Private Equity Compensation

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Intro

- Mechanics and details of PE compensation.
- Proposed tax changes for PE compensation.
- How those tax changes will affect GPs and the PE industry.

The Private Equity Process

- Managers of PE firm are the general partners (GPs), investors are the limited partners (LPs).
  - GPs = Blackstone, Carlyle, Silver Lake etc.
  - LPs = pension funds, endowments, wealthy individuals etc.
- GPs raise first fund. Say BCS I
  - LPs commit to a certain amount of investment. Say $1000 M.
    - » Commitment includes management fees.
  - GP draws down funds usually over first 3 to 5 years.
    - » Investment period.
  - Average life of fund is usually 10 to 13 years.
    - » Remaining 5 to 10 years is harvest / realization period.
- After investment period, raise BCS II.

Structure of Compensation:

- Management Fee.
- Carried Interest / Profit Share.
- Preferred Return.
- GP Coinvest.
- Deal and Monitoring Fees.

Structure of Compensation:

- Management Fee.
  - Paid quarterly in advance.
  - Usually:
    - » as a % of committed capital during the investment period.
    - » as a % of invested capital during harvest period.
      - I.e., as investments are harvested, management fee only applied to capital employed in remaining investments.
  - Also:
    - » as a % of invested capital.
    - » as a % of committed capital.
  - Usually 1.5% to 2.5% per year.
  - For $1 B fund with 2% management fee, means $20 M per year for up to ten years.
  - Alignment:
    - » Not aligned with investors because management fee paid no matter what.

Structure of Compensation:

- Carried Interest / Profit Share.
  - GPs earn share of profits.
    - » Usually 20% for PE. Long history.
    - » Up to 30% for top VCs.
  - Generally profits on committed capital.
    - » Sometimes profits on invested capital.
  - If $1 B fund turns into $3 B, then GPs earn:
    - » 20% of ($3 B - $1 B) = 20% of $2 B = $400 M.

Structure of Compensation:

- Carried Interest / Profit Share. Three ways to pay carry:
  - Carry paid only after all invested capital and expenses returned (including write-offs).
    - » European Model.
  - Carry paid deal by deal as long as fund is sufficiently profitable.
    - » Estimate current fund performance (based on investments realized and
    - » Write-offs/Write-downs, Realized Investments, Expenses
    - » Deal by Deal Model
  - Carry paid only after all commitments returned to LPs
    - » All Commitment Model.
  - Deal by Deal Model has been most typical. Now, increasing pressure for European Model from LPs.

Structure of Compensation:

- Preferred Return.
  - In PE funds, typically a preferred return of 8%.
    - » GP gets no carry unless LPs earn 8% IRR net of all fees.
    - » GP gets 20% of profits as long as LPs earn 8% IRR net of fees.
  - In VC funds, preferred return is 0.

- Alignment:
  - Carry aligns GPs and LPs.
    - » GPs get carry only if LPs get money back.
  - To the extent that carry represents an option, have to worry about taking excessive risk.
    - » Fund terms mitigate this in a number of ways.
      - Limits on fund leverage, investment in one deal, etc.
    - » Future fundraising also limits this.
      - Future fundraising based largely on relative performance.

Structure of Compensation:

- GP Coinvest.
  - LPs look for GPs to invest in fund.
  - Minimum GP commitment is 1% of committed capital.
    - » Generally less than one year of management fees.
  - LPs prefer to see GP commitments well above 1%, particularly if GPs have been successful and can afford it.
  - Alignment:
    - » Higher GP coinvest leads to greater alignment.

- Deal and Monitoring Fees.

Structure of Compensation:

- Deal and Monitoring Fees.
  - PE GPs charge portfolio companies fees for transactions (merger advice, financing advice, etc.) and for ongoing monitoring (monitoring).
    - » VCs do not do this because start-ups have no cash.
  - Most notably KKR who made very large such fees on RJR Nabisco while LPs earned a minimal return on the deal.
  - LPs noticed and began asking to share these fees.
  - Some of these fees used to reduce management fee, effectively sharing fees with LPs.
  - Time series:
    - » Initially 100% GP / 0% LP; then
    - » 80% GP / 20% LP; then
    - » 50% GP / 50% LP; now
    - » 20% GP / 80% LP and a lot of pressure for 0% GP / 100% LP.

Structure of Compensation:

- Deal and Monitoring Fees.
  - Alignment:
    - » GPs and LPs are aligned when these fees go to the LPs until LPs earn preferred return, then shared 20% GP / 80% LP.
    - » In other words, full alignment only when these fees offset management fees.

ILPA Principles

- To better align the overall relationship between LPs and GPs in PE.
- The Principles represent a basis for dialogue between LPS and GPs and reflect an intent to benefit all PE participants over the long term.
- The Principles represent suggested best practices in three areas: Alignment of Interests, Governance and Transparency.
- Alignment of Interests
  - These provisions focus on the economic terms and are structured to tie more closely together the economic incentives and results of the general partner to the returns realized by limited partners.
  - Ex. Move to European waterfall, stronger clawback protection, 100% fee offsets, substantial GP investment.

Proposed tax changes for PE compensation

- Under current tax law:
  - Management, deal and transaction fees taxed as ordinary income.
  - Carried interest taxed as capital gains.
  - Sale of interest in GP taxed as capital gains.

- Under proposed law change:
  - Management, deal and transaction fees taxed as ordinary income.
  - Carried interest and sale of interest in GP taxed 0%/25%/50% as capital gains 100%/75%/50% as ordinary income.

- If passed, law change increases taxes on PE investors markedly.
  - Metrick and Yasuda estimate that carried interest represents roughly 50% of PE economics.

Proposed tax changes for PE compensation

- If passed, law change increases taxes on PE investors markedly.
  - Metrick and Yasuda estimate that carried interest represents roughly 50% of PE economics.
  - If 100% taxed as ordinary income:
    - » Before 1$ PT: 50% x 60% + 50% x 80% = $7 AT
    - » After 1$ PT: 100% x 60% = $6 AT
  - Represents roughly a 14% decrease in PE investor compensation.

How will tax changes affect GPs and PE industry?

- Obviously, need to see final implementation of bill.
- That said, can say a few things:
  - Any time you increase a tax, you usually get less of what you tax.
    - » Primary question is how much less.
  - On the margin, GPs will locate non-U.S. citizens outside the U.S. in lower tax jurisdictions.
    - » Good for Switzerland, Singapore, Hong Kong.
    - » Not so good for U.S.

- Undoubtedly, will be ways for some GPs to obtain CG treatment in at least some transactions. Easiest:
  - » GP creates a thin layer of common equity in buyout deals.
    - This is typically done currently to allow mgmt to buy stock.
  - » GP invests in common in these deals.
    - Instead of carry, takes 20% of common in every deal.
    - Gets capital gains treatment.
  - » Negative (for LPs) may not be able to offset losses against gains.
    - Likely to be very contentious.

Summary

- Mechanics and details of PE compensation.
  - Very lucrative for successful PE investors.
  - GPs generally aligned with LPs.
  - ILPA pressure for greater alignment.

- Proposed tax changes for PE compensation.
  - Raise tax on carried interest.

- How those tax changes will affect GPs and the PE industry.
  - Will modestly reduce attractiveness of PE, particularly for VCs.
  - Will lead to attempts to circumvent change.
  - Will create more GP / LP conflict.