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FEE TRANSPARENCY & CARRIED INTEREST SERIES

Six most common reasons for variances between LP carry estimates and GP-provided carry numbers found during LP carry recalculation

PEAI carry methodology

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It has been a busy 2016 year-end and even busier quarter for us recalculating carried interest for Limited Partners (LP) clients. Carry validation is becoming more and more popular with LPs due to the pressure from various stakeholders such as trustees, retirees (in the case of public pension plans), regulators, the general public, the media and other stake holders, and in some states in the US even fee transparency legislation has been passed as a result of the public interest in the matter.

In the next few technical newsletters we'll be sharing some of our experiences gained in Q1 through our carry verification/recalculation services we perform for LPs. We feel that sharing this information will be not only useful to LPs, but also to GPs since some of the variances between the LPs' carry estimates and the General Partner (GP)-provided carry numbers are due to GP errors we have found in the process.

In this technical newsletter we have summarised the six most common reasons for variances that we have found between our carry estimates we calculate for LPs' investee funds and the GP-provided numbers.

We have ranked the most common reasons based on the frequency these reasons cause the variances. The sub-set we have reviewed includes approximately 100 funds with roughly 70% being US funds, 20% European and 10% the rest of the world (mostly Asia Pacific). We do not claim this is representative data, and the result may be a bit skewed towards the US funds, but from our experience, it pictures a pretty good image of what the current state of affairs is in respect of carried interest.

Reason #1. Discrepancies in the input data (LP vs. GP information)

One of the most common reasons for variances (although not as material as the ones under Reason #2) between the LP-calculated and GP-calculated carried interest is differences found in the LP records compared to the GPs' numbers found in financial statements, quarterly reports and even capital statements. Some examples of discrepancies are the total inception-to-date (ITD) contributions, total ITD distributions, and NAV.

This is a signal that LPs need to put their data in order and start recording more accurately certain attributes from the drawdown and distributions notices, capital accounts, financial statements and quarterly reports. In addition, they should be reconciling against the GPs' numbers the period and since-inception numbers on a quarterly basis, as well as whenever they receive a drawdown or a distribution notice, particularly when the notices provide since-inception information.

Also, if the LP is planning to perform carry recalculation, particularly if the LPs are aiming to calculate realised, not just total (realised + unrealised) carry, some additional data points need to be recorded such as deal-level information, including

Improved GP reporting, including distributions and NAV reported gross of carry, in addition to providing supplemental information on carry, coupled with more granular LP recording, can facilitate more accurate carry recalculation.

information about realised deals, not just unrealised ones, NAV at the deal-level, etc.

Unfortunately, it is not only the LPs to blame for these discrepancies. Often the GP information provided is insufficient, particularly when it comes to carried interest, so there is a lot of room for improvement in terms of the information provided by GPs on carry.

Bottom line, better GP reporting and more granular LP recording and regular reconciliations of the LP vs. GP data are required in order for the LPs to be able to perform more accurate carry/ fee recalculation.

Reason #2. Distributions and/or NAV amounts provided by the GP are reported net of carry

Number 2 reason that causes probably the most material variances between the LP and GP carry calculation is that most of the GPs report distributions in the distribution notices on a net (of carried interest) basis, instead of gross basis. Same applies to the NAV. The situation becomes even more aggravated, when the LP can't even find out from the GP notices and reports if the distributions and NAVs are net or gross of carry and needs to make their own assumptions.

In order for the LP to be able to replicate the GP waterfall calculation, if they know for sure that the numbers are net of carry, the LPs need to gross up the distributions and/or NAV (depending on which one is reported on a net basis).

Reason #3. Different assumptions and/or interpretation, or poorly drafted carry mechanics in the LPA

As we have pointed out on multiple occasions, poorly drafted waterfall provisions, or which is more common, not detailed enough carry provisions allow for a lot of room for GP discretion in the waterfall calculation and the GP sometimes intentionally (trying to benefit from the lack of detail using assumption that would lead to higher carry amounts), and sometimes unintentionally (because they just had to make some assumptions that they believed were reasonable) makes some discretionary assumptions in the calculation which may lead to totally different results compared to the results produced if other assumptions were made.

With regards to poorly drafted or conceptually wrong waterfall provisions, recently we came across an interesting example with a complex multi-tier waterfall model where the lawyers/GP (hard to say who exactly) didn't think through the waterfall provisions. This is an easy mistake for a lawyer to make due to the lack of practical experience in actually calculating the waterfall (not just using a simplified example) that provides for all the aspects and case scenarios that can happen in real life.

In the complex waterfall in question, the second tier of preferred return was triggered by two metrics – a multiple and an IRR, instead of only one (IRR or multiple) as it is usually the case, which is actually a great idea, but unfortunately with not so great execution. The LPA wording was *'100% to such Limited Partner until such Limited Partner has received cumulative distributions in an amount equal to (i) 200% of its aggregate Capital Contributions, and (ii) representing 15% IRR.'* The trouble with this specific wording is that in meeting both criteria at the same time, there is an implied assumption with regards to the time dimension whereby 2x multiple represents 15% assuming that all the capital was invested on Day 1 for 5 years ($1.15 ^ 5 = 2x$) – that's how we think they have come up with this provision. The reality, though, is that in private equity usually not all the capital is deployed on Day 1 and returned at the end of Year 5 which makes this assumption (and LPA provision) flawed. In this case, since the IRR as of a certain calculation date was very different from the 15% provided in the LPA when the 2x multiple was achieved, we were facing a difficult decision – which one shall we use to calculate the preferred return on this date – the IRR or the multiple? We believe that the intention was for the multiple to be the primary criteria, i.e. to double the investors' money before the GP starts taking carry, and based on our belief, we applied the multiple, which led to a massive difference between our carry number and the GP's carry number resulting in our carry estimate being a lot lower than the GP's carry number.

Based on the above, we would recommend that:

1. The waterfall provisions contain a much more granular level of detail needed for the practical calculation;
2. Testing the provisions under different scenarios with slightly more real-life examples before they become part of the LPA.

Reason #4. Fund-level instead of investor-level calculated carried interest

This is a point we have also reiterated on a number of occasions – GPs should be calculating carried interest on an investor-by-investor basis rather than on a fund-level basis, then applying the by-commitment percentages to arrive at the investor-level numbers, particularly if there

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are Excused Investors as these two methods can potentially lead to completely different results.

In support of this, we came across an interesting example with a GP client we were providing year-end services for. As part of the year-end process, and particularly its year-end carry accrual calculation, the GP came up with an interesting finding – when calculating carry at the fund level, there was no carried interest to be accrued at the total-fund level, however, for one Excused Investor that opted out of one or more deals, based on the specific investor-level cash flows, carry was supposed to be accrued. Their question was – what do we do in this case? And the answer is, carry needs to be calculated on an investor-by-investor basis and then added together (i.e. bottom-up) as opposed to top-down (i.e. fund-level calculation then broken down by investor based on the commitment percentages) as the GP needs to 'flip' carry from the LP to the GP based on the specific circumstance/cash flows for each investor and any investor may challenge the calculation if done otherwise, particularly if the LPA's wording suggests investor-level calculation. Luckily, in this case the GP was calculating carry at the investor level and spotted this discrepancy.

Reason #5. GP errors

GP errors in the waterfall calculation are more often than one would expect. Some of them are due to a lack of understanding of the waterfall mechanics, others of the mathematics behind it, and while errors are less common in the cases of simple most common carry mechanics (i.e. whole-fund/European carry with 20% carried interest, 8% hurdle, a full/100% Catch-up, and 80:20 residue split), where there are more complex mechanics, we often find errors in the GP calculation. Unfortunately, often we don't have a proof of exactly what caused the error. However, sometimes we get access to the GP's calculation and have a better insight into what went wrong.

> More rigorous process of drafting detailed carefully worded waterfall provisions tested under different scenarios and investor-level waterfall calculation performed by GPs would be another step in the right direction.

Strangely enough we have found errors made by GPs that resulted in lower carried interest than the GP was entitled to. On one occasion, we have come across the waterfall workings kindly provided by a GP that has tried to be very transparent – an effort that definitely deserves to be praised. Unfortunately for the GP, and interestingly to us, this resulted in a carry amount that was lower than the GP was entitled to, and the reason was that this particular arrangement, although generally quite common, didn't have a full/100% Catch-up which was mathematically inaccurately applied by the GP. In all fairness, catch-ups that are not full, i.e. less than 100%, are hard for many professionals, including on the GP side, to wrap their heads around. Through our carry training we find that even 100% catch-up often represents a challenge to fully comprehend and apply mathematically.

The question in this case when the LP finds an error resulting in lower (than the GP is entitled to) carry amount, is would the LP reveal its findings to the GP? Apparently, this error is to the advantage of the LP. However, this should be even more worrying to the LP and begs the question – if the GP can't calculate their own incentive, how good is it at managing the LP's money?

Please note that this reason may be ranked higher, but the problem is that we don't get the GP's carry workings very often (as in the case described above) to prove that the variances are due to GP errors, so in our opinion this reason is downplayed in our ranking.

Reason #6. Complex multi-vehicle structures

Another occasion when we often find variances is when there are more complex structures and the LP participates through multiple vehicles. The situation becomes even more aggravated if the LP does not record the cash flows from these different vehicles using different fund IDs and we can't distinguish between them to run separate waterfall calculation as sometimes these vehicles, which are often completely different legal entities, have different waterfall provisions.

Therefore, a word of advice to LPs, even when you consider it one investment, if there are multiple vehicles/legal entities, we would recommend that the LP records the cash flows and all the other information under different fund IDs despite the fact that the LP may feel tempted to consider them a single investment.

In our next technical newsletter

In our next technical newsletter, we'll discuss another interesting, although less common case – recalculating carried interest for secondary interests as usually secondary investments create an interesting situation from a number of different perspectives, and we'll analyse it from the LP's perspective in the context of carry recalculation.