All the pieces matter

Private markets: Improving commercial terms

June 2021

Black Business Growth Fund®

Contents

Introduction 3

Demand for private equity 4

Management fees 5

Performance fees 9

Conclusion 12

Glossary

LP	Limited Partner
GP	General Partner
Hurdle rate	Preferred return of the fund payable to LPs before the GP shares in any excess profit
ILPA	Institutional Limited Partners Association
Carry	The performance fee payable to the GP after returning capital and the preferred return to LPs

"You know what we got here? We got an elastic product. You know what that means? That means when people can go elsewhere and get their [business] done, they going to do it. You acting like we got an inelastic product and we don't!"
– Stringer Bell (The Wire)

Introduction

Continuing with the theme introduced in our recent survey release, the latest quote references another popular character in the Wire, Russell "Stringer" Bell, one of the foremost characters of a criminal organization.

In this particular scene, Stringer is applying the concept of elastic vs inelastic demand to a front business of their criminal organization. This particular front business needs to constantly innovate and maintain a quality level of service because its offering is widely available and largely interchangeable with other companies.

Similarly, there are more than 50 emerging black private equity managers in South Africa currently in the process of raising capital, many operating in the generalist, mid-market space.

In our engagements with these managers we find offerings remarkably similar in terms of strategies, team experience, targeted returns, track records, commercial terms, etc. Managers can stand out by adjusting their offerings to address the needs of investors, specifically those highlighted in our recent survey, being fees, impact and diversity. That same survey highlighted the unanimous view of asset owner respondents that current commercial terms in private markets simply do not work for them.

As an industry, private markets should be doing more to address this by implementing innovative fee arrangements that ensure alignment and also making private markets an attractive investment alternative for investors to consider. Currently the so called "2 and 20" model on committed capital is a strong disincentive to many investors, especially when you frame it in the following light: asking investors to back an unproven manager and an unknown portfolio of investments for a long period of time on the possibility of delivering returns and positive impact (e.g. transformation, job creation). It's effectively akin to buying something online after having the product described to you, and being asked to pay for the product upfront with delivery expected sometime in the coming years. I don't know about you, but I'd find it hard to part with my money. We have yet to see significant innovation to change this dynamic to make fund offerings more attractive to potential investors.

The Institutional Limited Partners Association ("ILPA") has issued guiding principles to investors and fund managers to foster transparency, governance and alignment of interests – ILPA Principles 3.0[1]. We would encourage all investors and fund managers to refer to this document for direction around what should be considered fair regarding commercial terms agreed between investors and fund managers.

Over the following pages we'll be setting out our view on why the existing model is outdated and how managers can improve their terms without necessarily compromising on their economics but also giving investors what they need - yes it can be done.

This is only one of the pieces of the private equity model that needs addressing and should be looked at in conjunction to the other areas highlighted in our recent survey, which we will unpack further in additional thought leadership pieces to be published over the coming months.

We hope you find the analysis and our views on the current commercial arrangements useful and that we'll start seeing some potential innovation being applied across the market. With any luck this will lead to more allocation from capital providers.

[1] Link to the ILPA Principles 3.0, issued by the Institutional Limited Partners Association: https://ilpa.org/ilpa-principles/

Demand for private equity

We estimate that around R100bn or 2% of South African retirement fund savings is committed or invested in private markets, significantly below current prudential limits of 10% under Regulation 28. The majority of capital is allocated to large institutional players within their captive private markets strategies and only 9% or R9bn of capital allocated directly to private markets in the hands of independent black private equity fund managers.

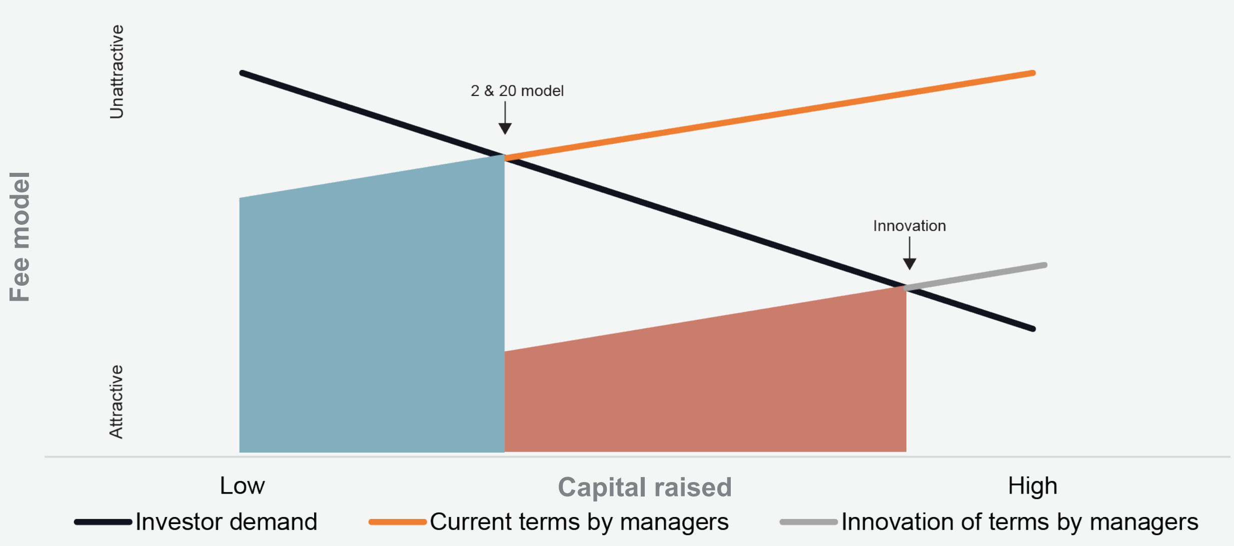
The proposed changes to the Regulation 28 prudential limits are to increase allowance for private markets to 15%, but discretion will still sit with retirement funds with regard to including this asset class in their strategic asset allocations. It remains to be seen whether an increase in prudential limits will have the desired outcome considering that most retirement funds are currently significantly below the current limits already. This illustrates that the current model is not sufficiently attractive to retirement funds.

At present, private equity fund managers are in effect chasing a limited amount of available capital with very similar offerings that makes it difficult for retirement funds to differentiate one offering from another.

The chart below aims to illustrate the above dynamic currently at play in the private markets space in terms of demand for mid-market private equity fund managers and their investment propositions at the “2 and 20” current model, which is exceptionally low. While the model remains unattractive to investors we believe that demand will stay low despite regulatory changes.

Among other things that need improving, becoming more innovative with the fee model in our view will help to shift the supply curve down to capture additional demand from investors. This is particularly true for those independent emerging fund managers focusing on the mid-market space, which is currently in over supply.

Illustrative demand (retirement funds) vs supply (private equity) curve



Management fees

Highlights
1. Significant upfront investment for 1 to 3 years before a manager starts generating fees.
2. Management fees should be based on reasonable expenses to ensure sustainability of the manager over the life of the fund, not to make material profits.
3. Management fees are only charged on commitments and invested capital and do not increase with an increase in growth of AUM.
4. Management fees reduce post the fund commitment period creating sustainability risk for first time managers.
5. The lower the management fees the quicker the path to achieving the hurdle.

Overview

Significant upfront investment is required by emerging managers to set up the investment team, develop pipeline opportunities and keep this pipeline warm for a period of anywhere between 1 to 3 years before reaching a sustainable fund close. This is something that retirement funds should have sympathy for. Before they start generating any income, emerging managers take significant risk incurring expenditure and accumulating losses before receiving any commitments and reaching a first close, with no ability to recoup these losses if unsuccessful.

Private markets products are also unique among asset classes as the current market norm is for management fees to be calculated on commitments to the fund over a commitment period (in most case five years) rather than on invested capital. Post the investment period fees are charged on invested capital reduced for any realised exits and / or permanent write offs over the remainder of the fund term.

When compared to most other asset classes where management fees increase with growth in assets under management, private markets are the opposite. Management fees reduce after the commitment period whereas the manager's cost of operating the fund increases. This, for independent managers results in sustainability risk, which is difficult to manage if raising a new fund can also take anywhere between 1 and 2 years.

What are management fees for?

In considering the current model and potential changes that could be implemented to improve the attractiveness thereof to investors, it is worthwhile highlighting the purpose of management fees. Management fees should be based on reasonable expenses related to the normal operating costs and actual allocation of resources required by the fund manager to execute the investment strategy of the fund. These primarily include salaries of the fund manager's employees, overhead costs (office rental) and any relevant advisers or affiliates, travel and other costs related to the investment activities. The manager should not be making material profits from management fees.

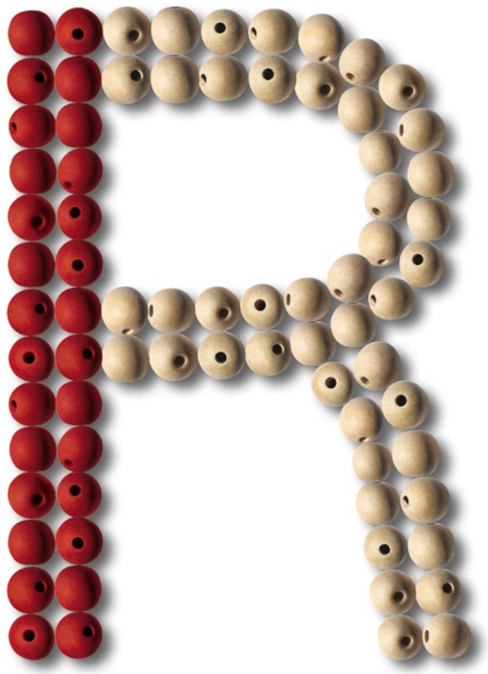
This focus on covering costs rather than making profit from management fees drives better alignment and focus on achieving targeted returns for the fund so as to share in excess profits above the hurdle, which is a significant incentive for the manager. The lower the management fees, the faster a fund can reach its hurdle.

A key part of any due diligence work undertaken by investors or consultants considering a private markets allocation should be to understand the sustainability of the manager at various fund sizes, balanced with having sufficient capacity to execute on its investment strategy. We have seen too often early fund closes that can give a manager a start, but do not provide the fee base for the development of a sufficiently resourced team to execute the fund manager's investment strategy and build a portfolio of diversified assets.

Current fee arrangement

Historically, the market norm has been to charge 2% annually on investor committed capital during the initial commitment period and then 2% (or a slightly reduced percentage) on invested capital over the remaining holding period of the fund. This has the following implications for the fund and the fund manager:

- The fund manager earns management fees ahead of any investment into portfolio assets from first close, resulting in a significant drag on initial fund returns, and resulting in the so-called "j-curve". The fund manager does need to return all capital invested by investors, including management fees and costs, but effectively it is already on the back foot from day one to generate the targeted gross and net returns for the fund.
- The fund is effectively borrowing from the investors at an interest rate of the preferred return, which the fund needs to pay back before fund returns can exceed the hurdle and start profit sharing between the manager (GP) and investors.
- Under the standard model the fund manager may realise significant profits from management fees over the commitment period, particularly early on. However, as the fund shifts from the commitment period to the realisation period, management fees will step down as fees are then calculated on invested capital and are further reduced each time an investment is realised and/or permanently written off. The expectation is that as investments are realised the fund manager shares in excess profits over and above the hurdle set for the fund, but this may only occur late in the fund's life, while its fund management costs are increasingly placing pressure on its short to medium term sustainability.
- This uncertainty over sustainability of the manager through fee decreases and delayed carry can result in staff turnover and team instability and the risk of not exiting transactions and returning capital to investors, despite this situation being foreseeable through the standard fee model. It also creates challenges when raising a subsequent fund as a result of the instability caused.



Alternative fee options

There are several alternative models to the standard 2% of commitments that can be considered in order to improve outcomes for investors, while still working for fund managers. These alternative models are not necessarily meant to reduce the overall fees paid, but are meant to better align fees to capital invested, as well as to better match fees to actual costs incurred by managers. Of course, the application of fees based on invested capital or validated NAV would show a dramatic improvement in net returns to investors, but this is not feasible for most independent managers.

Some alternatives to the standard 2% of commitments are set out below:

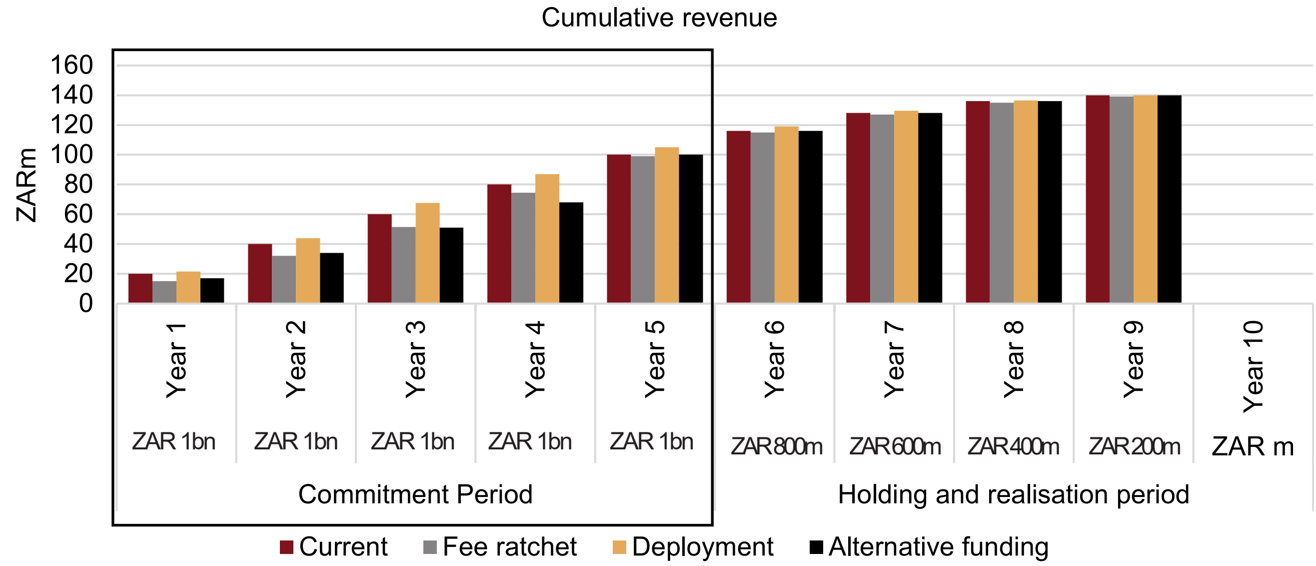
Alternative fee structure	Description	Benefit to investors	Risk to investors
Ratchet fee	An annual management fee that ratchets up as costs increase over the commitment period. The ratchet could be automatic or KPI driven to improve alignment. For example, the first year of the commitment period may have a 1.5% fee, increasing each year to the end of the investment period to 2.5% of commitments before reducing to 2% (or lower) for the investment holding period. The effect of this is to better match the actual costs of the manager to the fees paid through the commitment period that results in better sustainability of the fund manager. The overall blended fee would still equate to 2% over the commitment period, but more closely align income generated to costs incurred to operate the fund.	Lower upfront fees paid as the manager sources and deploys capital into investments, which should reduce the dreaded J-curve in terms of investing in private markets. It would also reduce the catch-up management fees payable by subsequent investors on follow-on closes.	Team may not be fully resourced at the start of the fund which may delay deployment. Manager budgets and resourcing should be considered carefully to mitigate this risk.
Nominal fee plus deployment bonus	A nominal annual management fee to ensure the fund manager at least breaks even annually, with a deployment bonus paid on closing an agreed number of transactions or quantum of capital each year. Effectively, this should incentivise fund managers to accelerate deployment over the commitment period versus dragging the commitment period out to earn management fees for longer. The mitigation for completing deals quickly without due care and consideration is the risk to the fund manager's share of excess profits if bad deals are selected during the commitment period. The nominal management fee should be to cover operating costs, excluding any bonuses paid to senior staff and partners, with the deployment bonus available to be used to pay discretionary bonuses to these staff members on an annual basis.	Incentivises accelerated deployment of invested capital alongside fund costs and management fees, potentially reducing the J-curve impact sooner for investors.	Incentivising deployment may encourage reckless behavior by the manager to generate deployment bonuses. However, this is somewhat mitigated through limiting the overall fee to 2% over the commitment period and also the strong alignment that performance fees provide.
Alternative funding options	The fund manager may draw management fees at their discretion up to annual caps, in order to generate a marginal profit annually over the commitment period. The manager would also have the ability to draw retrospectively to catchup fees at its discretion up to a cap of 2% of commitments for the full commitment period. This may require access to alternative cheaper funding (than the targeted return of the fund) or other income sources, or the fund manager carefully managing its operating costs over the commitment period. Keeping fees down can help the fund manager to achieve the fund hurdle more quickly, as any fees drawn also need to achieve the hurdle before the fund reaches carry.	Only works where the manager can source alternative funding or other sources of income and should be beneficial to investors and the fund manager over the longer term of the fund. This type of arrangement places greater focus on carry and can help to align interests between manager and investors.	Alternative funding sources to make up for lower management fees may distract the manager from its responsibilities to the fund. This is partly mitigated by the additional alignment from the performance fee (carry).

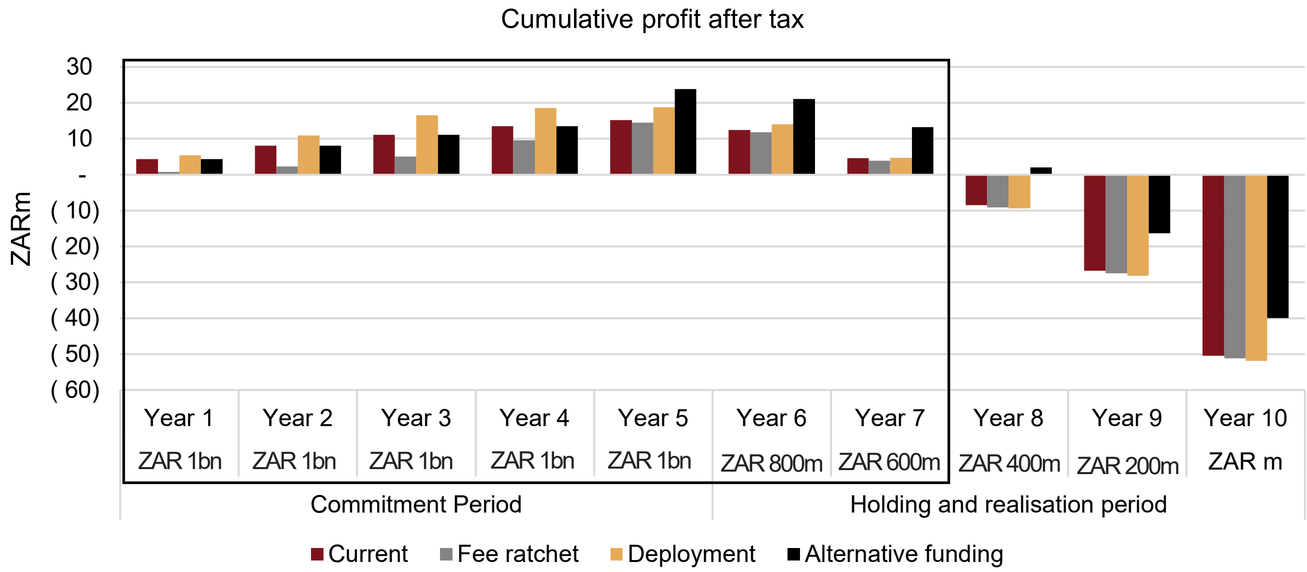
All these suggested alternatives have the added benefit of marginally reducing the drag on fund returns and the fund manager's ability to share in any excess profits above the targeted preferred return earlier than under the standard model.

Quicker deployment reduces drag of management fees and fund costs on returns

Comparative analysis

The charts below illustrate the fund manager's cumulative revenue and cumulative profit after tax (assuming no change in cost assumptions across scenarios) over a typical 10 year fund term under the current fee model and alternative models introduced here for a R1bn fund size.





Over the early part of the commitment period under the fee ratchet and alternative funding scenarios, the cumulative revenue and profit after tax are lower than the current fee model, but at the end of the fund term are broadly similar on a revenue and profit after tax basis with the current model. The benefit comes through in reducing the extent of the J-curve and drag on the fund's expected returns as lower fees are incurred while the fund manager ramps up its investment activity and deployment on investments.

The management fees in the deployment bonus model are slightly higher than the current model in the early part of the commitment period, but encourages the manager to deploy its strategy quickly. Assuming the investments made perform in line with expectations and grow at a reasonable rate, the speed of deployment should mitigate for the marginally higher management fees paid. This reduces the drag that management fees and fund costs have on returns to investors in the short to medium term of the fund life. This may also mean earlier exits as a result of the accelerated deployment and quicker path to realisation of performance fees.

In all scenarios, total revenue generated by the manager (total fees paid by investors) by the end of the fund term is similar across each fee structure. However, the impact on returns and alignment with investors is different with each one.

Performance fees

Highlights

1. Carry (performance fees) is the real commercial incentive for private equity managers.
2. The 100% catch-up model and no catch-up models do not create sufficient alignment to cater for a range of possible outcomes.

Performance fees (also called carry or profit share) are the real commercial incentive for private equity managers as significant performance fees can be earned on realisation of investments at targeted gross returns.

Allocators are familiar with the 20% share of profits convention, but in effect this results in 25-30% of excess profits above the targeted preferred return (or hurdle) accruing to the manager under most scenarios. One of the key drivers of this distortion is the allowance of a pure 100% catch-up phase in the distribution of proceeds. Put simply, a 100% catch-up means that all distributions of the fund above the hurdle are paid to the fund manager until the fund manager has received 20% of all the returns. This means that performance fees are effectively paid on total profits and not excess profits realised above a preferred return to investors (albeit that the timing of payment is altered by the hurdle).

Fund managers would argue that 100% catch-up drives alignment with investors where the fund is not performing by incentivizing the manager strongly to at least reach the hurdle rate. Our view is that although it does create some alignment between investors and fund managers in poor performing scenarios, it does not create general alignment across a range of scenarios. In fact, in some instances we believe it encourages the manager to aim lower to have more certainty of achieving the catch-up carry rather than reaching for the actual target returns of the fund. The 100% catch-up in particular can easily result in a relatively large carry payout to the manager where the investors do not regard the outcome as a success.

Were you to exclude the catch-up and only allow for 20% share in excess profits above the hurdle, this would reduce the fund manager's overall performance fee dramatically in low return scenarios, but tend towards the 20% in high return scenarios.

Performance fees example

To illustrate the difference in the above carry scenarios, we have assumed the following fund conditions:

- Fund size – R1bn (typical target of most emerging managers)
- Targeted gross return – 20% achieved
- Preferred return (hurdle) to investors – 10%

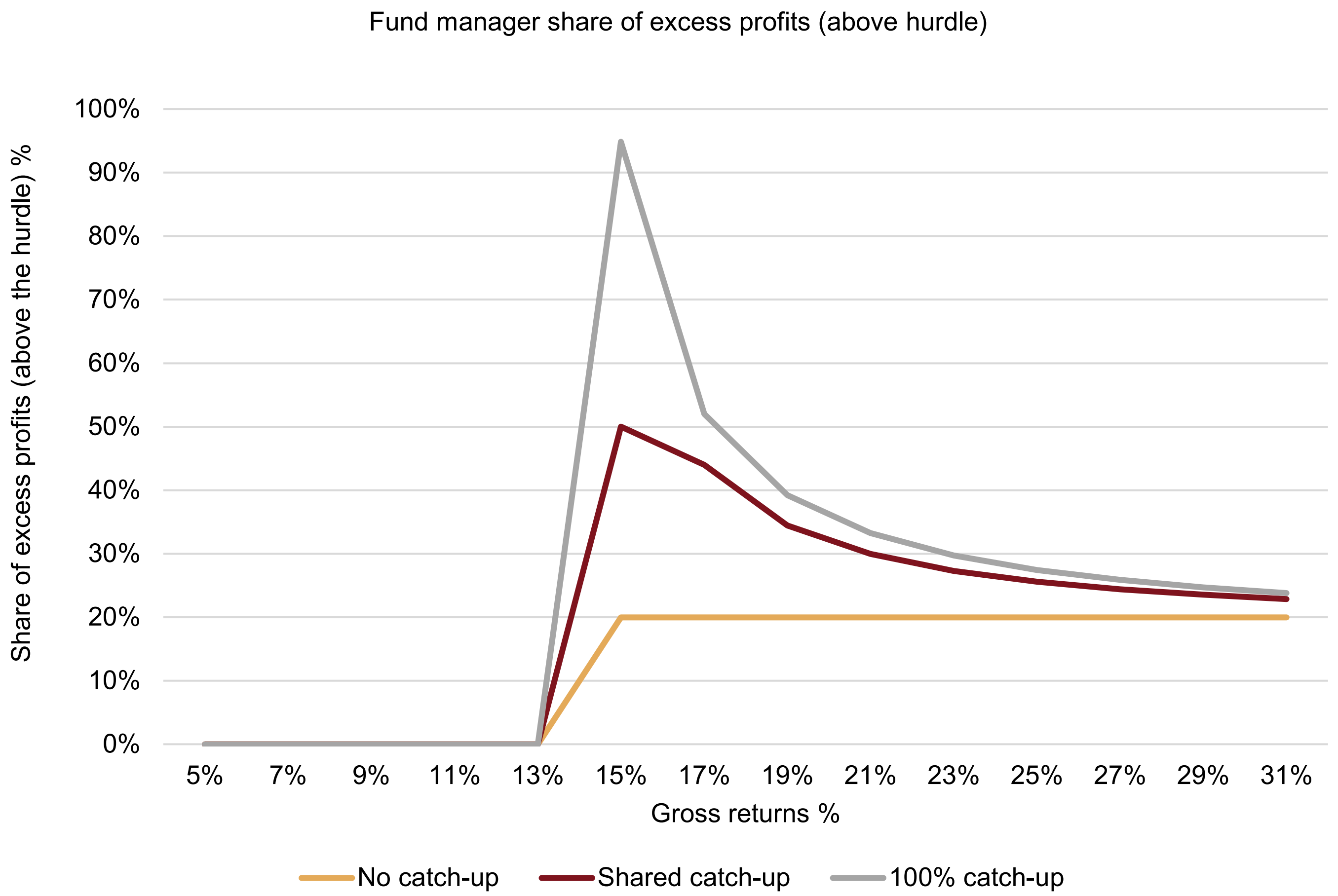
The key differences in outcomes for investors and managers are set out below:

	100% catch-up	No catch-up	Variance
Manager	Carry of R200m (R100m earned on achieving c.15% gross return due to catch-up)	Carry of R100m (only shares in excess profits above the hurdle)	R100m
Investor	Net return of 15% (Net return of 10% where the fund achieves a gross return of c.15%)	Net return of 16%	1% variance
Split of profits	65% investors / 35% manager above the hurdle and disproportionately skewed in favour of the manager (GP) as the gross return reduces	80% investors / 20% manager above the hurdle at all times	15% variance

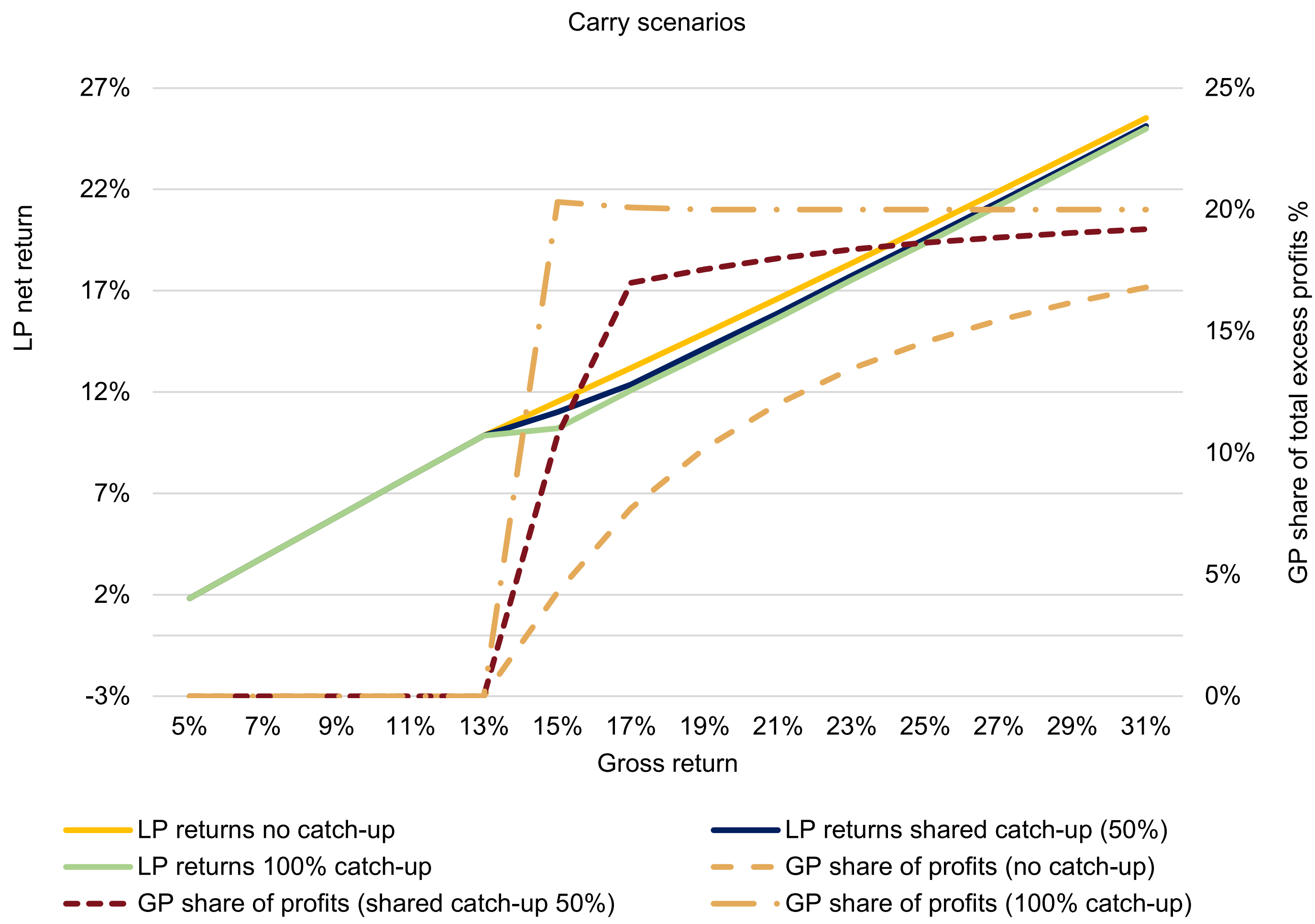
We note that the ILPA has recommended that to mitigate investor risks and to foster greater alignment, fund managers should ideally utilize a "hard hurdle" whereby the fund manager's performance fee is only based on the portion of profits that exceed the investor's preferred return, effectively meaning no catch-up.

Our view is that some allowance for catch-up may be provided for in certain instances (for instance emerging managers) to align manager and investor interests across all return scenarios. Rather than all distributions flowing to the manager in the catch-up stage, a proportional share of catch-up phase distributions going to investors and fund managers would create better alignment.

The chart below highlights the above differences between 100% catch-up, no catch-up and what we term "shared" catch-up and the manager's percentage share of excess profits above the preferred return.



Scenario	100% catch-up
100% catch-up	Under this scenario, the fund manager would receive all excess profits from when the preferred return is achieved to 15% gross returns, effectively almost 100% of excess profits, reducing to around 25% as target gross returns above 25% are achieved.
No catch-up	Under the no catch-up scenario the fund manager's share of any excess profits is maintained at 20% after the hurdle is achieved at every level of gross return.
Shared catch-up	Under the shared catch-up scenario the manager's share of excess profits would be a maximum of 50% immediately after hurdle is achieved, reducing to 20% as targeted gross returns are achieved for the fund.



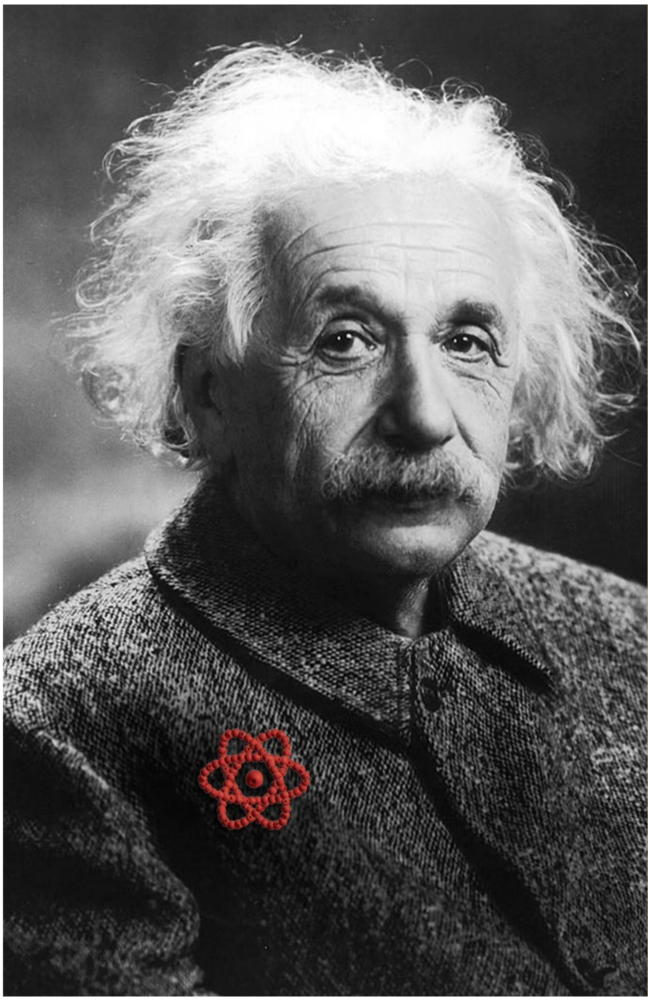
The chart above illustrates the returns achieved by investors versus the fund manager's share of total profits under various catch-up scenarios. Under the no catch-up scenario, investors have a more linear share of net returns, whereas under the 100% catch-up scenario investor returns are capped at the preferred return between 12-15% until the fund manager receives its full catch-up performance fee. The shared catch-up scenario is more muted between 12 and 15% for investors, but at the same time providing the manager with some early catch-up of performance fees, thus in our view creating better alignment.

Conclusion

Like with everything in the world, things change and we believe it is time for the private markets industry to make some changes to how it addresses the needs of investors, starting with commercial terms. The current vanilla "2 and 20" model is an impediment to investment, evidenced by the lack of independent funds closing over the last three years and general low uptake from institutional investors. The onus is on the industry to lead with the change required.

The levers available to fund managers set out in this note still allow for meaningful rewards for fund managers where they are successful, while attempting to bridge some of the most common areas of perceived misalignment between investors and fund managers.

For further information on the 27four Private Markets team and how we can assist investors with evaluating the market please contact privatemarkets@27four.com



Recently published:

All the pieces matter
Private markets fundraising

Look out for our thought leadership pieces on:

Returns
The gross to net IRR conversion conundrum

Reporting
What matters to investors?

Originating pipeline and demonstrating track record
Convincing investors

Team matters
Building team diversity

Black Business Growth Fund®

Disclaimer:

This document is for information purposes only and is not intended to be a recommendation, offer or invitation to take up securities or other financial products. The information contained in this document is general and objective information only and is not intended to constitute a securities recommendation and should not be construed as constituting any form of investment advice or recommendation, guidance or proposal of a financial nature in respect of any investment in the fund or any transaction in relation to the fund. This document does not take into account the investment objectives, financial situation and particular needs of an investor. Past performance is not indicative of future returns. Errors and omissions excluded.

27four Investment Managers (Pty) Ltd is an authorised financial service provider with license number 31045.