

PE Pathways* — Carried Away Series – What’s Changing in GP Economics*Speakers: Thao Le, Stephanie Pindyck-Costantino, Ted Edwards****Recorded: 4/6/26****Aired: 5/6/26****Thao Le (00:04):**

Welcome to *PE Pathways*, our podcast series where experienced deal makers share their thoughts on current private equity and M&A trends and developments. My name is Thao Le, a partner in Troutman Pepper Locke's Private Equity and Investment Funds practice, and I'm excited to announce that today we are starting a multi-episode miniseries entitled *Carried Away*. This is a focused podcast series on the economics of private funds, from management fees and carry to GP co-investment and the tax rules that sit behind them. Each episode brings together Troutman lawyers to explore what's really happening in the market. We will have candid discussions on current trends in GP fees and carry, the way GPs are sharing their economics with anchor investors and strategic partners, how firms are using carry to recruit and retain talent across the organization, and how recent and pending court decisions are reshaping the tax planning for management fees.

(00:59):

Our first episode is on the current trends we are seeing in GP economics, from management fees to transaction and monitoring fees to carried interest, as well as the growing role of GP stakes and continuation vehicles as liquidity tools. Joining me today for the first episode are my fellow PE partners from our Investment Funds group, Stephanie Castantino and Ted Edwards. Steph and Ted, welcome.

Ted Edwards (01:23):

Thanks for having us.

Thao Le (01:24):

You want to tell everybody a little bit about your practice before we jump in?

Ted Edwards (01:27):

Happy to. I focus primarily on regulatory and transactional matters in the investment management space. That encompasses everything from fund formation to secondaries and transactions and compliance and regulatory matters.

Stephanie Constantino (01:43):

I tend to focus on everything from the bottom to the top, top to the bottom in the investment funds and investment management space. We cover everything from private equity, venture

capital, growth equity. We do a multitude of different types of things and structuring, and we're really happy to join you today.

Thao Le (01:58):

Great. Thank you. This is a little different from our prior episodes where I actually asked our speakers to tell us a little bit more about their backgrounds, because this sets the stage really on letting you know what we're seeing in the norms of what is coming about in management fee and carry. And I think Ted's specialty of the regulatory perspective of some of these items as well. So why don't we start with you, Ted. Every LP knows the 2 and 20 shorthand, but is that still the norm? And what is really the 2 and 20 shorthand?

Ted Edwards (02:30):

The 2 and 20 shorthand refers to the fee structure received by a sponsor of a private fund. The 2 refers to the management fee and the 20 refers to the carry or the percentage of profits that a sponsor will receive. So in a very vanilla typical fund structure, a sponsor will receive 2% management fee in addition to 20% of the profits generated by the fund. Now, that's a very simplistic way to characterize the fee structure. It's certainly an anchor around which sponsors and limited partners orient themselves, but it really does a lot to hide a lot of the nuance. So there are questions like what the 2% is based on? When does it begin to accrue? The 20% sort of hides distinctions in waterfall type. Is there a preferred return, a catch up? So all of these questions and nuances bear on the ultimate economic take-home for the sponsor, but they're sort of hidden underneath the gloss of the 2 and 20.

(03:39):

Different types of funds and different managers may not adhere so strictly to the 2 and 20. Emerging managers may offer a 1 in 10 or 1.5 in 20. So, while it's a helpful heuristic for a cocktail conversation, it's not really precise or particularly meaningful when negotiating a deal, modeling a transaction or drafting a document.

Thao Le (04:03):

That's a very good point. But I think that in order to really identify how to draft the document, we should really have a good understanding of what some of the current fee menus look like, right? Yes. Steph, what are you seeing as far as the current fee menus looking like? 2 and 20, 1.5. I mean, what really is the range of management fees and structures of carry that you're seeing?

Stephanie Constantino (04:25):

Building off of what Ted said with respect to understanding and appreciating what the 2 and 20 means, I think what we see and are seeing in the market really is 2 and 20 is a great place to start for the discussion. I think we see really a couple of different types of iterations of that. You can see 17.5 for a carry and you could see 1.5 for a management fee. You can see your step-down. You can move what's called your step-down to different times within your fund life. You can calculate your step-down, which is when you would reduce your management fee so that it

doesn't actually fall below a certain level. That's a tool that's very useful that we're seeing as well. So you could reduce your management fee by 0.1 over the course of five years, for example, but it'll never go below 1% of invested capital.

(05:18):

That's a tool we see. Again, what that's designed to do is to provide both the general partner and the limited partner some sort of assurance that you're always going to be keeping the lights on. I'm sure both general partners and limited partners have often heard this, right? You don't want a team that's spending a lot of their time worrying about keeping the lights on. And so what you look for really when you're quote unquote talking about what the current fee menu looks like is both a combination of providing the type of certainty you need to provide the management team what they need to keep quote unquote keep the lights on and to also really in a competitive market to bring in the talent that you want running your fund, right? That's very important as well, but also to align the team when it comes to incentive compensation, right?

(06:04):

Especially in a competitive market, you want to make sure that you understand and appreciate what you need to offer your team, again, bring in and keep the talent. And so that again, we see that your carry is anywhere between 17.5 to 20% carry. You said, again, building off of what Ted said, it's then you can have certain types of sweeteners involved. You can offer a 20% carry, but 0% carry on a certain amount of co-invest or 10% carry on a certain amount of co-invest. So there's certain ways to kind of blend your fees and blend your carry to kind of achieve the goal that everybody's looking to achieve, but it's really important that everybody kind of shows up at the table with a common goal, which is to achieve the best results ultimately for the fund itself.

Thao Le (06:49):

Just to ask the same question, but with a different lens, which is on the management fee, Steph, I think you raised a very good point about how we want to be able to charge a management fee so we can keep the lights on and not have to worry about it. But with an earlier stage manager, are you seeing that that management fee is higher because of that, for that reason? And then a more experienced manager who's like on fund three or four, they may not be as sensitive to the management fees because they've got a steady flow because they've got three funds running. They're more focused on the carry. I want to ask a question of both of you, which is that if I'm a first fund manager, what's my focus, management fee or carry?

Stephanie Constantino (07:27):

I think if you're a first-time manager or even a second fund, what's your focus? Is it carrier management fee or both? I think it's really hard to actually answer that question in a vacuum because I think it depends on a lot of things, right? Are you spinning out of a larger platform, for example? Are you bringing a fairly large team because what you're investing in is a resource heavy type strategy, and therefore you're coming out of the gate with a fairly expensive payroll. On the other flip side of that, if you're in fund seven, but you've had to build out a really big team, you're not as agnostic to the management fee as you might think you would be. The market is very sensitive to this idea of excess fee, management fee where you have fee on fee

on fee. And so understanding and appreciating that mechanic, I think LPs kick the tires on that question.

(08:16):

They want to understand and appreciate what that looks like, what's needed, and are sensitive to those types of costs. So I think it's really understanding and appreciating the strategy, what the team looks like, what a budget might look like, and really what the quote unquote with the first-time manager, where they're coming from and how they're hitting the ground running. And if they need that management fee to really quote unquote keep the lights on, they will be very focused on their kind of floor management fee because it's really imperative that they have that so that they can get the runway they need to really put in place the strategy to achieve the results that the LP is looking for.

Ted Edwards (08:56):

I agree with that. And just to put some numbers on it, the spectrum of management fees that we see is probably 1 to 2.5% with a concentration around 1.5 to 2% and 2% being by far the most common. That's really only part of the story, right? The other part is the base on which that percentage is charged. So in the commitment period, investment period, it's typically based on commitment amount. After the investment period, it may step down or transition to invested capital or some other metric. So you really need both sides of that coin to really appreciate the management fee in its entirety.

Thao Le (09:36):

Ted, I think that's a good point as to what the base is. I think we can all agree that the common marketplace, the percentage is about 1.5 to 2%. The base on which that 1.5 to 2% is calculated can vary. So when you're talking about capital commitments during the commitment period, that's pretty easy. And then the other part is when you flip the switch to go into invested capital, what does that really mean, just so our audience understands that a little bit more about this concept of management fees on invested capital?

Ted Edwards (10:08):

It's a good question. And to Stephanie's point, it is something that investors kick the tires on. They look at pretty closely what that means because from fund to fund, the definition of invested capital may change. One of the areas that we tend to focus on are write-offs, timing of write-offs, whether they're complete or partial write-offs, and how those factor into the management fee base. We'd also look at dispositions. They're always excluded from the management fee base on invested capital. So it is an area that investors focus on, and it's important to their bottom line.

Thao Le (10:44):

Let's turn to the big money item, carry. We talked about the 20% carry, but the devil is in the details, right? It's 20% of carry, meaning 20% of profit at a certain level, and what is that level?

So how does the carry and distributions interplay with each other? And what are we seeing as far as at what level does the carry get paid?

Stephanie Constantino (11:06):

When you look at distribution waterfalls, I think there's three different types of waterfalls. There's the deal by deal waterfall, the net cumulative waterfall, and then everybody's favorite, the hybrid waterfall, which if you were to ask anybody what a hybrid waterfall is, I think we all have different definitions and we all sometimes struggle with whether or not what we're looking at is actually a hybrid waterfall. And so a straight deal by deal waterfall is very much what it sounds like, right? You earn carry on the deal itself. A net cumulative waterfall is very much paid on how the fund itself performs. And so the carry that a manager earns is based on how the fund performs on the whole. A hybrid waterfall is exactly what it sounds like. It's some sort of return of expenses, typically from a current investment that's throwing off the income itself, and usually expenses from realized investments, including anything that's been written down or written off.

(12:07):

And there may be some other modifications to that as well, and then you'll start to participate in carry. And with all of those waterfalls, there are permutations, right? There could be a preferred return, there can be a catch-up, there's all sorts of things that are in the model so it's important to understand that. But we see all different types of waterfalls right now in the market, and depending on the type of fund we're talking about, whether that be private equity, growth, equity, venture capital, or others, or real estate, for example, we see different types of waterfalls being used. And really what you see though, I think in all instances is I think limited partners are expecting a return of expenses, right? They're seeing preferably a return of their capital contributions to date. And then if there's a preferred return, they're looking for that as well.

(12:51):

And then you'll see the general partner start to participate in some fashion. And depending again on the kind of fund you're talking about, there's mechanics in place to ensure that the general partner doesn't over-participate, so to speak, and that would be your clawback.

Ted Edwards (13:06):

Yeah. If I could just add to that, it's very important to understand the type of fund and the asset class you're dealing with. Just to underscore that, if you look at the independent sponsor market where there are waterfalls in those deals, it goes well beyond the traditional 20%, up to 30, 40, 50% of profits, depending upon the performance of the underlying asset. Now that's a different deal. There's concentrated risk relative to a blind pool, but it just goes to show you that the range of waterfall structures varies considerably in the asset management space.

Thao Le (13:43):

And Ted, on that point about independent sponsors, what you're also seeing is you could have a different fee arrangement, not just with carry, but also management fees with independent

sponsors, right? Because you could have a situation where the independent sponsor doesn't charge a management fee at the SPV level, right? In other words, like the fund vehicle that they're going through, but it's really just a special purpose vehicle for one investment, but they charge a portfolio company a monitoring fee.

Ted Edwards (14:11):

Absolutely. A monitoring fee is akin to a management fee, but it is different, to your point. Oftentimes it's based on the enterprise value of an asset as opposed to the capital commitments or invested capital. Independent sponsor may also receive a diligence fee or a closing fee upon the closing of a transaction, a portion of which is very frequently rolled into the deal itself. So, the economics of an independent sponsor deal resemble, in many respects, those have a blind pool, but they do have their own unique characteristics that need to be appreciated.

Thao Le (14:45):

And Steph, in a traditional fund, that fund manager can still charge monitoring fees and transaction fees to the portfolio company, but does that have any impact on the management fee that's paid by LP, then?

Stephanie Constantino (14:58):

It's important to look at the governing documents of a fund to determine whether or not the fees outside the management fee that are received by a manager or their affiliates' offset management fees. And so oftentimes in many documents, there's a percentage of fees that are received for other services' offset management fees. And you look at the governing documents of the various investment funds, you have to understand and appreciate if 100% of the fees that they receive offset and reduce the management fee, if a percentage of the fees receive offset the management fee, and then for example, if the manager waives fees for certain LPs, then they'll keep that percentage typically of the fees that they receive and that won't actually offset the management fee. And then there'll be often a subset of fees that are actually carved out from the offset. And so those are often fees that a third party would provide otherwise, right?

(15:57):

They happen to have an affiliate that can provide those services, for example. And so they provide those services and they disclose them to the limited partners and they do not expect those to be offset because they would be hiring a third party to provide those services and the fund would therefore be incurring those charges in addition to the management fee otherwise.

Ted Edwards (16:18):

Yeah. This is—wearing my regulatory attorney hat—this is a very important area to make sure that your disclosure and your practices are in alignment. And this is across asset classes, but particularly in real estate funds where managers and sponsors and their affiliates provide a

range of services to the portfolio assets, it's very important to have your disclosure and your practices really dialed in and in alignment.

Thao Le (16:46):

Yeah. And Ted, if you put your regulatory hat on, isn't this an area that is also on the SEC's radar as far as making sure that your disclosures are consistent and your practice is consistent with your disclosures, I would say?

Ted Edwards (17:00):

Absolutely. That's a perennial priority for the exam staff, making sure your practices and your disclosure are in alignment.

Thao Le (17:06):

That was a very good point about the disclosures. And thinking about that, you also have clawbacks. That's very close and dear to the hearts of GPs. Where do you see the clawback documentation and disclosures happening and how do they really work in practice? I recently dealt with a situation where I had an investor, not even an anchor investor, minority investor, independent sponsor deal, granted that's a little different, but an independent sponsor deal who insisted on having the carry deposited in escrow as well as a GP guarantee. So let's go over the clawbacks, how are they working and what are you seeing as far as LPs demanding in terms of escrows and clawback guarantees?

Ted Edwards (17:45):

A clawback at the highest level is a mechanism in a fund agreement that ensures general partners or sponsors do not receive a greater portion of the profits of the fund than they should under the terms of the agreement. And this is particularly important in a deal-by-deal fund where the risk of overdistributions early in a fund's life are greater than sort of a whole fund context, but they apply nonetheless across waterfall types. So a clawback guarantee is very common all the way up to the individuals that receive the carried interest. Carry escrows, I think they were much more prevalent five, eight, 10 years ago. We're seeing them less and less in my experience, but do see them here or there. What's more common, I think, are audit holdbacks and interim clawbacks. So an audit holdback is a requirement to leave carry in the fund until an audit's conducted and determines that the carried interest has been properly calculated.

(18:51):

Interim claws are also more common. So rather than waiting to the end of the life of a fund, which can be seven, 10, 12 years down the road, we might have an interim clawback at year five, seven, nine, or otherwise. And that just serves as a sort of a way point to true up any distributions that have been made or refresh the carried calculations. Clawbacks are typically a net of tax and limited to the amounts actually received by the sponsor. So just as the clawback serves as a mechanism to make sure that limited partners are made whole, clawback is not going to pull back more than the sponsor has actually realized from the fund.

Stephanie Constantino (19:36):

I think it's important to flip the lens and go to the other side, which is the LP clawback as well, which I think it's important to be able to take money back from limited partners to the extent it's needed in certain circumstances. And I think what you saw a few years ago was the growing trend, for example, the bifurcated claw where you saw both the deal claw and the end of life claw, so to speak, where you could reach into the LP pocket for certain types of claims, especially if you had notified the LP prior to the distribution or simultaneous with the distribution and there's some sort of cap on it typically, whether that be timing and/or amount. And then the deal claw was typically outside of that. And that was designed to allow for quicker and more efficient distributions in larger amounts of deal distributions with the understanding that you could reach for those proceeds outside of the claw that was in place for the end of life claw, so to speak.

(20:36):

But I think the LP claw also a really important tool to understand and appreciate what is at stake, how you need to plan for that. I know, Thao, we have looked at that with rep and warranty insurance, for example. It's become very important to understand and appreciate that funds that have deals, large deals at the end of life, for example, have really had to understand and appreciate how that mechanic dovetails with their ability to hold back capital, how they need to plan, what their distribution looks like. So I think that's also an area as funds have had to extend their life in the past few years as they see later exits, I think it's become a really important diligence point for limited partners and also a really important point for general partners as they've been planning certain types of exits at the end of term.

Ted Edwards (21:24):

Yeah. You might see this referred to as a recontribution or giveback obligation, something a little more benign than a limited partner clawback.

Thao Le (21:32):

It's all about the marketing.

Ted Edwards (21:33):

That's right.

Thao Le (21:35):

I want to explore a little bit more, something that you said here about the longer life of the funds and they're holding on investments for longer periods. And with everything that's going on in the world right now and the volatility of the market, you are seeing investments being held for longer periods. And what LPs, or I should say, what GPs are seeing are continuation vehicles and secondary transactions as a way quote unquote having an exit. So how do continuation vehicles affect the carry economics?

Stephanie Constantino (22:07):

So it's really interesting with respect to how continuation vehicles affect carry economics. It really depends on, in some respects, the success of the actual deal that you're potentially rolling for a continuation fund, for example. In some instances, what will happen is there'll be a fairness opinion and you'll set a value for the actual investment itself that's being rolled into a continuation vehicle ultimately, and there'll be a crystallization and that crystallization is that you'll create a liquidation waterfall and you'll ascertain what would be the carried interest for the general partner at the time with respect to the continuation vehicle, with the asset that's being rolled into the continuation vehicle. And depending on your lead investor for the continuation vehicle, that the manager may be asked to roll all or some of their carried interest into the continuation vehicle as a contribution. So how it affects it, Thao, is a couple of ways.

(23:09):

They may actually realize the carry, but not actually realize it in a cash distribution. They may realize it as an equity contribution to the continuation vehicle being made by the manager itself into the next vehicle, right? To continue that idea of the alignment of interest, right? They think this is such a good investment and they're going to continue it, then they're going to put to work the cash that they are actually realizing. The other thing is, is that oftentimes in the continuation vehicle, there'll be a real discussion about what the carrier should look like, for example, and so the next round on the investment, right? If they had a 2 and 20 on the last fund with respect and that investment was part of that fund, there'll be a robust discussion with the lead investor with regards to what the economics should be with respect to the continuation fund where the same investment is involved.

(23:58):

And that will be about whether or not there should be a reduction in the carry, for example. And if so, what should that look like?

Thao Le (24:05):

I just have one final question for both you, Ted, and Steph. This episode was focusing on what's changing in GP economics. What is your one takeaway from changes in GP economics? Ted, I'll start with you from a regulatory perspective. If I'm a new fund manager or I'm a fund manager and I'm raising another fund, what's the key regulatory spin that I should be focused on in terms of economics?

Ted Edwards (24:29):

Clear disclosure and full disclosure, not trying to hide the ball, but get it all out there in plain English for limited partners and regulators to see, digest, and appreciate.

Thao Le (24:45):

And I think also in one additional vein of that comment, while you want clear, plain English disclosure, you also have to be able to live up to that disclosure. So don't have the Cadillac of disclosures and the Cadillac of LPA provisions about your compensation arrangements and offsets and all that if you can't live by it. And that's where I think we see a lot of fund managers get in trouble, which is they come up with this ideal type of disclosure, "Oh, I've got the risk factors and conflicts of interest disclosures. I'm Teflon now, right? No one's going to be able to come after me." I think there's also that element of fairness to LPs as well as being able to live by the words that you're putting out there.

Ted Edwards (25:30):

Absolutely.

Stephanie Constantino (25:32):

I think Thao, one of the things that is really important to keep in mind is that words matter and that when you use the word market or arms length or third party, that it's really important that you have the file to back those claims up and that when regulators come to look and if they are testing your fees, they will look for that type of backup because the words do matter. And if you are going to say that something's market, you have to have your backup for those types of claims. And so while a general partner may shy away from a number or making some sort of stake in the ground with regards to what they're going to charge, if you know what you're going to charge and that's not going to change, sometimes that is actually the easier mechanic to employ going forward, especially in this regulatory environment, the testing and the scrutiny that will be applied with regards to quote market claims or third-party claims, I think is real.

(26:38):

And so I think it's something to keep in mind when you're designing your fee structures. And to Ted's point earlier, you are allowed to charge additional fees and you're allowed to put in additional fee disclosures. It's just important that those fee disclosures are accurate and wholesome and that you understand them and that they are reflective of your actual practices.

Thao Le (26:57):

A lot of our discussion today has been focused from the lens of the GP. So Steph, my question for you as a takeaway then is for putting your LP hat on. What is the one thing that you would take away from the changing in GP economics so that our fund manager listeners can be aware of? What's on the LP mind?

Stephanie Constantino (27:17):

I think limited partners are, as they've always been, but I think very much so, are very return minded. They want to understand and appreciate what their returns are going to look like, when you're going to call for expenses, when you're going to start their fees, the timing of things. They

want to understand and appreciate the timing of it. And they want to understand if you're going to sit on capital for a long time, then when are you going to call their fee, for example, because performance matters. And in this market, performance really matters and it can be very much impacted when the only thing you're calling for is fees.

Thao Le (27:53):

Great. Thank you both. This has been a great discussion and I'm looking forward to future installments in our Carried Away series. I'd like to thank our listeners for listening today. Please keep your eyes open for future episodes of *PE Pathways*, where we bring experienced deal makers on to share their thoughts on current private equity and M&A trends and developments. You can find the latest episode of *PE Pathways* wherever you get your podcasts.

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