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Stepping up on Granularity

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Taking a proactive and detailed approach to fees and expenses is becoming increasingly important as LPs ramp up scrutiny, say Troutman Pepper partners Julia Corelli, Stephanie Costantino, and Paul Steffens, who recently were interviewed by Private Funds CFO on this topic. Read their full interview where they discuss the types of fees being charged, the issues associated with different kind of fees, and enforcement trends in the market, among other topics related to fees and expenses between LPs and GPs.

What types of fees are currently being charged by private funds, and how do those vary across asset classes?

Stephanie Costantino: The types of fees that are charged by investment vehicles and private funds depend in part on the sector the fund is focused on. There are certain base fees that are charged, like a management fee, that are sector-agnostic for the most part, as are some types of incentive fee like carried interest. You might also see monitoring fees or fees related to operating partners, where relevant.

Julia Corelli: We still see funds charging closing fees or transaction fees to the portfolio company, particularly on the private equity side, but those frequently offset the management fee in full. We also see administrative services fees if there is a third-party administrator, and custodian fees being charged in addition to management fees.

Across the market, there is a focus on making sure fees are a known quantity for the LP. Investors almost don’t care whether it is offset or not, or if there is a lower management fee and an additional fee elsewhere. They just want to know their total expense burden, that it is within an acceptable range, and that there is a rationale for each charge.

What fees and expenses does the market expect the GP to absorb?

SC: GPs and LPs like to keep things separate. They want the GP to pay for itself and the fund to pay for itself to the extent they can delineate. Where it becomes more difficult is where you have services that benefit both parties and where there are questions around how you allocate cost-sharing.

JC: There is a whole world of expenses to consider and everyone wants them to be segmented, but by definition in an LPA it almost always comes down to named things being the GP’s or manager’s expense, including overhead and compensation, and everything else is the fund’s. That is because the manager has a finite revenue stream. The vast majority of expenses will be fund expenses. The LPs typically push back where they can and look for fund expenses to be as specifically articulated as possible.

Paul Steffens: When I started doing this 20 years ago, the partnership expenses provision in the LPA was three-quarters of a page, and now in some funds it runs to several pages. Negotiations can get really granular into who pays for travel expenses, dead deal costs, everything. It used to be that the fund sponsors were not heavily regulated, but now a lot of them are registered with the US Securities and Exchange Commission and there are all types of additional costs related to that.

What fees should offset a management fee?

JC: The LP will utilize the offset to control their overall expense burden. Typically, fees subject to offset are monitoring fees paid by portfolio companies, director fees paid to any of the fund manager's personnel on portfolio company boards, and any financing or other transaction-related fees. The LPs feel the manager is getting compensated for those already by receiving the management fee, so those are typically 100 percent offset.

PS: In real estate there is more discussion on this. A lot of fees are those that would be charged by a third party at the asset level if the affiliate of the fund sponsor were not providing the services, so those are not offset. An example of a fee that might be offset, however, includes where a fund sponsor charges an asset management fee to a JV that the fund entered into with an LP to acquire an asset, as it relates to the fund's investment in the JV.

What are the problems associated with different kinds of fees?

SC: The primary problems are the calculation of the fees and whether the disclosure provided by the GP or the manager lines up with that. There are a lot of things that go into management fees – write-downs, for example, were included for many years, but the timing and amount of write-downs have been questioned by regulators and investors. Now many GPs try and quantify those differently and remove them from the fee, which is not necessarily an LP-friendly result. It does, however, highlight the issue of calculating the fee in a way that is transparent and understandable for multiple parties.

JC: Another problem is timing, with the classic example being broken deal expenses and termination fee proceeds which typically offset each other in the LPA, with the net accruing in favor of the LPs. The fund usually bears broken deal costs and will be entitled to any termination fee. However, the LPs that originally bore broken deal costs may have left the fund and new investors who came in will end up receiving the recovery fee instead. In such cases, fund LPAs usually do not try to pair up the cost with the recovery.

PS: In evergreen vehicles, management fees are often based on net asset value rather than committed or contributed capital. Usually the manager determines the NAV that has a direct bearing on its fee, which creates a conflict. In closed-ended funds, where an affiliate provides services, there is potential conflict over how to determine the market rate for those. There is a degree of transparency required and a lot of funds will employ third parties to verify valuations or fees.

Are you witnessing any LP pushback on expenses in the market today?

SC: We are seeing more focus on compliance costs. LPs want to make sure that compliance costs belonging to the manager are treated as such.

There is also increased LP sensitivity around allocation of certain other costs, like travel costs, diligence costs and marketing costs.

What is current market practice in relation to granularity of disclosures around expenses?

SC: There is a very fulsome litany of expenses and, in many respects, regulation has created a transparent, manager-heavy disclosure regime. GPs err on the side of disclosure because if something is not disclosed, there is always the chance someone will allege it is not permitted. There is now a tremendous amount of line-item disclosure in expense provisions, which has been a consistent trend.

What enforcement trends are you seeing regarding expenses?

SC: Enforcement has been very active in this space, analyzing expenses across private equity, venture capital, growth equity and real estate funds to understand the fees and disclosures and whether or not investors appreciate the totality of the burden they are bearing, and the totality of remuneration the manager is receiving.

PS: There is an educational aspect for regulators. Historically, they were used to regulating registered advisers that were investing in public securities and everyone understood what those fees and expenses looked like. When private equity fund managers were swept in, they had a whole bunch of folks not used to looking at those fees and expenses who had to get up to speed.

How are decreases in transaction volume and market volatility impacting fee discussions?

PS: More illiquid markets make it more difficult if you are managing an open-ended fund that bases its fees off of NAV. It was already difficult to determine NAV and it is now even more challenging, which may drive arguments on fees. We are starting to see transaction volumes pick up, but if the slowdown goes on for an extended period, that will cause issues for the way fees are calculated for asset-based valuations.

Are we seeing any fee reductions or suspensions in connection to a decrease in fund transaction volume?

SC: We are seeing discussions between LPs and GPs with respect to reductions and suspensions of fees by GPs that may not have done so previously. I think it is fair to say that when the market was incredibly tight, certain GPs would not entertain such discussions. This does not mean that such discussions ultimately lead to a fee concession, but it may lead to other concessions for the requesting LP.

PS: I'm not seeing any of the fee reductions, suspensions or waivers that we saw during the global financial crisis. A lot of the fees are based on capital commitments, not deployed capital, which is why LPs might complain during times of slow transaction volumes, but so far this environment has not lasted long enough to justify that.

JC: Even during the covid-19 pandemic people entertained reductions, but managers still had to pay their people and no one wanted to let people go. Most LPs would rather keep the team together than require managers to forego the management fee during a hiatus or slowdown. No doubt, this is in part recognition that the foregone fee would be small over a 10-year investment term and a 30-year relationship.

Finally, what are the latest themes emerging from *Private Funds CFO*'s Fees and Expenses Survey, and how have those evolved in recent years?

JC: The surveys have given people the comfort of commonality. There wasn't much in the market 10 years ago about what managers were paying but now there is a greater ability to market test, as well as greater transparency. As a result, the granularity and detail in those conversations has increased. We see investors looking for even more specificity and seeking greater predictability so that they can estimate their returns and better manage their own business's – and their investors' – expectations in challenging times.

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