The Importance of Testing Term Sheet Math

GPs need to focus on the language of their waterfall calculations to avoid LPs coming knocking at their door years later.

By Olin Monty

Investors and managers can spend dozens of hours negotiating a working waterfall profit distribution model. However, a failure to pay attention to specific term sheet language can cause trouble years down the line and impact the alignment between general partners and limited partners.

“A term sheet will often be in the range of several pages, with somewhere between a few lines and a few paragraphs on fees,” says Roy Schneiderman, a principal at Bard Consulting. “The problem is, once the term sheet is hammered out, people sometimes go on autopilot.”

Schneiderman points out that problems often occur at the point where term sheets are converted to full-fledged legal frameworks. It’s a problem that has put many LP-GP relationships out of alignment at the outset, but changes in process could help lessen the heartache.

Once term sheets are completed, the actual waterfall structuring is often passed on to legal advisers, with little oversight thereafter. “Missing the mark on fine print can lead to a great deal of friction,” says Schneiderman, referring to fund, venture, and operating documentation that, if too general, leaves remaining stakeholders open to interpret ambiguities.

One fund manager, commenting on the challenges of executing on loose documentation language, says, “The hardest thing to wrap our heads around is the nuances in our waterfalls. When you think of expenses...you have to wonder if your investor is interpreting them the same way. We’ve had a time when we were literally off by pennies, and we got a knock on the door.”

Among strategies for investors, Schneiderman recommends avoiding boilerplate language, as it can contrib-
“When terms and calculation methodologies are not fully vetted, issues are discovered years down the line when the waterfall models are actually run.”

–Dillon Lorda, PCA

The use of “blind-eye testing” to validate incentive fee language and structures, whereby an analyst or other third party not involved in the negotiations runs cash flow models based on the specific language used. “Without using examples, [this analyst/third party] helps ensure the language accurately reflects the intentions of the people negotiating the terms, based on documentation language alone.”

More than ever, investors are adding advisers to their talent pool to tackle the waterfall conundrum. Specialists are being employed to reduce the litany of loopholes that can occur in fees, structuring, and documentation. One prominent pension fund portfolio manager says that waterfalls have been the most difficult topic to educate their team on and agrees that consultants have offered a huge lift, though risks are always present.

Ultimately, Schneiderman says, “recognize you haven’t finished when completing the term sheet. It’s important to pay careful attention to the legal documentation and make sure to include one or more examples of how the waterfall will work.”

Dillon Lorda, PCA

November 3rd, 2015
Chicago—Gleacher Center