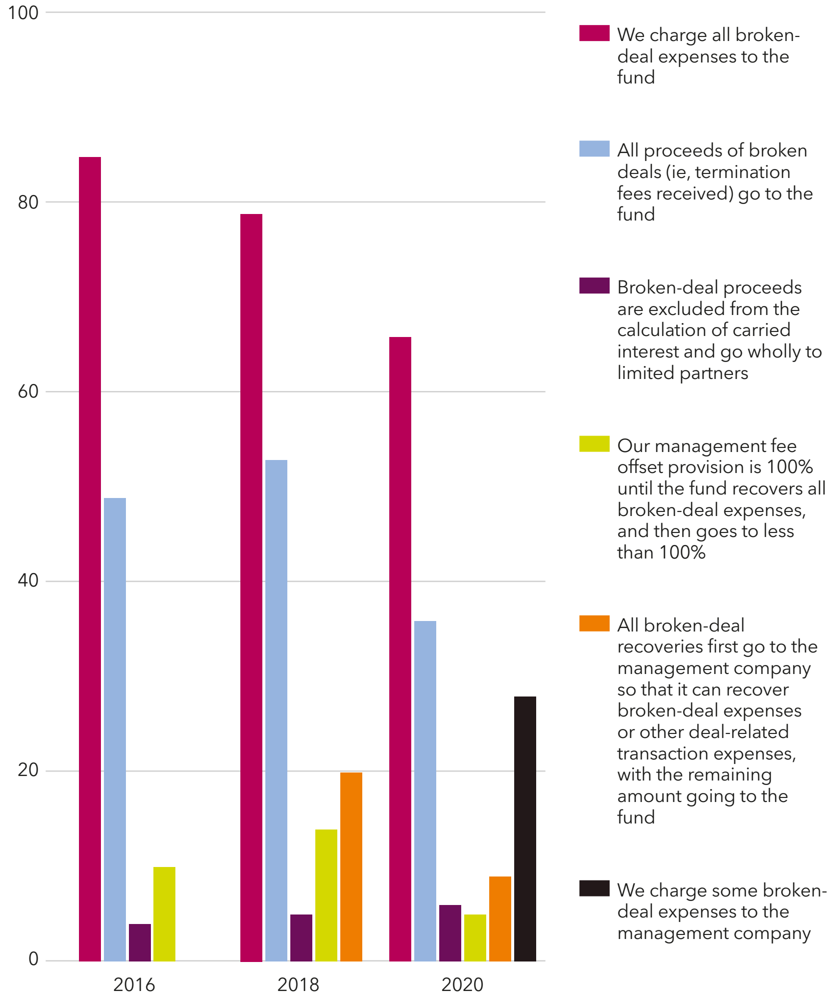




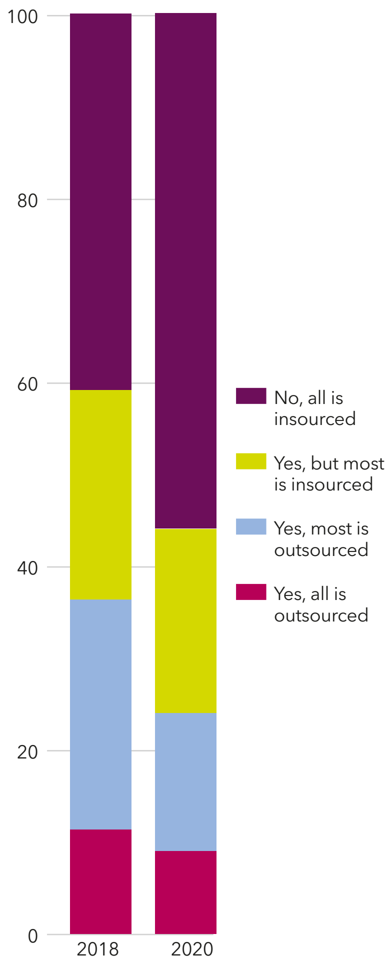
Changes to LPAs after SEC examinations were less common in 2020 (%)



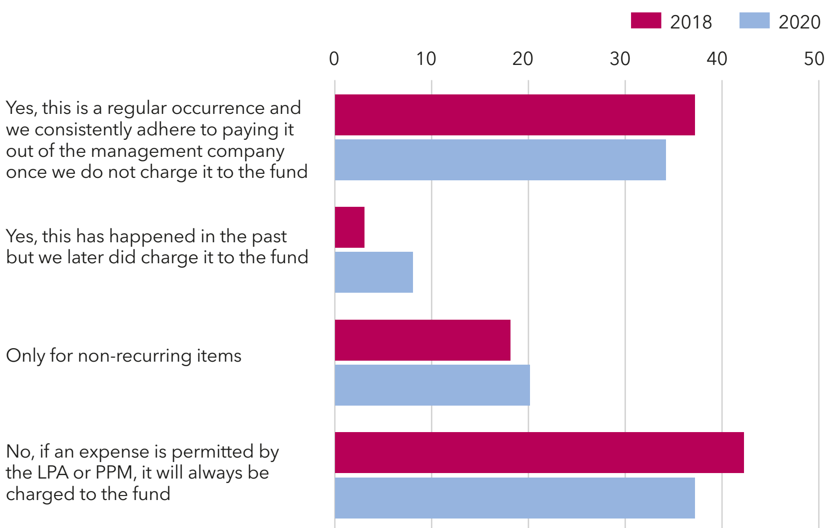
Broken-deal expenses are being charged to the fund less frequently (%)



Data management is increasingly being handled in-house (%)



Have you ever decided not to charge to the fund an expense that was expressly permitted in the LPA or PPM? (%)



EXPERT COMMENTARY

Viewing commitments to private equity as an expense management exercise can be detrimental, writes PEF Services president and CEO Anne Anquillare

Management fees are all about alpha and alignment

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We have all heard the comments and read the articles highlighting investors' concerns about fees paid to private capital fund managers.

And while carried interest clearly aligns with performance for investors, management fees are more contentious. But, how does a firm operate without income? This obstacle is especially problematic for the next generation of managers who need a budget to attract talent and build infrastructure.

Private equity is an alpha asset class where manager selection is, by far, the driver of success for investors. And, the next generation of managers is also critical to the long-term success of this asset class.

So when investors view commitments as an expense management exercise, they tend to limit their chances of working with a successful, established fund manager or limit the resources required by a new fund manager for success. There needs to be a balance where investors are confident that they are getting value for their fees and fund managers have sufficient budget to successfully operate. Until then, management fees will be a constant source of pain for the industry.

It used to be simple – firms charge 2 percent of committed capital until the investment period was over and then 2 percent of invested capital while you start raising your next fund. But that was when funds were smaller and firm operations were simpler.

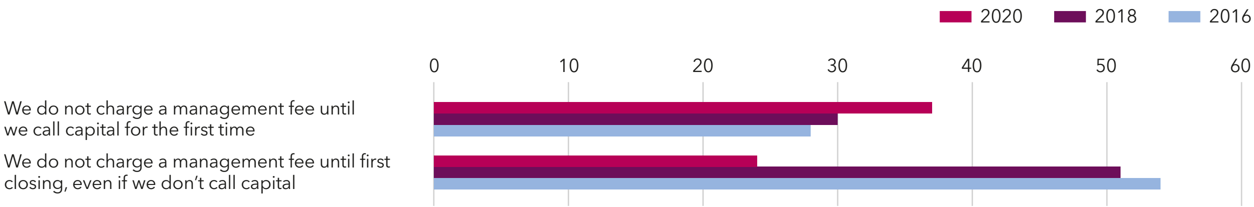
Nowadays, firm operations are more complex and cover all aspects of business, including cybersecurity and compliance. The determination of what is covered by management fees versus partnership expenses is also more complicated. And, on top of all that, formulas for management fees are complex and unique to different investors. Fee offsets are waning and more disclosure is required when used, but other nuances are gaining scrutiny by investors and regulators. So, we are making progress but the goal line keeps moving.

Old fund/new fund

Since we can't address all issues in one article, we'll focus on some real pain points for GPs and LPs. Spoiler alert, it all comes down to alignment.

Let's tackle the transition between the previous fund and the new fund. This is a tricky time. GPs want legacy LPs to commit to the new fund but they

Which is true of your most recent fund? (Selected answers, %)



Source: Private Funds CFO Fees & Expenses Survey 2020

also want to expand their investor base. So, when do you start charging management fees on the new fund?

According to our survey, starting the management fee at "closing" is declining while starting the clock ticking on the first capital call is increasing (and yes, subscription lines are also impacting these trends, but that is a topic for another article). Also, there was a pickup in funds not charging management fees on the new fund until the former fund's investment period is over (which typically triggers a step down in management fee formula).

While it might be hard to piece it all together, this makes sense as investors don't want to pay twice for something but as a fund winds down, so too does its management fee. Also, subsequent funds might trigger additional infrastructure spend, so the firm can't wait too long to start collecting additional management fees. The ability to earn additional management fees to continue to support and build the firm is one of the economic drivers for GPs to start their next fund and contributes to the alignment of GPs and LPs.

Let's dive a little deeper into how management fees work in this post-investment period.

In theory, the GP has a successful fund winding down and a new fund ramping up. Management fees formulas have two basic components – percentage and base. The step-down period typically adjusts only one of them.

For the majority in our survey, the base was adjusted. In those cases, the base went from committed capital to "invested capital" less unrealized depreciation and write-offs (since they are no longer in the cost). And, as long as the GP is initiating a new fund, this approach should not disrupt alignment.

'Invested capital'

There are many questions and potential points of misalignment. For starters, what exactly is 'invested capital'? Is it determined by capital invested by the LP, or capital invested in the portfolio?

To the extent the base is cumulative paid in capital of the investor, what is the impact of recycled proceeds? What if the manager decides to use income from investments (eg, debt funds) for fees and expenses of the fund? Should the term 'invested capital' for an investor be grossed up to include these amounts?

Should managers issue a net capital call/distribution documents so that these amounts are more easily tracked? For fund of funds, this scenario can get even trickier as proceeds from one fund can be used to fund a capital call for another fund.

What if proceeds are used to pay down a subscription line as opposed to calling additional capital? Without disclosures and supporting documents, any type of recycling (which is a good cash management practice) can cause a lot of confusion on the calculation of the management fee base.

There are a few overarching themes to address the numerous questions. If the paid-in capital amount is calculated at a point in time, net of distributions, recycling doesn't create a problem since investors would be in the same economic position as if the fund did a net capital call/distribution. However, the risk of the manager deferring distributions to investors increases. Another potential alignment issue.

'Invested capital' could also be cost basis for the fund's investments. Are guarantees included? What if the fund is providing the collateral for a third-party loan to the portfolio company? If the fund is receiving the fees for guarantees and collateral, shouldn't the manager also be receiving a fee for managing those 'investments'?

Keys to success

Two key practices: First, make sure everyone knows the full cycle of management fee calculations and how the base is calculated. Second, disclose and document every item that impacts the base and the percentage. Many investors are doing fee recalculations, so make it easy for them.

Unless investors and GPs can both understand and easily explain/disclose information about management fees, they will be a constant source of pain for the industry and could dampen our industry's ability to foster the next generation of firms.

Management fee income is crucial for fund managers to build their team and firm infrastructure, especially in the firm's first 10-15 years. Once you get past fund IV, things get a bit easier to manage, funds tend to be larger and management fee income more predictable. At that point, investors should start having conversations about expense management balanced with succession planning because it is still all about the alpha. ■

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Our solutions are supported by senior professionals with extensive experience in alternative investments. We deliver fund administration solutions that add value and decrease risk for Funds, General Partnerships and investors in illiquid alternative assets, including Buyout, Venture, Real Estate, Energy, Debt, SBIC, Fund of Funds, Secondaries, and Special Purpose Vehicles.

With PEF, firms increase operational efficiency, control operating costs, and improve focus on core capabilities.

We address key client challenges:
- Meet investor expectations for faster, robust fund data
- An integrated platform that enables seamless processes
- Redeploy staff to strategic roles
- Achieve greater continuity & consistency
- Minimize errors & enhance client trust
- Elevate investor service

PEF's ViewPoint™ platform is a secure accounting & investor portal that supports data visualization, detailed performance and capital reporting, and organizes/stores documents for on-demand access. The accounting portal provides clients access to their fund's books and records as well as workflow for review and approval. And, all sourced directly from the golden source of data, the official books and records of the fund. The ViewPoint™ platform also provides a file exchange, an investor data base, as well as workflow for investors to securely update their contact information and bank information.

For nearly 20 years, PEF Services has been at the forefront of fund administration technology. Combining our world-class services and technology we help General Partners and Limited Partners of every size and investment strategy to minimize costs, elevate service levels, streamline operations and achieve sustainable growth.

PEF Fund Administration Services include:
- Fund Accounting
- Financial Reporting
- Administration & Compliance
- Capital Management
- Investor Services
- AML/KYC Compliance Services
- Emerging Manager Operational Performance Services
- SBIC Consulting & Administration

A mindset of execution infuses each engagement. We build an engagement plan based on the nuances of the firm and fund, and then apply our staffing resources and technology platforms to make it happen.

We help each firm achieve their goals by solving complex problems with the same intensity and sophistication they bring to bear regarding their portfolio of investments.

We help them drive growth and achieve greater efficiencies while focusing on strategic initiatives.

PEF Services is proud to be featured as a 'Top Private Capital Fund Administrator' in 2020 by Preqin

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The ILPA effect

Bespoke fees and expenses reporting remains common practice

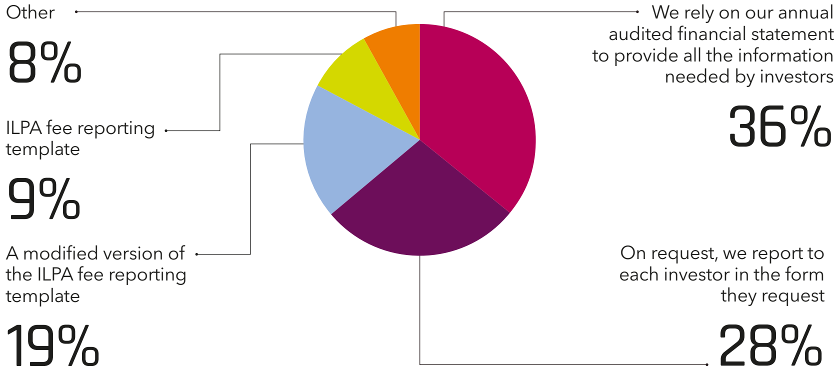
Just over a quarter of managers are either exclusively using the Institutional Limited Partners Association fees and expenses reporting template or a modified version, the latest *Private Funds CFO Fees & Expenses Survey* shows. Meanwhile, 28 percent provide the information in the form for each LP, and 36 percent rely on audited financial statements.

"A lot of LPs are invested in multiple funds and they need to make sure they can pull all this information together so that they can produce reports," says Withum practice leader Tom Angell. "They want to compare apples with apples. So, it is the GPs that end up putting this information into multiple different formats."

PEF Services CEO Anne Anquillare agrees it is the LP community driving bespoke reporting. "A lot of that has to do with investors having different systems on their side," she says. "What we are seeing though, is that the universe of data points that needs to be collected has stabilized. That means bespoke reporting doesn't have to be too arduous. You are just presenting the same data in a different format."

Smaller firms with more limited resources, tend to find it too costly to put together bespoke reports and so "let the audit speak for itself," says Angell.

How do you currently report your fees and expenses to investors?



Neal Prunier, director of standards and best practices at ILPA, however, views the dilemma from the opposite perspective. "If you are invested across 20 different managers you are going to be getting documents in 20 different formats. It can be difficult to get to the bottom of your various fees and expenses when you have to master each GP's way of doing things."

This was, after all, why ILPA designed the template back in 2016 – to provide greater standardisation. But Prunier admits it is not a one-way street, as LPs themselves have a variety of approaches to data. Private equity CFOs themselves will, of course, use the system that best meets their needs.

For Joshua Cherry-Seto, CFO and CCO at Wolf Capital Partners, that means including the data elements of the ILPA capital notice templates, but not the templates themselves. "We do not produce the fee and expense template either," he says. "It is generally a lot of work to produce something that LPs are not specifically looking for, so instead we work with LPs on their actual needs."

Blinn Cirella, CFO at Saw Mill Capital, meanwhile, relies on a detailed income statement: "We also have an annual fee and expense report that we provide at the fund level. I think if your financial statements are detailed and you have additional information in your footnotes, then that should be enough." ■

Deal or no deal

Few costs are as unwelcome as those for broken deals

Few areas of the LP-GP relationship are as thorny as the allocation of costs resulting from broken deals. It goes without saying that paying for investments that fail to materialize is a bitter pill to swallow. Indeed, controversy surrounding the allocation of fees and expenses related to broken deals has continued to rumble on, even as other areas of contention are resolved. Firms to have fallen foul of broken-deal fee violations famously include KKR and, more recently, Platinum Equity Advisors.

That said, there is a clear direction of travel, with 66 percent of respondents to the survey this year stating they charge all broken deal expenses to the fund, down steadily from 79 percent in 2018 and 85 percent two years earlier. However, PEF Services CEO Anne Anquillare says this shift is not without its challenges: "Where broken-deal costs are not considered fund expenses, you could get into the situation where the manager isn't spending enough on due diligence or else doesn't want to pull out of a bad deal."

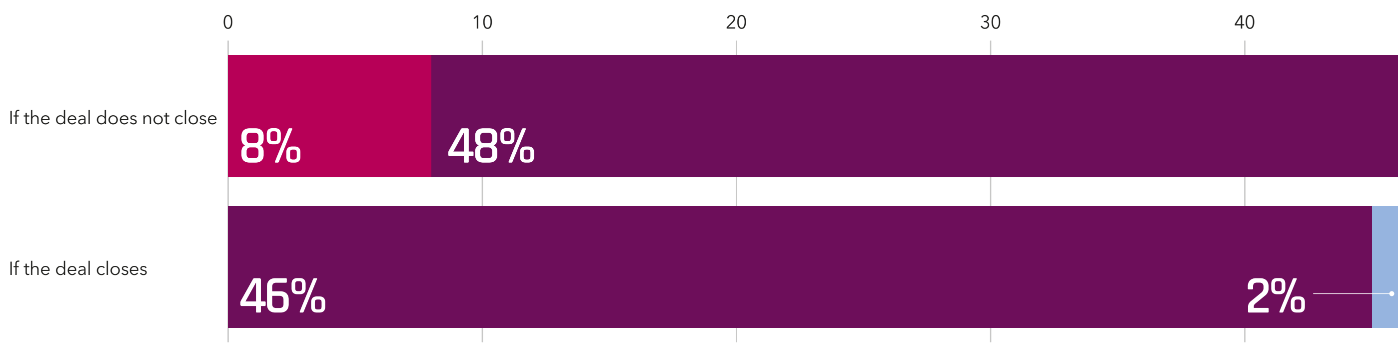
Blue Wolf Capital CFO and CCO Joshua Cherry-Seto also rejects the idea that the fund bearing the cost hurts alignment. "This is a negotiated item, which is a cost of doing business, but LPs may feel that there is not enough alignment to sufficiently control the cost unless there is more skin in the game for the GP," he says.

"However, there is a significant commitment of the GP in the fund and all GPs expect their funds to exceed the hurdle, in which case, 20 percent of any excess expense is effectively borne by the GP in foregone carry, so it is actually highly costly."

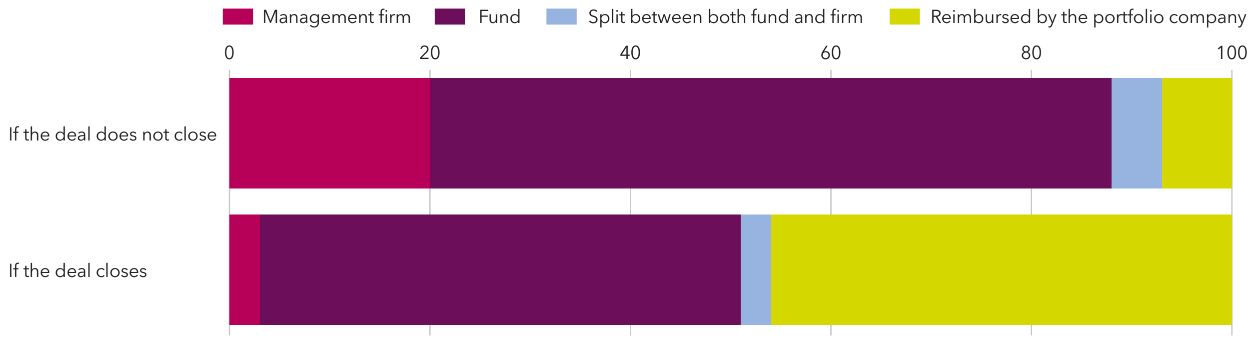
Saw Mill Capital CFO Blinn Cirella, however, believes that resistance to LPs bearing broken-deal costs is more of an emotional one.

"My guess is that it has to do with the cost of travel – with GPs frequently flying on private jets," she says. "In an LP's mind, this should be what the management fee covers, as it's a routine part of doing business. Our first fund did not allow for travel related to broken deals to be passed through to the fund – only legal, consulting and

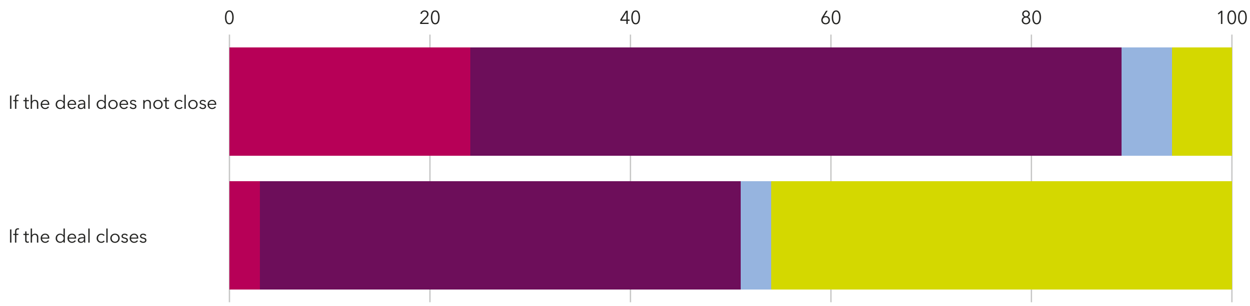
After a definitive agreement is signed, the firm's financing team agree a lending package for the deal. Who pays legal fees incurred by the lender? (%)



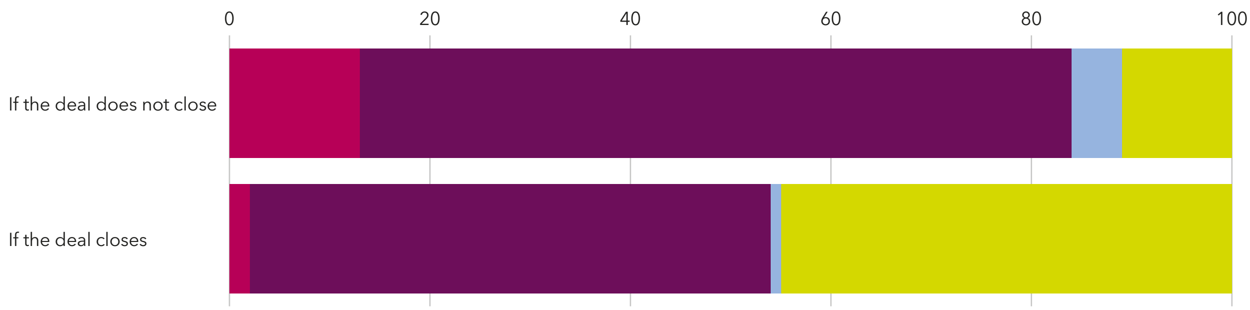
After data room review in an auction deal, a non-binding indication of interest is executed in connection with which you incur legal and accounting expenses. Who pays for these expenses? (%)

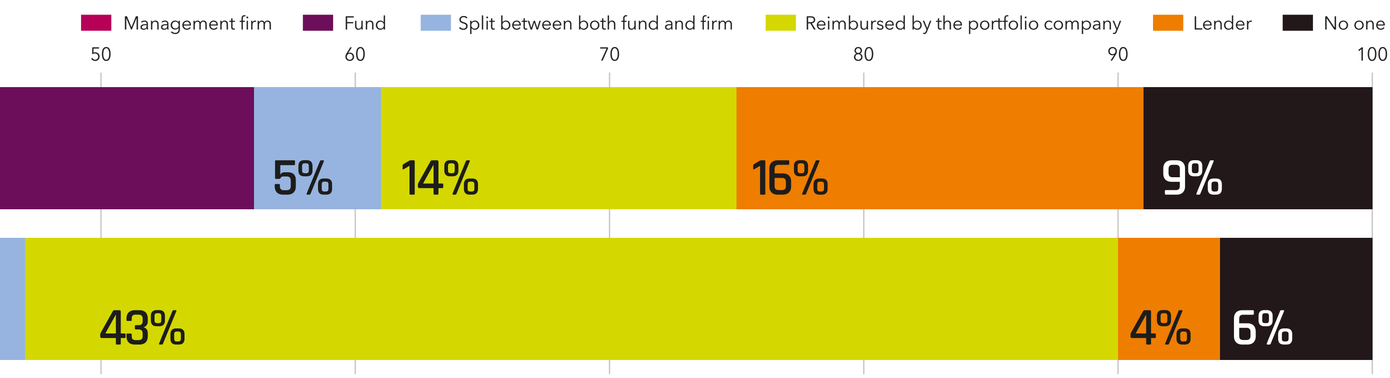


During due diligence and before a formal letter of intent is signed (binding or non-binding), the firm hires lawyers, consultants, accountants and other service providers to work on the transaction. Who pays for these expenses? (%)

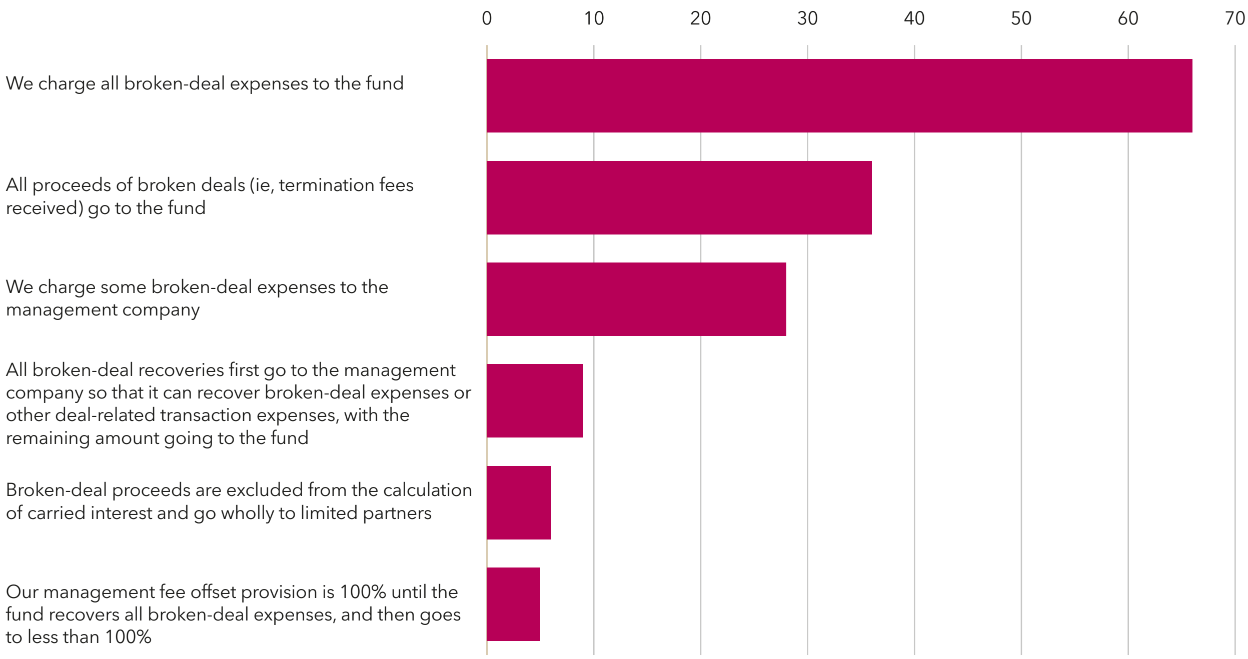


After a formal letter of intent is signed, the firm hires lawyers, consultants, accountants and other service providers to begin working on the transaction. Who pays for these expenses? (%)

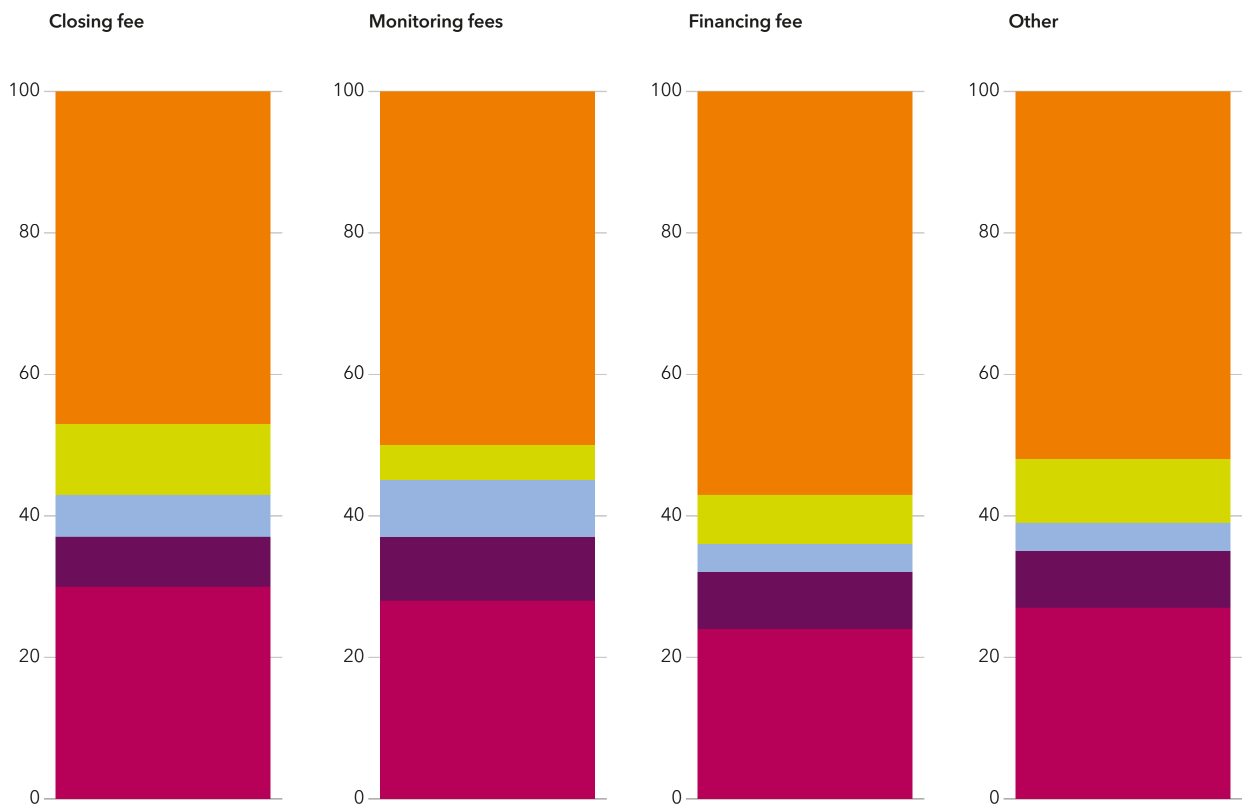




In terms of broken-deal expenses, which of the following applies to you? (Respondents were allowed multiple answers, %)



What percentage of your transaction, monitoring or any type of investment-related fee received by an affiliated entity is offset against your management fees? (%)



"20 percent of any excess expense is effectively borne by the GP in foregone carry, so it is actually highly costly"

JOSHUA CHERRY-SETO
Blue Wolf Capital

We do not charge these fees

<50%

Between 50% and 80%

Between 80% and 100%

100%

finder's fees. The definition of broken deal costs is important."

Meanwhile, the proportion of managers that allocate all proceeds from broken deals, for example, termination fees, to the fund, ekes upwards, albeit from a low base. In 2016, just 4 percent of managers considered this usual practice, compared with 5 percent in 2018 and 6 percent this year. But not everyone is a fan of the trend.

"When I started at Saw Mill in 2006, the fees collected from portfolio companies were shared 50/50 with LPs," says Cirella.

"Over time, LPs have demanded a great share. Our second fund, the share was 80 percent to the LP and newer funds are 100 percent. Why bother with the fee if you can't keep a portion of it?"

There has also been a marked decrease in the use of ancillary fees, such as monitoring fees, which are known to have particularly riled the regulators – and LPs. In 2018, 35 percent of managers surveyed did not make use of monitoring fees at all. That has risen to over half this year.

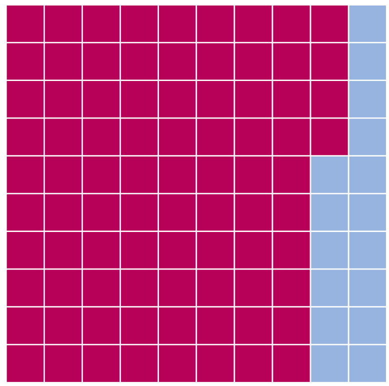
Financing fees are also on the decline, now used by only 42 percent of managers compared with 57 percent two years earlier, with just under a quarter of those that do employ the mechanism offsetting it completely. Furthermore, just 51 percent of managers still charge closing fees, with 30 percent completely offsetting them, compared with 64 percent charging closing fees and 44 percent completely offsetting in 2018.

"The market is demanding 100 percent offset as firms grow and mature, which means the reduction in the use of these fees certainly makes sense," says Cherry-Seto. "However, it still pays for GPs to charge these fees, as they reduce the J-curve by reducing early checks written directly by LPs. In addition, the fund usually has a higher percentage of fees from an investment than their equity interest in the company, and so earns more through fees than equity." ■

If your firm charges investment-related fees, do you disclose to investors:

The nature of services being charged?

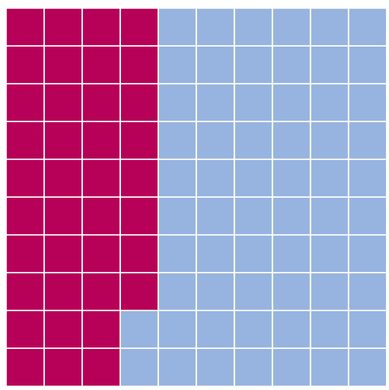
Yes 84%



No 16%

Evidence of the market rate of this fee?

Yes 38%



No 62%

EXPERT COMMENTARY

Advisory committees are becoming intertwined with fund operations, say Troutman Pepper partner Julia Corelli and associate Patrick Bianchi

LPACs move into the hot seat

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With increasing regulatory scrutiny on fees and expenses, fund managers are turning to their limited partner advisory committees (LPACs) more as a body with approval rights than for oversight by significant limited partners (LPs).

While managers seek greater transparency and protection from second-guessing with the benefit of hindsight, LPAC members' increasing responsibilities raise concerns of time commitments, conflicts, compensation and liability. Compared with prior bi-annual surveys, the *Private Funds CFO Fees & Expenses Survey 2020* shows this tension and reveals many areas in which LPACs are increasingly relied upon.

Valuations policy reviews

Valuation policies are a priority of SEC examinations and enforcement actions for funds. In the two years leading up to our 2020 survey, nearly half of firms visited by the SEC needed to make changes in their fund documents to adjust their valuation policies.

Although fund managers generally determine the valuation policies for fund-held securities, it is increasingly more common for the LPAC to approve changes to valuation policies. The SEC's focus on portfolio company valuations, particularly how valuations may impact management fees charged to LPs, adds pressure for the LPAC to review and approve these valuations, including the management fees based on them on occasion.

Typically, LPAC members have resisted approving portfolio company valuations based on liability risks and not having the same access to information as managers, focusing instead on confirming the consistency of valuation methodologies with market practice. Valuation policy changes require a more detailed review by LPACs, bringing them closer to actual valuation approval obligations. This increase in responsibility may also impact insurance coverage and an LP's willingness to serve on the LPAC.

The 2020 survey also showed a 5 percent decline (from 38 percent in the 2018 survey) in the number of firms that outsource some or all valuation services. For the firms outsourcing valuations, there was a 3 percent decline (from 44 percent) of management firms charging only themselves for the cost of outside valuation expertise.

This dynamic increases the need to obtain LPAC approval of in-house valuations to avoid regulatory issues upon examination. Managers fare better in a regulatory examination of valuations if the LPAC approved the valuations contemporaneously.

If the LPAC reviewed and approved the valuations, the manager's decision will be far less susceptible to revision, upon regulatory examination, with the benefit of hindsight. If the LPAC will not or cannot approve in-house valuations, the solution becomes an external valuation – but fewer firms choose that path, and those that do are more likely to charge it to the fund.

Since the 2016 survey, we have also seen a trend of fund managers disclosing deficiencies set forth in SEC examination reports to only those limited partners with a side letter requiring disclosure (16 percent in 2016, compared with 29 percent in 2020), who often have representatives on the LPAC, and not to all of the limited partners (50 percent in 2016, compared with 36 percent in 2020). Thus, LPs without an advisory board representative who want disclosure of deficiencies, particularly concerning valuations, should request disclosure requirements in a side letter.

Conflicts for advancement of expenses

When principals are the subject of a claim brought by LPs, the advancement of expenses to those principals is often the means for them defending the claim. This is particularly true for smaller fund managers whose management fees cover operating expenses without much excess.

Absent an advancement provision in the fund's limited partnership agreement, the principals could receive indemnification from the fund only after the claim has been resolved in their favor. This year's survey shows a 7 percent increase (from 13 percent in 2018) in the number of managers who turn to the LPAC to approve the advancement of expenses. This approval may present a conflict of interest as the LPAC is frequently populated with representatives of the fund's largest LPs, who are often the ones to institute a claim. These LPs may even bring a claim based on information that the LPAC has gleaned from interactions with the management team. Managers need to consider conflicts carefully in negotiating advancement provisions if the advancement of expenses requires LPAC approval.

Approvals of affiliated transactions

Using affiliates to provide fund services is a longstanding practice, which weighs economies of scale with conflict risk. Firms frequently use legal and human resources personnel to provide support to portfolio companies. The fund effectively bears the cost of such services.

A fund's offering documents typically disclose the manager's authority to hire affiliated service providers, so long as the rate charged does not surpass the market rate. The 2020 survey showed both a 5 percent decline (from 16 percent) in managers who charge the fund for such insourced services in addition to a management fee, and an 18 percent increase (from 29 percent) in managers who disclose evidence of the market rate of fees charged to the fund for insourced services.

We see in the 2020 survey that disclosures proving that the affiliated service provider does not charge more than an unrelated third party are becoming standard, and that the recipient of those disclosures to clear conflicts of interest is the LPAC.

Routinely, LPACs get requests to approve fees charged to a fund and receive evidence of the 'fair market rate' of the charges, but LPAC members may not be able to judge if the manager or its affiliate is the optimal provider of those services. Legal services may be easier to assess; analyst, insurance, property management, tax, or other services provided to the fund or its portfolio companies may be more difficult. The LPAC member usually does not know the market for these services and knowing it does not usually fall under the expected LPAC service role for the limited partner appointing that person to the LPAC.

Fund extensions

The 2020 survey found that 68 percent of funds require that the LPAC or LPs must approve all term extensions. The survey did not inquire which of these approvals is an action submitted to the LPAC or a majority in interest of LPs.

Decisions to extend the fund term are not easy for an LPAC. Some investors may prefer to wind down, even if some investments are sold at a loss, while others may encourage the manager to raise co-investment funds to support the remaining portfolio companies for a couple years.

If the fund agreement does not provide that the LPAC member can decide a question presented to the LPAC solely based on the best interest of the LP represented by that LPAC member, the LPAC member asked to approve an extension is conflicted. In addition, many funds allow the manager to extend the investment period with the LPAC's consent, and we expect to frequently see this conflict here, as well in the wake of the coronavirus pandemic.

LPAC friction

As the survey shows, there is an increasing intertwinement of LPAC activities with the operational management of the fund.

LPACs were originally contemplated as an oversight function, akin to board observers in the corporate context. The 2020 survey evidences how the LPACs' role in fund operating activities has increased, which is more akin to the 'independent director' role.

Investors appointing LPAC members often express concern over the time commitment now required to serve on the LPAC. Members who serve on multiple committees may also find it difficult to manage inconsistent definitions of the LPAC role across different funds, often devolving to the common denominator across them all (ie, the most involved role becomes the standard), which leads to friction with managers that expected less involvement from the fund's LPAC. ■

troutman pepper

Private Fund Services

Our Private Fund Services practice helps U.S. and international funds and their sponsors, managers, advisers, and investors define and achieve their business goals. Our attorneys have represented hundreds of pooled investment vehicles, including committed funds, permanent capital/evergreen funds, independent sponsors and others—experience that we bring to bear in the dynamic and ever-evolving arena of investment structuring and regulation. Our team brings clients focused insight based on regulatory, industry and private practice experience. Our attorneys include veterans of the asset management industry, the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the Department of Justice (DOJ), and other regulatory agencies. Renowned for our full-service practice that addresses all issues that arise in a fund's life cycle, individuals and organizations often call on our firm for comprehensive guidance on achieving their business goals and strategies or provide insights or second opinions.

Our clients include a wide range of funds and their sponsors, managers, advisers, placement agents and investors, including:

- Early-stage/seed, venture capital, growth equity and private equity funds
- Hedge and hybrid hedge/private equity funds
- Debt and hybrid debt/equity funds
- Distressed investment funds
- Real estate funds (open-end and closed-end)
- Special purpose funds, such as Term Asset-Backed Securities Loan Facility (TALF) funds
- Small Business Investment Companies (SBICs)
- "Funds of funds," including closed-end funds of funds
- Industry-specific funds
- Permanent Capital Vehicles for both liquid and illiquid strategies
- Alternative investment vehicles, blocked entities, structured finance SPVs and SPACs
- Captive funds/risk management vehicles
- Investment trusts and business development companies
- Independent sponsors
- Platform companies for secondary market exchanges

Areas of Focus:

Fund Formation

Fund Operations

Secondary Transactions

Successor Fund Counseling

Management, Succession, and Compliance

Examination and Enforcement

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When the SEC comes knocking

Private equity remains firmly in regulators' sights, despite marked improvements in transparency

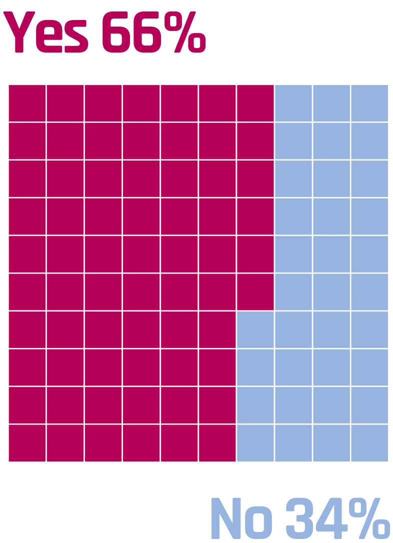
There is no doubt that transparency around fees and expenses has come on in leaps and bounds since the SEC first fixed its crosshairs on private equity. Just this summer, however, the regulator issued a risk alert highlighting "widespread deficiencies in behavior and numerous instances of investors overpaying for services." Clearly there is more progress to be made.

The alert pointed to old bugbears such as unresolved conflicts of interest, failures in procedures relating to the disclosure of material non-public information and, of course, inaccuracies in the allocation of fees and expenses in areas ranging from outsourced consultants to due diligence on failed deals.

Indeed, last year alone, those that fell foul of SEC investigations included Lightyear Capital, Yucaipa and, most recently, Rialto Capital Management, which was penalized regarding the allocation of expenses for third-party tasks performed by in-house employees, despite the fact that its LPAC had agreed to the attribution. The SEC clearly has no intention of loosening its grip on the asset class.

"I think intentions are good, but the operational demands on private equity firms have increased dramatically," says Anne Anquillare, president and CEO of PEF Services. "Not everything can be done at once. And with so much going on in 2020, in particular, I think some efforts to improve transparency around fees and expenses may have ended up on the cutting-room floor."

Is your firm registered with the Securities and Exchange Commission?



Meanwhile, some CFOs question the end result of SEC scrutiny. "It has rightly forced GPs to be thoughtful about allocating expenses, particularly between the house and the funds," says Joshua Cherry-Seto, CFO and CCO at Blue Wolf Capital Partners.

"But there is no materiality threshold, so it has, at times, created more cost to administer than it has benefit to LPs."

Who pays?

Against this backdrop, the latest *Private Funds CFO Fees & Expenses Survey* reveals some important shifts in the way firms are addressing the issues emerging from SEC investigations. For example, when asked who would pay accounting and legal costs to remedy a deficiency finding around valuations, three-quarters of GPs stated the management firm would meet the expense; 15 percent would expect to split the tab, while only 10 percent would look to the fund to bear the full cost.

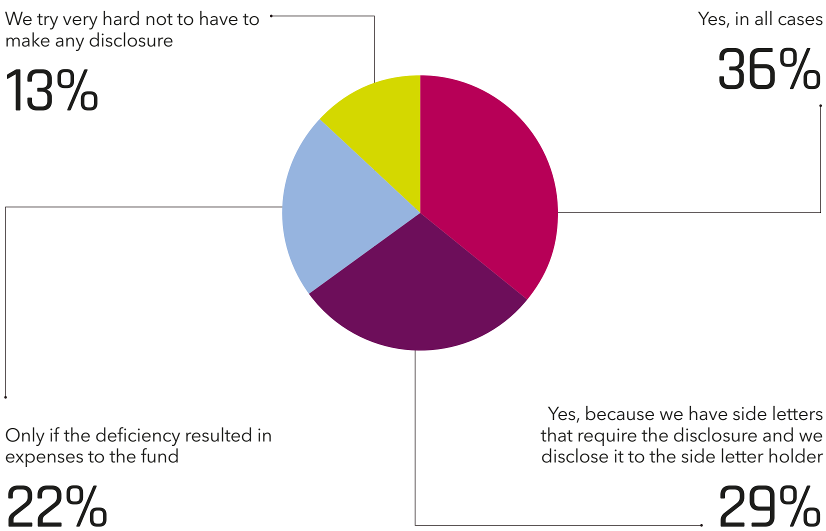
This compares with just 58 percent of GPs that believed the management firm had sole financial responsibility when we conducted this survey four years ago. At that time, just under a third of GPs would have passed on the burden to the fund.

"This is probably because LPs are insisting that costs related to SEC remediation are not included in the definition of fund expenses," says Blinn Cirella, CFO at Saw Mill Capital. "But it could also be optics. LPs don't want to be paying for the sins of the private equity firm. That type of expense should be paid by the management fee. Negative press is powerful."

The degree of willingness to share

Your firm is visited by the SEC or a state regulator for a routine regulatory examination which leads to a deficiency finding around valuations. You decide to redo the last two quarters' reports and deliver the new ones along with an explanatory letter to your LPs. Who pays for the accounting and legal costs in getting through this correction process?

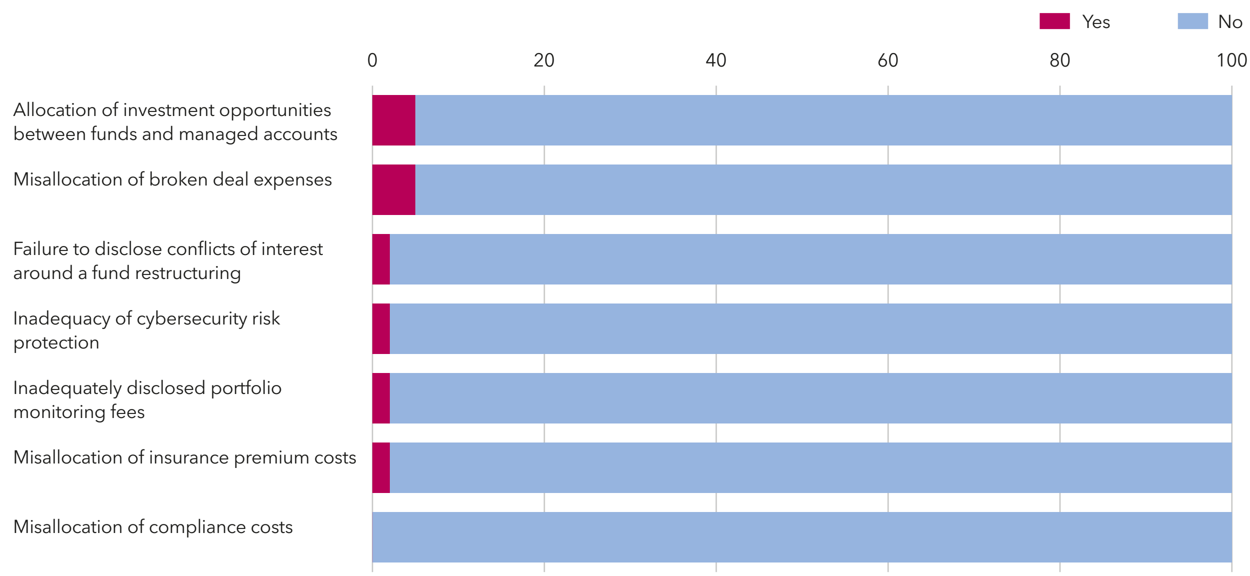
As a result of a routine examination, the SEC highlights deficiencies in the examination report. Do you disclose these deficiencies to your LPs?



information on shortcomings exposed by the SEC, meanwhile, continues to vary widely, implying that transparency issues persist. Only 36 percent would share the findings in all cases, 29 percent if specifically obliged to by side letters, while 13 percent would avoid doing so at all costs.

In fact, the proportion of GPs prepared to disclose in all cases has significantly reduced. "It is no longer an automatic thing. Investors have to ask for it," says Julia Corelli, partner at Troutman Pepper. "The deficiency letters go into a great deal of detail. Managers don't want their LPs to have that information, so they resist disclosure. LPs, meanwhile, are pushing for transparency and so we end up with side letters."

Has the SEC raised the below issues with your firm? (%)

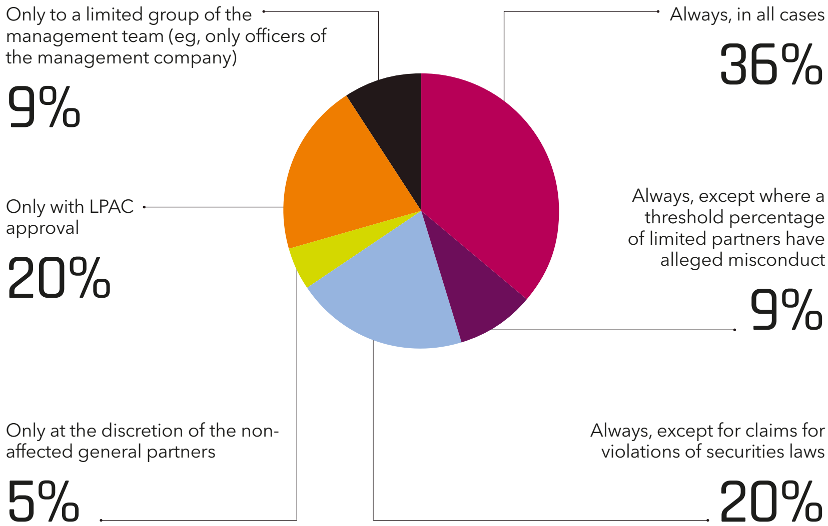


Driving change

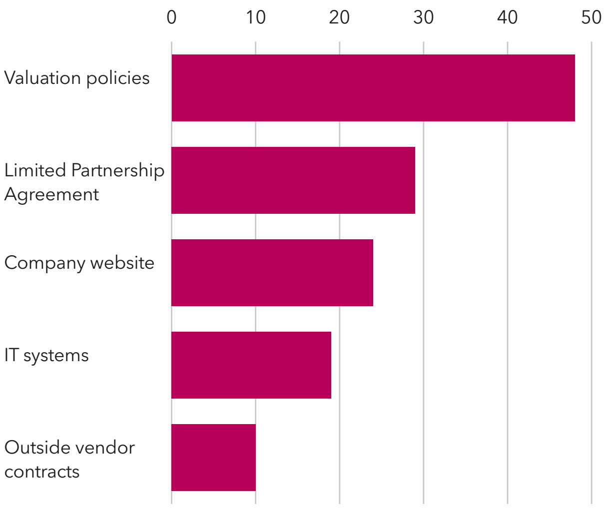
It is clear, nonetheless, that despite the SEC's ongoing concerns about the asset class, its investigations are leading to systemic changes in practices, with almost half of managers having made changes to their valuation policies in the wake of an SEC visit. "The proportion of managers making changes to valuation policies has risen by 7 percent in the past two years, as a direct result of the SEC prioritizing how securities are valued," says Corelli.

"At the same time there has been a decline in the proportion of GPs that have amended their LPAs," she continues. "I think that reflects the fact the industry is getting used to a certain level of scrutiny around expenses." ■

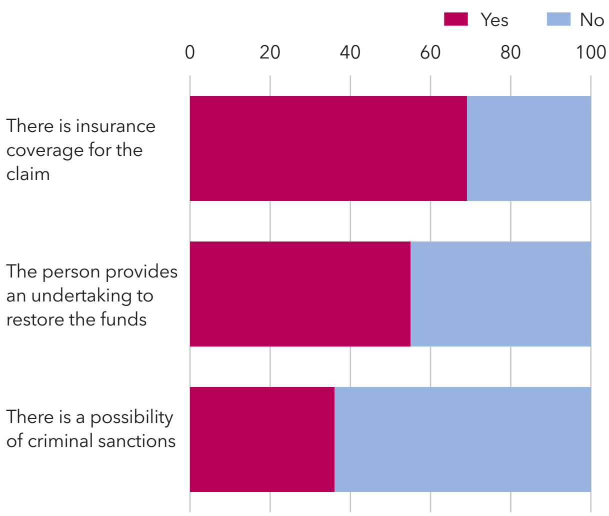
If your LPA provides indemnification of principals serving on the management team, does that indemnity provide for advancement of expenses:



If you've made changes to any documentation following an SEC visit, what documentation was updated? (Respondents were allowed multiple answers, %)



An individual principal within your firm is the subject of an inquiry from the SEC that involves the firm's activities and the activities of the funds you manage. Do you advance expenses for the principal's defense if: (%)



Who pays what?

As outsourcing soars, debate around who foots the bill rumbles on

With limited partners already paying a hefty management fee to support operational costs of management firms, the extent to which GPs then either impose additional running costs on the fund, or else look to share the costs, can sometimes become a bone of contention.

Part of the issue is a growing trend towards outsourcing. As complex regulation has proliferated and as increasingly sophisticated LPs have demanded a more streamlined approach, more and more management firms are focusing their in-house attention on fundraising and investment alone.

Blue Wolf Capital CFO and CCO Joshua Cherry-Seto adds that tight labor markets make in-house hiring difficult and as service providers become more sophisticated, they are providing greater value and scalability. The impact of covid-19 will only accelerate the demand for outsourcing. The outbreak of the coronavirus and subsequent international lockdown shone a spotlight on individual firms' business continuity plans and automation capabilities.

Indeed, as an initial reluctance to cede control of operational functions wanes, a desire to get back to core business blossoms. But as everything from fund administration and investor reporting to data management and even compensation consultants and mock auditors is farmed out to third parties, the question of who should be paying for these services intensifies.

"Being able to clearly outline why you are outsourcing; how fees are being used to pay for it and how those costs are being recovered is extremely important for LPs," says Neal Prunier, director of standards and best practices at ILPA. "The benefits have to be weighed against the costs to the fund and ultimately to the investor."

Anne Anquillare, CEO of PEF Services, adds: "We have absolutely seen outsourcing gain momentum, at the bequest of LPs and unofficially by regulators."

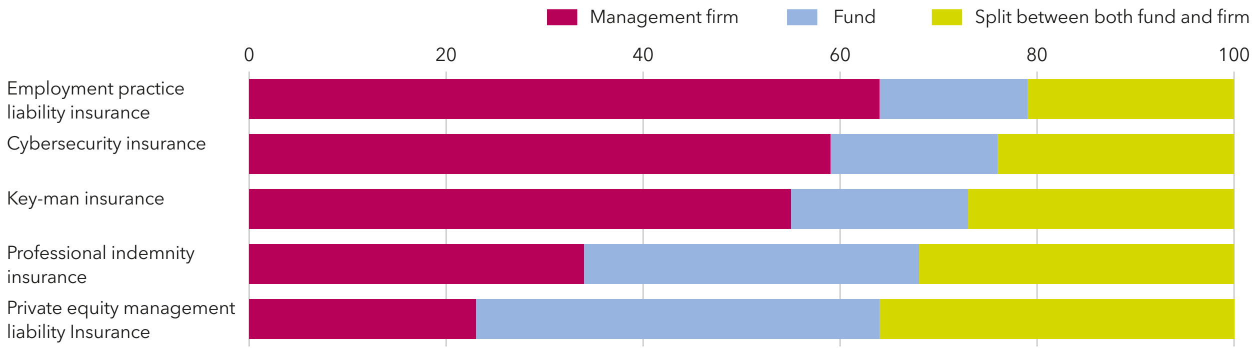
The hired help

The latest *Private Funds CFO Fees & Expenses Survey* showed that over 90 percent of firms are outsourcing the majority of their legal work, while over half are outsourcing the majority of their fund admin. Over a third turn to some form of outside expertise for help around valuations, while 44 percent hire in data management support.

One area where there has been a

Insurance costs

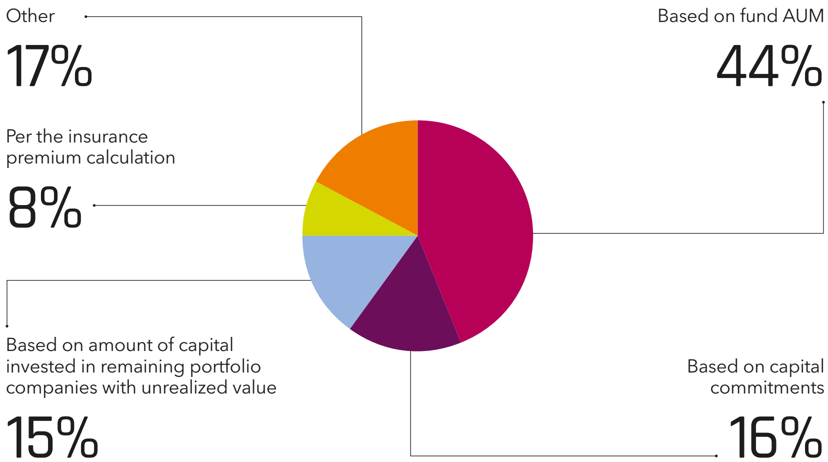
When your firm takes out new insurance policies covering the below, who bears the premium? (%)



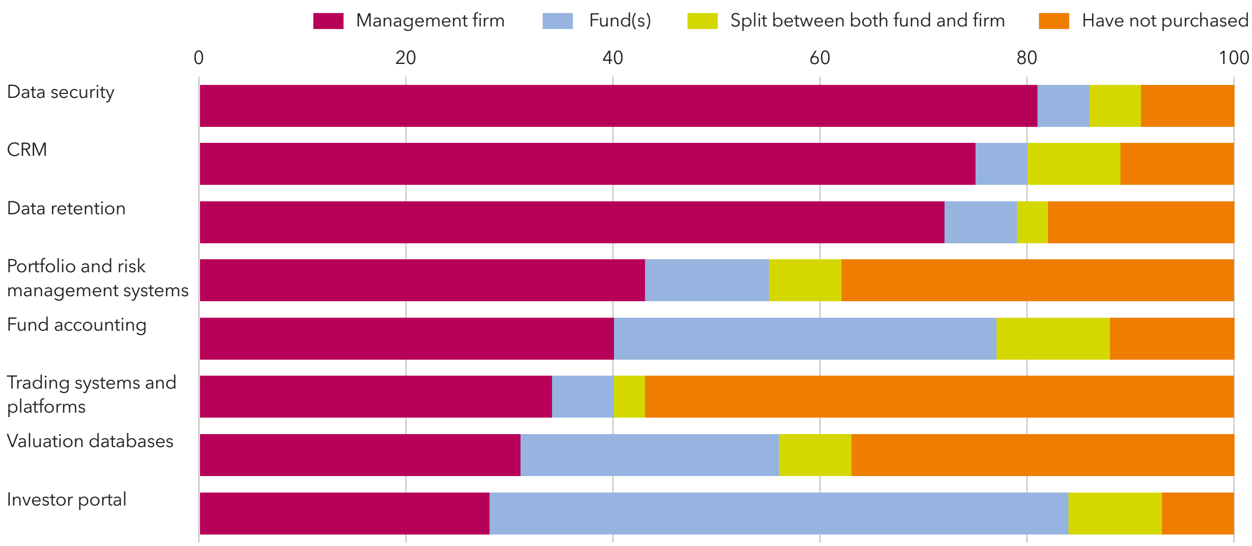
shift toward bringing the service back in house is that of valuations. Troutman Pepper partner Julia Corelli believes this is reflected in findings that suggest the Limited Partner Advisory Committee is increasingly being relied upon to approve changes to valuation methodologies in the wake of SEC scrutiny.

The extent to which the fund or manager picks up the bill, meanwhile, depends on what service is involved. The areas of data access, management and security are among those most likely to be fully borne by the management firm, while fund administration is

If you allocate these costs across funds, how is this allocation calculated?



When your firm implements technology-driven systems covering the below, who pays the initial acquisition and ongoing costs? (%)



most likely to be fully absorbed by the fund. The costs involved with employing ESG consultants, meanwhile, are primarily borne by the management firm, with 67 percent picking up the full cost. However, if the consultant is the requirement of a specific LP, 22 percent would require that LP to bear the cost themselves.

"The trend is certainly to try and charge as much to the fund as possible if you are using outsiders," says Corelli. "That is where the tension arises because LPs are already paying a management fee. Where managers have hired outside expertise in areas such as fund administration, as private equity has become operationally more complex, those costs are generally viewed as a fund expense. Other services such as data analytics or industry consultants now tend to be paid for by the management company, however, following tremendous push back from investors."

Keeping it in-house

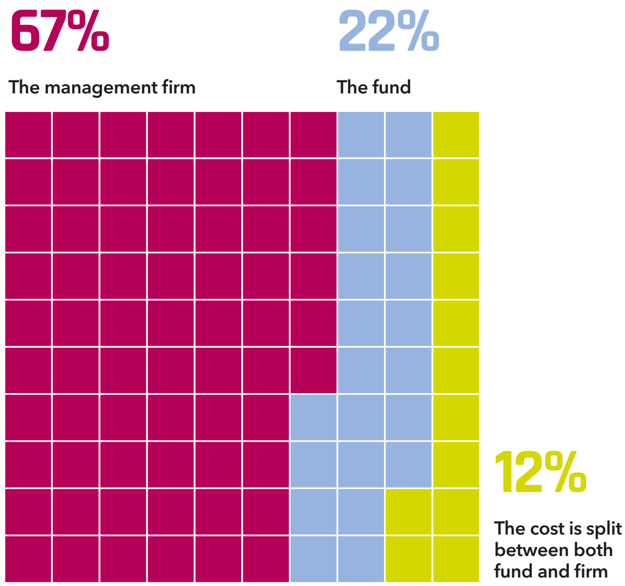
Not all firms believe outsourcing is the way forward. "Private equity managers and administrators will cite efficiencies and enhanced ability to focus on their core investment strategies as reasons for outsourcing their accounting function, for example," says Lou Sciarretta, chief operating officer at Kline Hill. "In addition, administrators will have controls, processes and technologies that newer firms, in particular, may find too costly or time-consuming to implement in-house.

"However, other firms with complex carry waterfalls, multiple fund strategies, varying fee schedules or a mix of separate accounts, advisory and commingled funds may find that an in-house function provides greater consistency around accounting talent, staff turnover and high-quality service to LPs than a fund administor may be able to provide," Sciarretta adds.

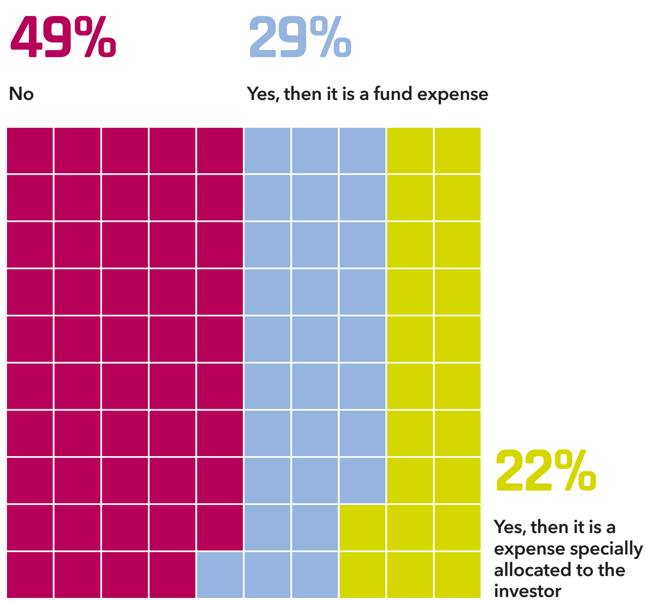
Where services are kept in-house, meanwhile, the majority of firms do pay for their provision through the

ESG consultants

Your firm employs an ESG consultant to advise on a responsible investment policy across your portfolio. Who pays?*



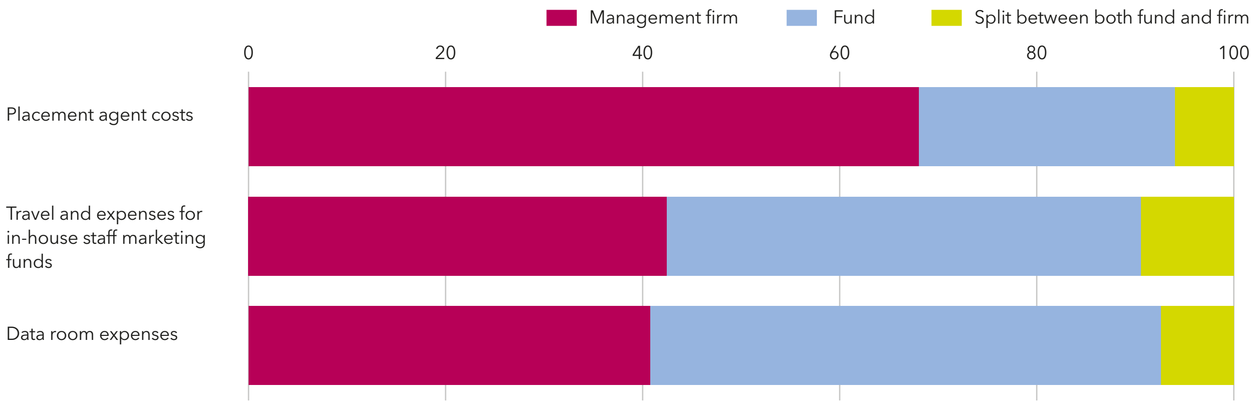
If an ESG consultant is a requirement of a particular limited partner, does this change your answer to the above question?



* Data may not add up to 100% due to rounding

Marketing costs

Who pays for the following fund marketing costs? (%)



management fee, the survey finds. However, 11 percent charge the fund, even when no third-party provider has been brought in.

Furthermore, of those that expect the fund to stump up for additional costs, 27 percent do not disclose the nature of services provided, and 39 percent provide no details about their allocation methodologies.

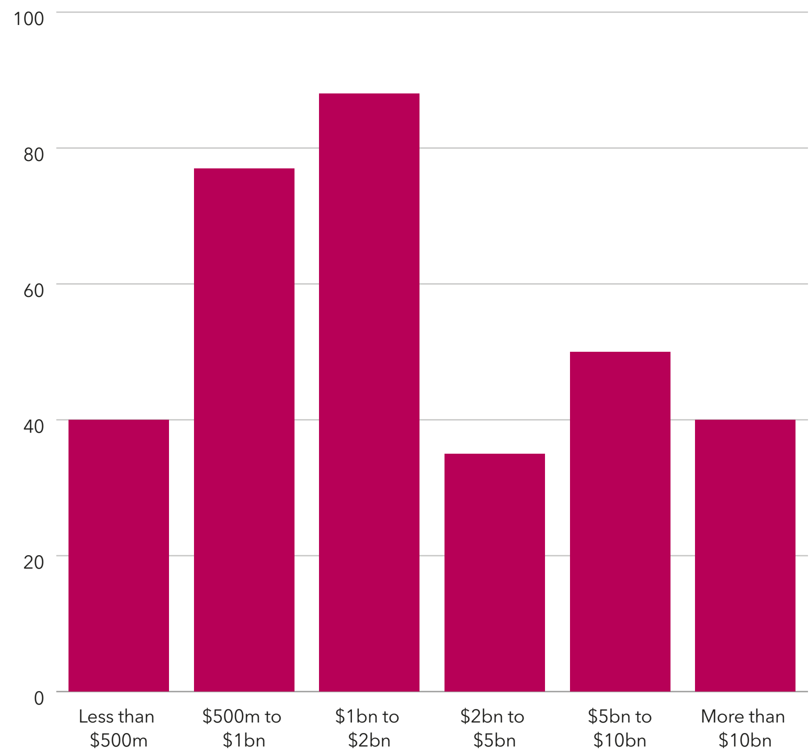
"If a firm effectively outsources its back office to itself, it is obliged to prove it is offering market rate or better, and that it is providing the same or a better service than could be found elsewhere," says Anquillare. "That's hard to do, because it is not their core business."

"It's definitely a controversial practice," adds Prunier at ILPA. "LPs get frustrated because it becomes yet another way to bring money in, where there isn't necessarily the skill set there to support it. That is certainly problematic." ■

Outsourcing costs

For the following services, do you outsource to third parties: (%)

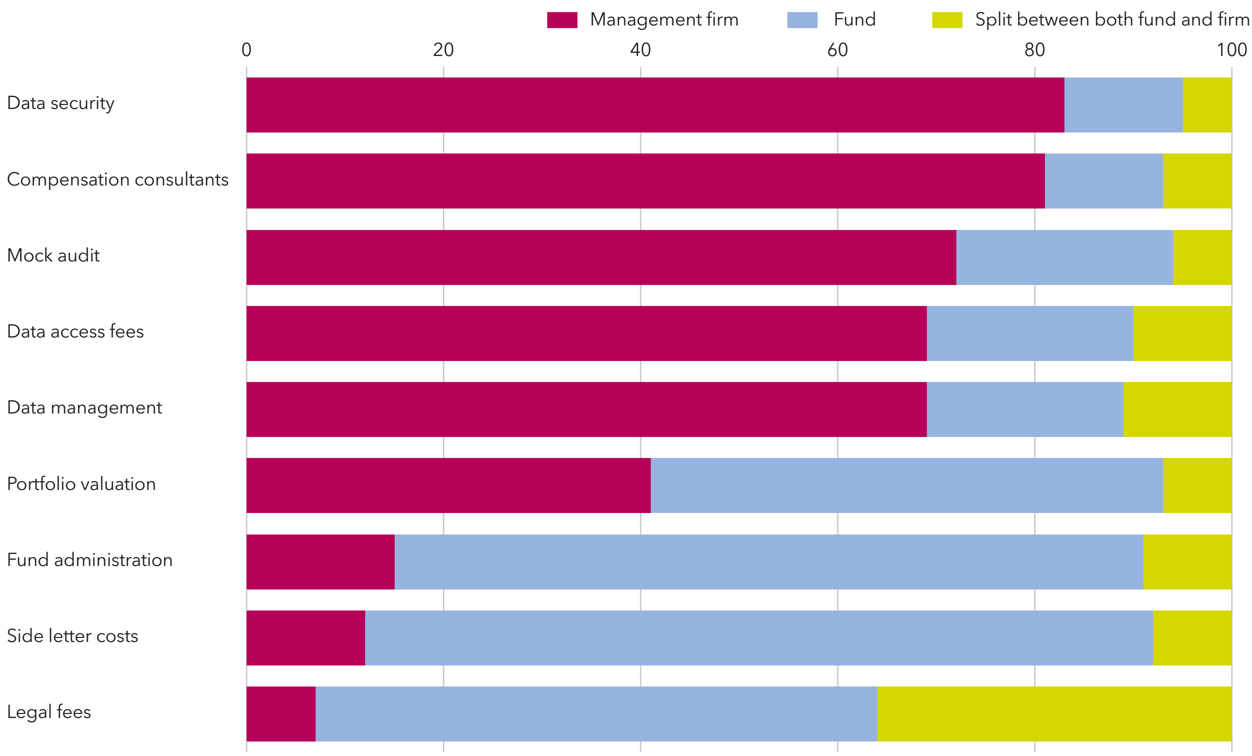
The percentage of respondents that outsource all or most of their fund administration by AUM size (%)



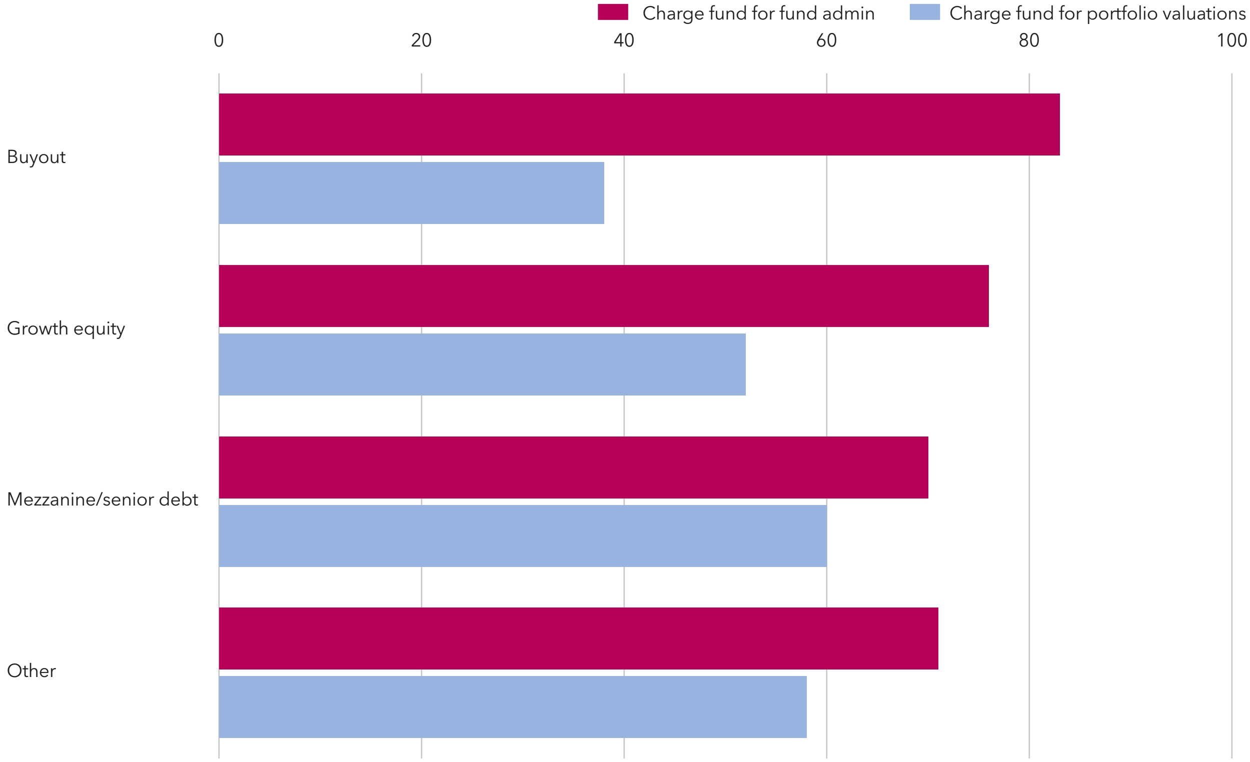
"If a firm effectively outsources its back office to itself, it is obliged to prove it is offering market rate or better"

ANNE ANQUILLARE
PEF Services

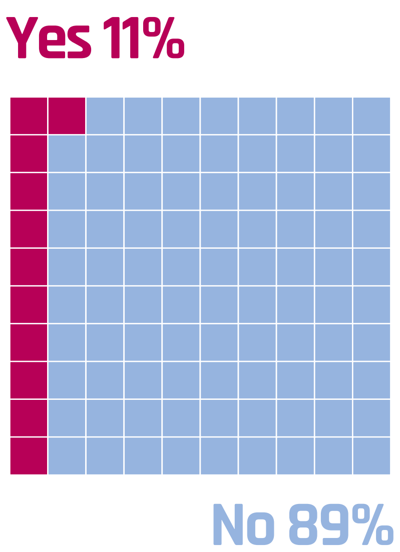
Who bears the cost of the following outsourced services? (%)



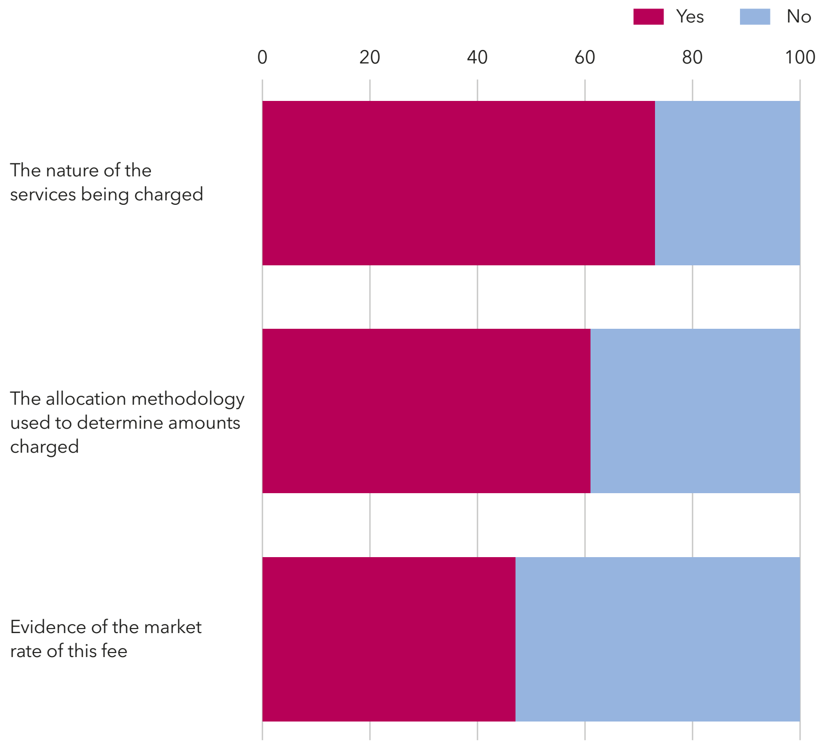
Funds that outsource and charge fund administration and portfolio fees to the fund, by strategy (%)



If you are insourcing any of the above services, do you charge any of these services to the fund in addition to the management fee?



If yes to the previous question, do you disclose: (%)



EXPERT COMMENTARY

In 2020, the more straightforward an investment, the better, writes Withum partner Tom Angell

The future of co-investing: Cloudy with a sprinkling of optimism

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Like most things 2020, the near-term outlook for private equity is cloudy with a sprinkling of optimism. For now, the dark clouds of the covid-19 economy are parting and offering some clarity. With greater clarity come rays of positivity – one of which is co-investing.

Co-investments have proven to be of tremendous benefit and value to PE funds. The advantages are multi-fold: shared investment risk, increased access to supplementary capital, enhanced tax-planning efficiency and ever-desirable diversification, diversification, diversification. For LPs, it also presents an invaluable opportunity to build relationships and extend their reach in collaboration with their most trusted GPs.

In true pandemic form, industry suppositions and an analysis of the *Private Funds CFO Fees & Expenses Survey 2020* responses create a disparity between what one might think 'should be' and what actually 'is.' If there is one thing industry veterans and newcomers alike have learned in these fluid times, it is that agility is key to formulating a realistic perspective and strategic plan for moving forward.

In doing so, it is important to note how – like covid-19 itself – the PE fund sector and the economy in general can shift at any moment. As a result, it is important to note that the following commentary synthesizes what respondents shared about co-investing in late spring 2020. What it all means and what we can expect moving forward are being theorized in late Q3 and early Q4 2020. And whether a second wave of the virus hits is anyone's guess.

The who and the what

When posed with a general yes or no question as to whether a firm is even offering co-investments, three-quarters of the respondents replied in the affirmative. The fact this many firms are entertaining co-investing as a vehicle did not really come as a surprise. What did garner attention, however, was the revelation that this marked a 12 percent drop from the 2018 survey, where 87 percent were offering co-investments.

So, what changed?

While this particular question was

not posed in 2016, there are several obvious factors that have come into play over the last 24 months that could be influencing this strategy – the most impactful of which has to do with the SEC's emphasis on transparency in fund documents regarding the offering of co-investments to all LPs.

As a result, this may have forced some GPs to refrain from even offering them. Whether the SEC truly dampened the attractiveness of this structure is a matter of debate.

Co-investments as separate entities

While cost-cutting has been the name of the game in 2020, one has to seriously consider whether this influenced the frequency at which co-investments were structured as separate entities rather than direct investments in portfolio companies.

According to the survey respondents, 66 percent of the participants engaged in structuring co-investments as separate entities 80-100 percent of the time in both 2016 and 2018. Comparatively, in 2020, only 50 percent did so (41 percent were 100 percent of the time and 9 percent were around 80 percent of the time). Even more telling in 2020, a full 35 percent noted they structured their co-investments as separate entities *less than 50 percent of the time*. This marks an appreciation of 8 percent and 6 percent over 2018 and 2016, respectively.

Based on this data, one can hypothesize the practice of implementing a direct investment strategy is most likely linked to its overall simplicity. Direct investments are cleaner and offer a more streamlined process. In other words, in 2020 the more straightforward the better.

Broken deal expenses

Despite the SEC's deep dive into ensuring co-investors bear their proportionate share of transaction fees and expenses over the past four years, respondents mirrored the percentages from 2016 and 2020. When asked whether co-investors have any responsibility for broken deal expenses if the deal does not go forward, 57.5 percent replied "yes" if the co-investment entity has been formed (the deal breaks post signing and pre-closing), or because it is part of their indication of interest in co-investing.

Similarly, 42 percent of total respondents in those same years indicated "no," either because [they] charge each co-investment deal that closes a fee to compensate the fund for the risk of being a broken deal, or the broken deal expense is purely a fund expense.

This level of consistency demonstrates although each deal is negotiated on an individual basis and there are inherent fluctuations, the mindset related to assigning broken-deal expense responsibility has remained fairly constant – with a slight deviation in 2018.

Co-investment vehicle charges

Speaking of assigning fees and expenses – broken deal or otherwise – there have been a number of line-item shifts since 2016. For the first time, this year respondents had the opportunity to weigh in on whether they charge a management fee or a fee for carried interest – to which they replied *they do not* at a resounding benchmark of 61 percent and 53 percent, respectively. Notable areas in which charge categories dropped by significant percentage points included:

– Organizational and/or set-up fee (down 11 percent),

– Management fee equal to the management fee that is paid to the fund (down 19 percent), and

– Carried interest equal to the carry payable by the fund (down 10 percent).

There was a 12 percent bump in the management fee which is less than the management fee paid to the fund category with 80 CFOs chiming in.

12%

Decrease in investors offering co-investments compared with the 2018 survey

61%

Of managers do not charge a management fee

Undefined allocations

When not outlined in PPM, LPA or policy documents, the manner in which questions around undefined fee and expense allocations are addressed almost identically mirrors those from 2018. While there was a slight 3 percent bump in consulting with the LPAC, the most drastic change notes a shift away from the CFO as the sole decision-maker.

This point of consultation dropped 10 percent between 2018 and 2020, marking a new era where these decisions take on a more collective approach rather than an individual-responsibility response.

There is no doubt co-investing has been white hot, slowly weaving itself into the fabric of PE funds to become a preferred investment darling.

As the economy regains its footing post-pandemic, projections indicate the best is yet to come for co-investing vehicles. Most immediately, indications point to the fact that many funds are considering how – not when – to deploy their capital at a time when valuations are bifurcated.

Strong sectors like groceries, technology and logistics have fortified their place on the resiliency ladder. As a result, they are expected to garner a lion's share of attention when it comes to near-future co-investment strategies. Transparency and smart technology are absolute priorities. Without them, long-term fund health is not possible.

As opportunities abound, investors, LPs and GPs need to be mindful. ■

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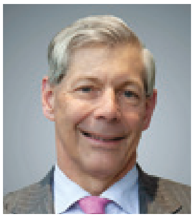

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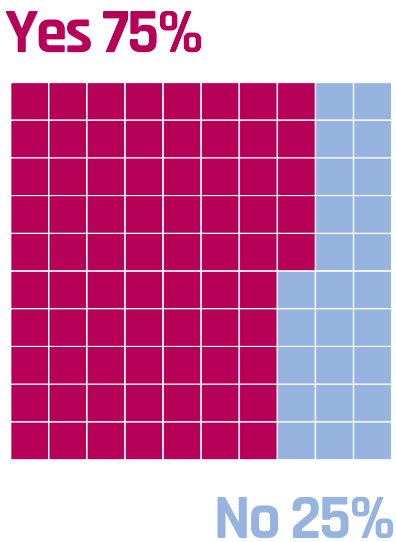
Conflict over co-investment

GPs pull back on sharing deals amid controversy over fees and transparency

Private equity co-investment has soared in popularity in recent years. The real scale of such an opaque market can be hard to judge, but typical estimates fall in the $55 billion-$60 billion annual dealflow range. LPs have been clamoring for direct investment opportunities in a bid to gain alpha, often citing the lure of a no-fee, no-carry option.

Does your firm offer co-investments?



Despite overwhelming appetite from LPs, however, the share of managers that offer co-investment has fallen from 87 percent two years ago to 75 percent in 2020. This could reflect an SEC push on transparency about the way that co-investment opportunities are shared and how transaction fees are divided between co-investors and the fund itself.

"The need to treat every LP fairly may mean co-investment has become more trouble than its worth for some," says Tom Angell at Withum.

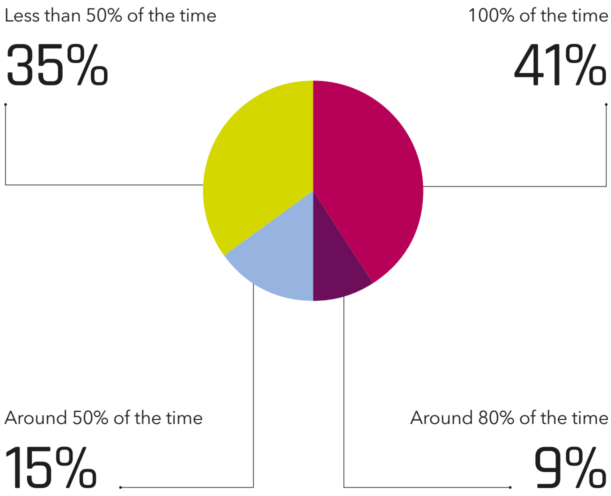
"If you have 50 investors in your fund and you have to offer all of them a co-investment opportunity, and then some don't get back to you in a timely manner, that hinders your potential to do the deal. Prior to the SEC's involvement, you could simply go to a few of your larger institutional investors and get a quick response. It may simply be too difficult for smaller managers to comply."

In addition to fairness and transparency, the way in which broken deal expenses are shared between co-investors and flagship funds has become one of the hottest issues for the SEC in recent years. This is particularly contentious, of course, when the co-investors in question are the individual general partners themselves. In 2015, KKR was charged with misallocating $17 million of broken-deal expenses to its flagship private equity fund. Two years later, Platinum Equity Advisors paid a $3.4 million fine after charging three of its private equity fund clients broken deal expenses that should have been borne by co-investors.

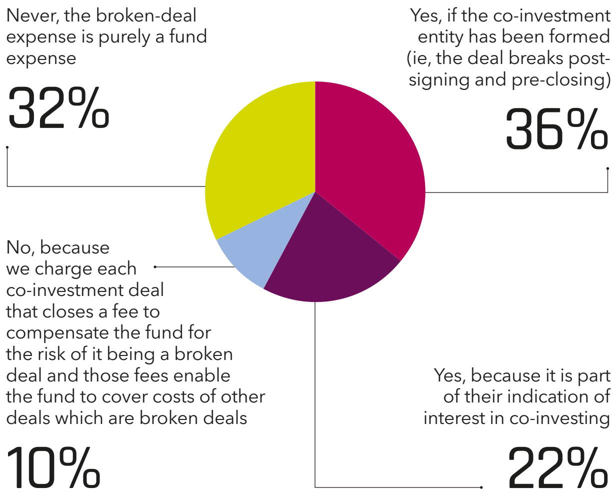
The SEC is less concerned about how broken-deal expenses are allocated between fund and co-investors – although it has insisted that investors are "treated fairly." The emphasis, however, has been on ensuring fund managers make policies clear and stick to them. For example, Platinum's limited partnership agreement allegedly did not disclose that funds would be required to pay broken-deal expenses for the portion of each investment that would have been allocated to the co-investor. And managers have been urgently tightening up documentation in the wake of these eyewatering fines.

But while transparency around broken-deal cost attribution may be increasing, the attribution itself has changed little. A total of 58 percent of respondents to the *Private Funds CFO Fees & Expenses Survey* this year said they did expect co-investors to bear proportionate costs of broken deals, either if a co-investment entity has been formed – ie, if the deal had

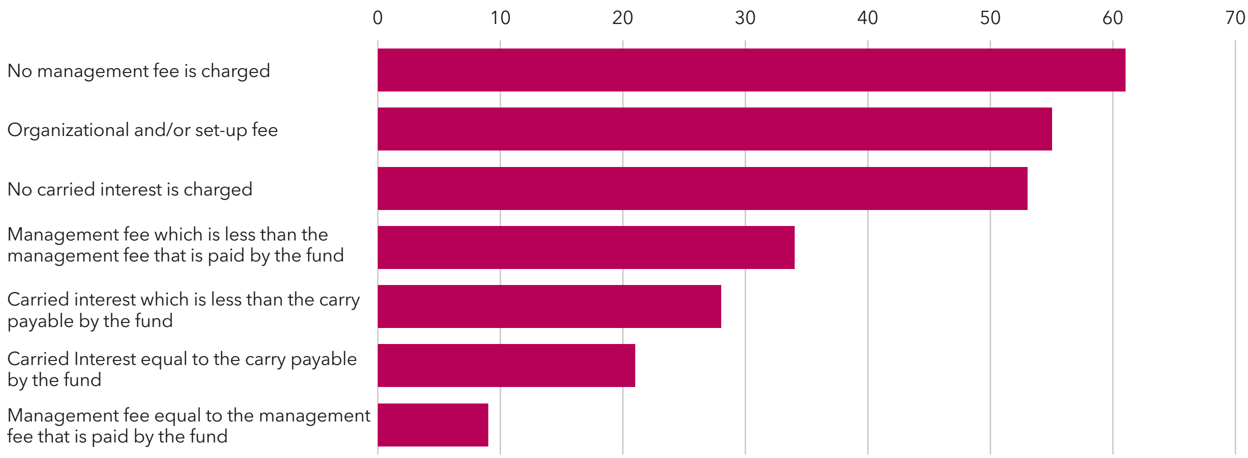
How often are your co-investments structured as separate entities (as opposed to direct investments in portfolio companies)?



Do the co-investors have any responsibility for broken-deal expenses if the deal does not go forward?



Which of the following do you charge to your co-investment vehicles? (Respondents were allowed multiple answers, %)



broken down between signing and closing – or because they considered a willingness to take on costs to be part of their indication of interest regarding the co-investment. This compares with 53 percent in 2018 and 57 percent two years earlier.

Similarly, the proportion of managers that do not charge broken-deal expenses to co-investors simply because they already charge a co-investment fee to compensate for such eventualities has remained fairly constant – registering 10 percent this year. And the proportion that do not charge co-investors broken-deal fees also holds steady at about one third. Indeed, despite the SEC having to take a hard line on co-investment and broken fees, it is clear the issue remains controversial. "This is contentious because certain deals would only proceed with co-investors, but co-investors, on a one-off basis, will not sign up for expenses until very late in the process, if at all," says Blue Wolf Capital's Joshua Cherry-Seto.

"This is an important issue to cover clearly in LPAs to ensure it is understood that co-investment is a cost of doing business and therefore generally borne by the main fund. Maybe there should be consideration to the fund versus the co-investment for taking the investment risk, but the market demands pari passu treatment currently."

"Here is the deal," adds Blinn Cirella of Saw Mill Capital. "A broken deal is a deal that was never consummated. Let's say you have two co-investors who are investing $25 million each and the fund is investing $30 million. The deal breaks and the costs are $600,000. If these costs are shared based on the intended investment split – that would mean each co-investor would be on the hook for $187,500 and no investment to show for it. Whoever agreed to that deal is going to lose their job." ■

Going long

What happens to the management fee when a firm runs out of time?

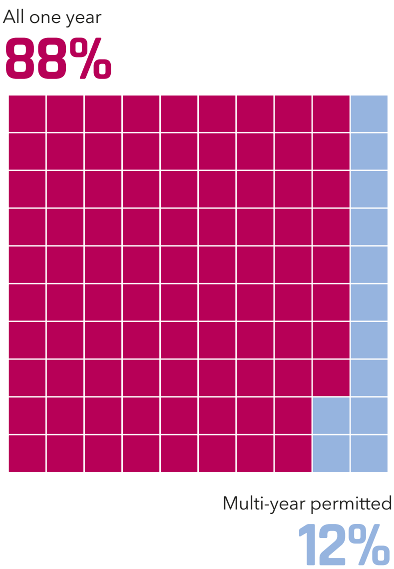
The intense economic uncertainty surrounding the coronavirus pandemic initially suffocated private equity investment and divestment activity. Certainly, managers are eyeing opportunistic dealflow, but spotting the bottom of a market artificially buoyed by unprecedented state support is tough. Meanwhile, exits of the caliber that will keep investors happy are likely to be few and far between until prices significantly rally.

As a result, it seems inevitable that GPs will be seeking fund term extensions, both to create cashflow breathing space, and to allow managers more time to deploy capital when the market eventually recalibrates. Equally, fund restructurings, which have already soared in popularity in recent years – shifting from the course of last resort to a legitimate portfolio management tool – are likely to proliferate still further.

"I think we will see an increase in demand for extensions. Clearly covid has caused delays to investment activity, primarily because it has been difficult to value companies during this period of extreme volatility," says Patrick Bianchi, associate at Troutman Pepper.

"There has been no buying and selling for seven months and getting back to full speed will take a while," adds Blinn Cirella CFO of Saw Mill Capital. "For example, we have one remaining investment in our first fund. We've extended the fund twice, as allowed by the LPA, and the final expiration date is 12/20/2020. We were five days away from taking that last portfolio company to market when covid hit and we will now not be able to sell before the end of the year. So, there will be funds that because of the 'pause', won't be able to liquidate as intended."

Do fund extensions last one year or are any multi-year extensions permitted?



With LPs potentially facing a surge in approval requests, it is preferable that existing documentation provides for as many scenarios as possible.

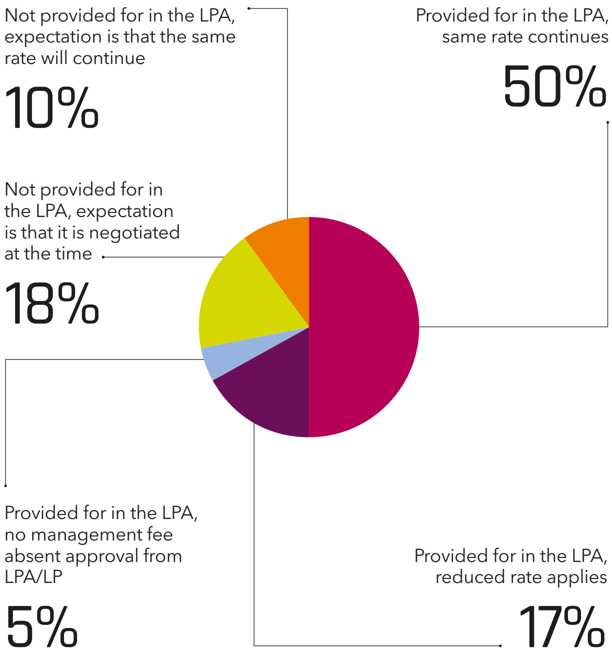
However, over a quarter of respondents to this year's *Private Funds CFO Fees & Expenses Survey* have no provisions pertaining to management fee impact in an extension period contained within their LPA. Of those that have failed to provide for this event, 18 percent presume that a reduction will be negotiated at the point of agreement. A further 10 percent, however, presume that fees will continue as normal.

"This was an issue when we conducted the survey in 2018 as well," adds Tom Angell, practice leader at Withum's Financial Services Group. "As much as attorneys try to get GPs to focus on these issues when drafting documents, there are clearly still those that resist."

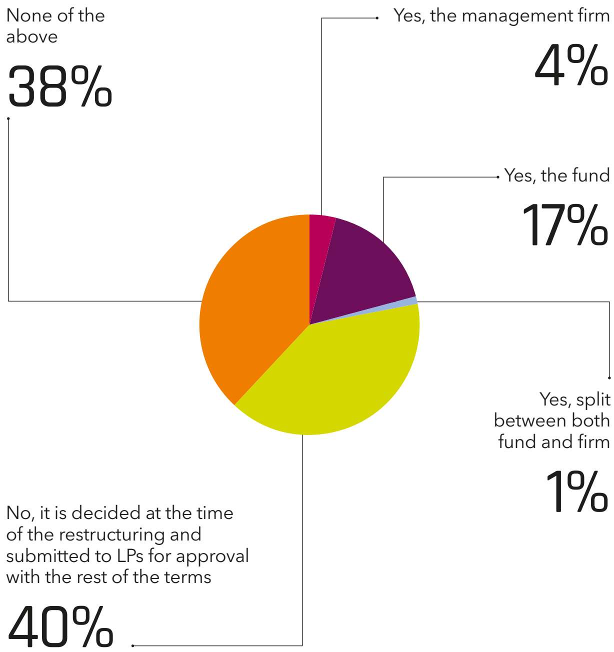
Of those managers that have addressed this issue in advance, meanwhile, half have allowed for fees to continue at the same rate, while 17 percent have agreed a reduction and 5 percent have agreed that the management fee can be eradicated altogether.

"In two years' time, I would expect to see a decline in the proportion of

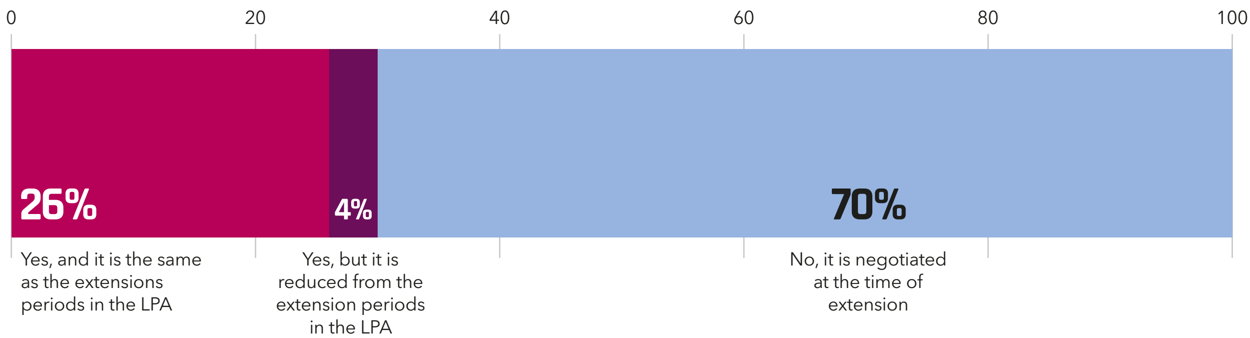
What does your LPA provide regarding the management fee charged in an extension period?



Did you stipulate in your LPA who pays for costs relating to a potential fund restructuring?



Did you stipulate in your LPA the fee and expense arrangements if your fund life is extended beyond the extension periods allowed in the LPA?



"We do expect to see an increase in extensions and restructurings"

NEAL PRUNIER
ILPA

respondents charging the same management fee during an extension period," says Troutman Pepper partner Julia Corelli. "Since we usually act on the management side, however, we would resist that strenuously, arguing that the fee has already been reduced through a step down in rate, or the base on which it is being charged."

Meanwhile, an overwhelming 78 percent have no provisions within their LPA regarding who will bear the costs of any restructuring – 40 percent have simply agreed that the decision will need LP approval at the time, while 38 percent have not referenced the scenario whatsoever.

"We do expect to see an increase in extensions and restructurings, and it is challenging when something isn't written into policy," says Neal Prunier, director of standards and best practices at Institutional Limited Partners Association. "Investors need to know exactly what they are getting into and so it is important to have strong, open dialogue between GPs and LPs on this matter." ■

Points of view

Expert insights on what's to come for fees and expenses

"Management fees are cash out of the LP's pocket and they don't want to pay the fund until they are actually making investments"

BLINN CIRELLA
Saw Mill Capital

"The market is demanding 100 percent offset as firms grow and mature, which means the reduction in the use of [financing] fees certainly makes sense"

JOSHUA CHERRY-SETO
Blue Wolf Capital

"We do expect to see an increase in extensions and restructurings, and it is challenging when something isn't written into policy"

NEAL PRUNIER
Institutional Limited Partners Association

"We have absolutely seen outsourcing gain momentum, at the bequest of LPs and unofficially by regulators"

ANNE ANQUILLARE
PEF Services

"The need to treat every LP fairly may mean co-investment has become more trouble than it's worth for some"

TOM ANGELL
Withum

"In two years' time, I would expect to see a decline in the proportion of respondents charging the same management fee during an extension period"

JULIA CORELLI
Troutman Pepper