Callan Institute

Callan's Research Cafe

How to Navigate Private Equity Fees and Terms

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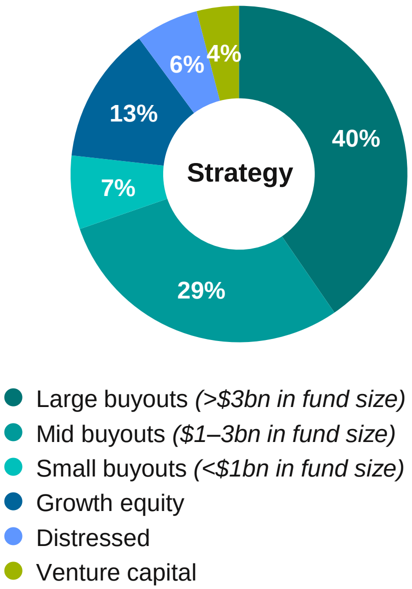
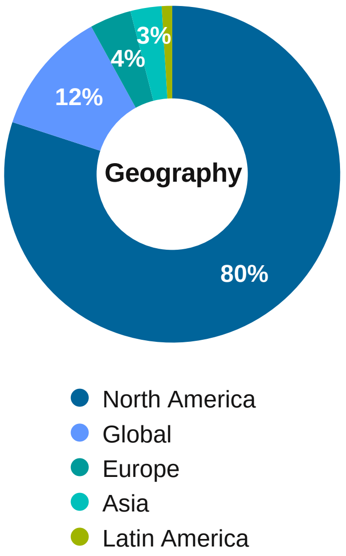
Overview

Our *Private Equity Fees and Terms Study* included 90 partnerships, representing funds in the market and reviewed by Callan in 2018 and 2019.

- Objectives
  - Help investors evaluate funds
  - Provide a benchmark for a partnership's terms compared to peers—especially useful when reviewing terms with general partners (GPs)
  - Develop a tool for GPs to compare their terms to others
- Focused on a select set of terms to provide a concise market snapshot

Partnership Characteristics

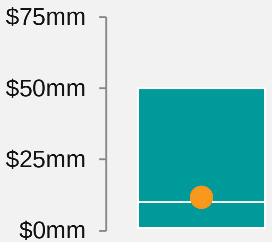




Commitment Levels

Minimum Limited Partner (LP) Commitment

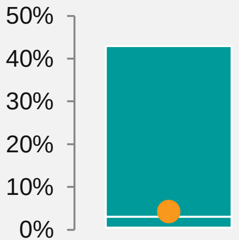
- $10 million fairly standard
- Roughly 25% of the dataset had higher minimums, typically to constrain the LP base to larger investors



Maximum	$50.0mm
Median	$10.0mm
Minimum	$1.0mm
Average ●	$11.7mm

General Partner (GP) Commitment

- 3% the market standard
- A significantly lower commitment may indicate a lack of alignment between the GP and LPs
- Higher commitments typically involve GP balance sheet capital



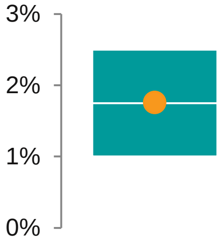
Maximum	42.9%
Median	3.0%
Minimum	0.5%
Average ●	4.3%

Management Fees: Investment Period

- Captured management fee paid during the investment period (typically the first 5–6 years of a fund's life) and after the investment period
- Median fee of 1.75% during the investment period almost always paid on committed capital

Investment Period Management Fee

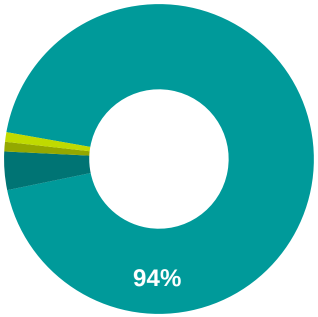
Fee Range



Maximum	2.50%
Median	1.75%
Minimum	1.00%
Average ●	1.76%

What the Fee Is Paid on

1% Lesser of NAV, committed capital, or net invested capital
1% Unfunded commitments
4% Net invested capital

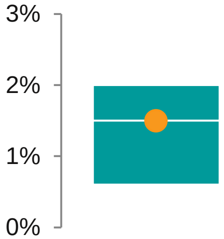


Committed capital

Management Fees: Post-Investment Period

- After the investment period, fees drop to a median of 1.5%, almost always paid on invested capital (a lower capital base)
- 17% of funds charge fee on same capital base (either committed or invested capital) over their entire life
- Higher or lower fees can signal whether investors are overpaying or benefiting from fee savings

Post-Investment Period Management Fee



Maximum	2.00%
Median	1.50%
Minimum	0.60%
Average ●	1.50%

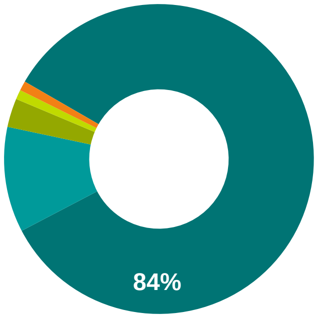
What the Fee is Paid on

1% NAV

1% Lesser of NAV, committed capital, or invested capital

3% Lesser of NAV or invested capital

11% Committed capital

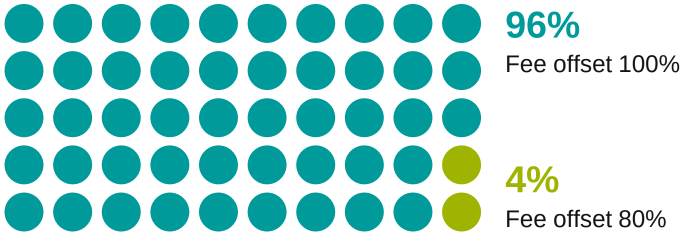


Invested capital

Management Fee Offset

- Every GP offset management fees by transaction, monitoring, or other fees received by the fund
- Fee offsets significantly lower than 100% are not in keeping with the rest of the market

Management Fee Offset



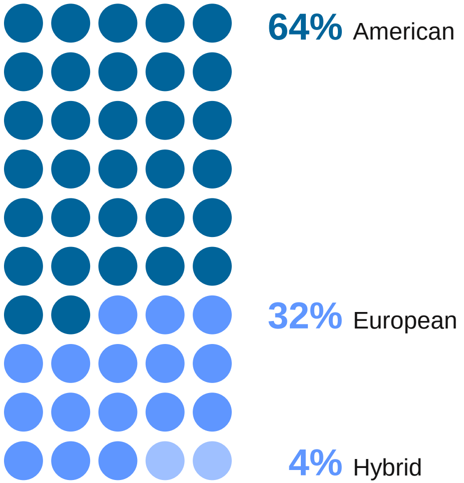
Waterfall

Two types:

- **American (deal-by-deal) waterfall:** carried interest paid to GP on a per-investment basis (more GP-friendly)
- **European (fund-as-a-whole) waterfall:** carried interest paid on a cumulative basis across all investments (more LP-friendly)

The American waterfall is more prevalent.

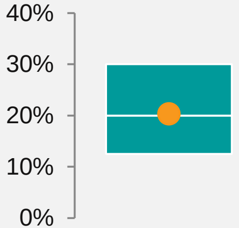
Type of Waterfall



Carried Interest and Hurdle Rate

Carried Interest

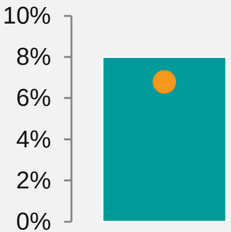
- Industry standard is 20%
- Funds with carried interest as high as 30% are often venture capital funds or funds in high demand
- For such funds, investors need to determine the impact on net returns and ensure it can be offset through strong performance



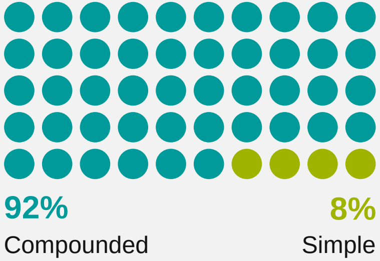
Maximum	30.0%
Median	20.0%
Minimum	12.5%
Average ●	20.3%

Hurdle Rate

- Typically 8%
- 13% had no hurdle rate
- Vast majority use a compounded calculation



Maximum	8.0%
Median	8.0%
Minimum	0.0%
Average ●	6.8%



Callan Analysis

Little Variation

– Relatively high level of uniformity for fees and terms among the partnerships in the study

LP Bargaining Power Limited

– Given the recent boom in industry, partnership terms have been leaning in the GP's favor
– With annual commitment levels tripling over the last 10 years, private equity demand has resulted in many oversubscribed funds, limiting the bargaining power of LPs

Emphasis on Manager Selection

– GPs are in the driver's seat, making careful manager selection even more critical

Power Shift Possible

– Across a cycle, power can shift back toward LPs, often resulting in fee discounts and/or more LP-friendly terms
– With COVID-19, this shift has occurred at the margin, but the dynamics of the market may be further reset if the pandemic deepens

When evaluating a partnership, Callan helps institutional investors determine whether the terms are consistent with the rest of the market, with particular emphasis on the alignment of interests between GPs and LPs.

TAKEAWAYS

- Our study is designed to serve as a benchmarking tool to evaluate and compare private equity partnership terms.
- Given the recent boom in the private equity industry, partnership terms have been leaning in the GPs’ favor.
- With LPs’ negotiating power limited, prudent manager selection is even more essential.
- Stay tuned for next year’s study, which will reveal the broader impact of the COVID-19 pandemic on partnership terms. Across a market cycle, we often see power shift back toward LPs.

Biographies

Ashley DeLuce, CAIA, is a vice president in Callan's Private Equity Consulting group. She assists in all aspects of private equity consulting, including research and client servicing, portfolio reviews, manager searches, research projects, and performance reporting for clients. She is a shareholder of the firm. Ashley earned the right to use the Chartered Alternative Investment Analyst designation.

Pete Keliuotis, CFA, is an executive vice president and the head of Callan's Alternatives Consulting group, which includes the private equity, private credit, and hedge fund consulting teams. In addition to leading these teams, he performs research and advises clients' alternative investment portfolios. Pete is a member of Callan's Alternatives Review, Client Policy Review, Management, and Editorial committees. Pete is a holder of the right to use the Chartered Financial Analyst® designation.

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