ALL THE PIECES MATTER

Private market returns:

Gross to net to net-net.

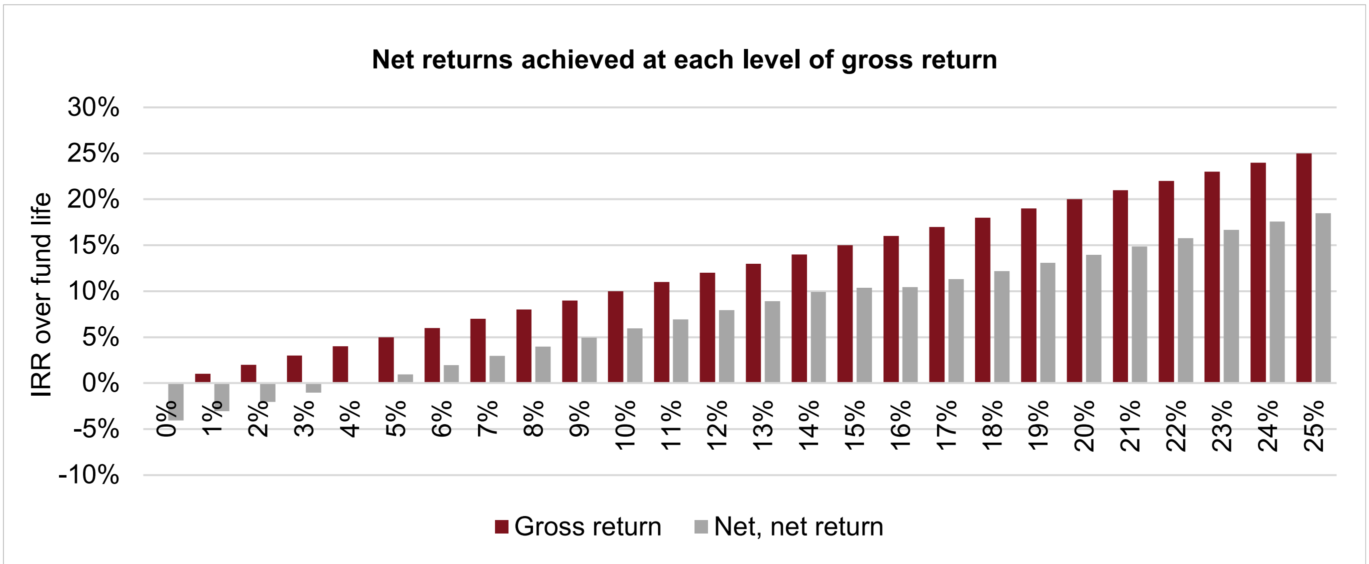
October 2021

Black Business Growth Fund®

> "That's like a forty degree day. Ain't nobody got nothin' to say about a forty degree day. Fifty? Bring a smile to your face. Sixty? S**t, people are damn near barbecuing out that motha*****. Go down to twenty? People get they b****h on, get their blood complainin' But forty? Nobody give a f*** about forty, nobody remember forty, and ya'll is giving me way too many forty degree days...."
>
> - STRINGER BELL, THE WIRE S03E03

Why do institutions invest in private markets?

Institutions invest in private markets primarily on the promise of alpha, a return premium as a payment for sacrificing their option for liquidity. These high return targets are what attract Limited Partners (LPs) to look outside of traditional investments, but in the conversations between General Partners (GPs) and potential LPs about returns, a disproportionate amount of time is spent on gross returns and very little on net returns. In fact, in many instances when we ask fund managers what net returns we can expect at different levels of gross return, the answers are variations on: "we'll get back to you". This indicates a lack of focus on the end product being sold to investors (the net, net return) and too much on the ego boosting but ultimately less important gross return.



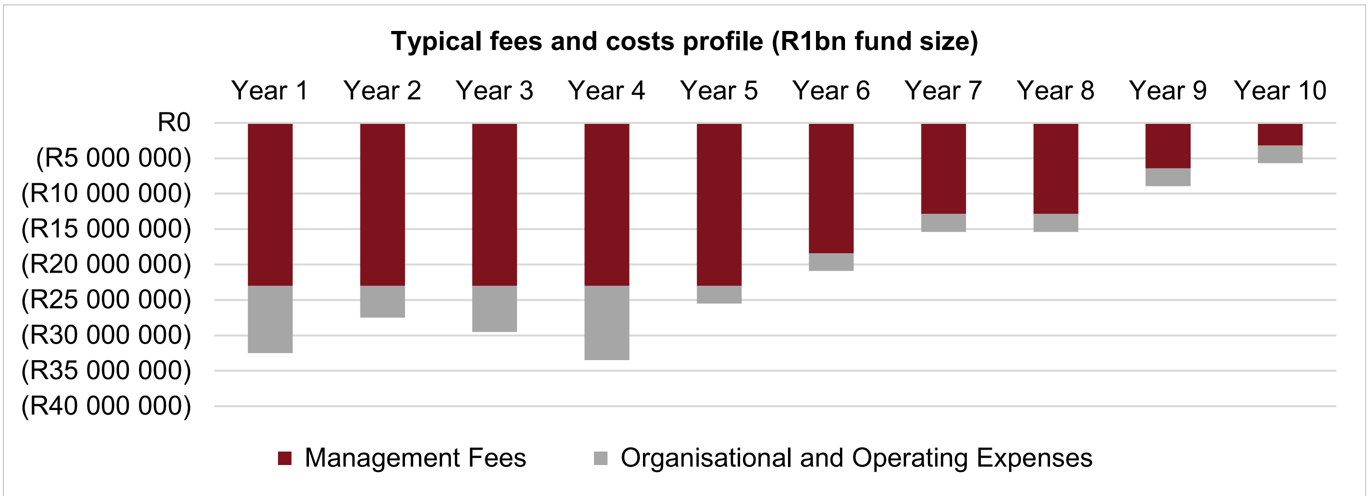
In many other asset classes this may be somewhat of an academic debate, but given the costs involved in private markets investing, the differential between gross investment returns on portfolio investments can be very wide. In most independent private equity funds the gross to net differential over the full life of a fund is somewhere between 5-10% as a reduction of gross investment returns. This means that unless the gross to net conversion is well understood and planned around, investors will land up with Stringer Bell's forty degree days and wondering what happened to the sixty degree day they were promised pre investment. This is particularly true in the low growth environment experienced for several years in South Africa, which has led to low gross and net returns.

When it comes to fees and costs, it must be noted that not all private markets asset classes are created equal. While this note primarily focuses on private equity, the gross to net conversion differs significantly by sub asset class. As a rule, the more bespoke and difficult to implement the strategy is, the more expensive it is. For example, a private equity strategy in a market where deal flow is difficult or requires significant resources to execute will have a significantly greater gross to net loss than a strategy to invest in syndicated bank debt.

While we understand the reasons for this, we believe there is too little focus by GPs and LPs on the gross to net conversion and a high level of tolerance for fund costs. We find that private equity fund managers will spend large amounts of time structuring their deals to cater for risks and performance outcomes, but very little time working out how to narrow the gross to net conversion. This is strange as it is certainly in the fund manager's interests to do so, in that minimising this drag helps the manager to get to carry.

Why is PE so expensive?

There are many reasons why private equity funds are expensive to run, including bespoke structuring of fund and deals, high legal and due diligence costs and above all, high costs to employ experienced teams leading to high management fees. There are smaller costs too, including independent investment committee members, audits and scrip counts and independent valuations. Like in all things private markets, ALL THE PIECES MATTER and controlling these costs is no exception.

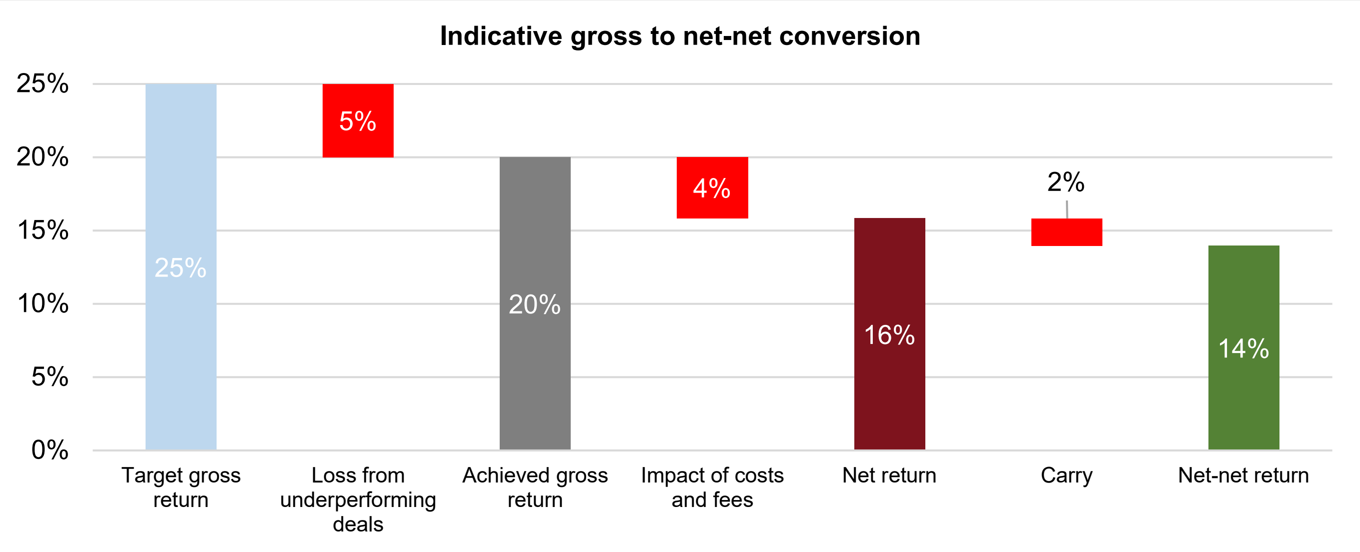


In trying to understand the impact of these costs, the quoted numbers can be misleading. For example, management fees are most often based on committed capital rather than invested capital which is more common in other asset classes. The result of this is to turn a 2% management fee into a return drag of over 3.25% even on a relatively speedy deployment cycle of 4 years. Similarly, annual fund operating expenses of 0.25% on commitments become a drag of almost 0.5% on annual returns, worse if there are more costs incurred earlier in the fund life.

Another example is fund setup costs, where a common cap is 0.5% to 1%. If this full cap is used this will result in a drag of close to 0.2% on annualised returns over the life of the fund.

Gross, net and nett (net-net)

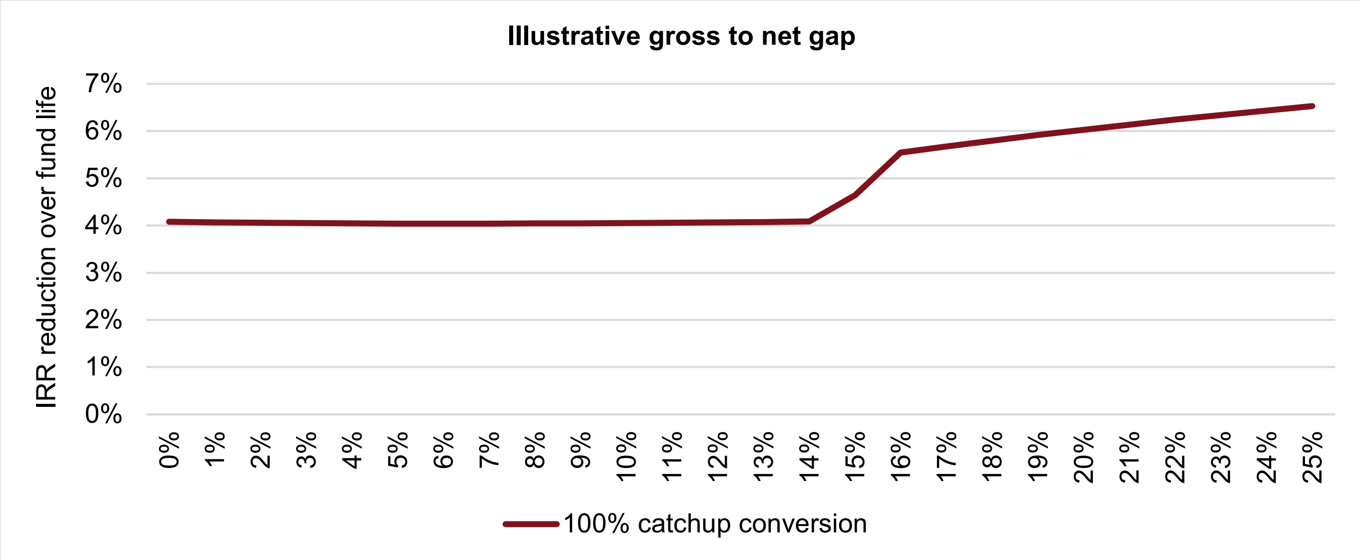
In South Africa most private equity fund managers target 25% as a gross return. This means that when considering potential investment, the manager will only approve deals that can realistically achieve this gross return target. When this is done across a portfolio of deals, the expectation is that the majority of deals will perform and that a minority will underperform. This combination of performance on the investment portfolio may mean that the actual gross portfolio return could be lower than the gross return target, for example, 20%.



All of the costs involved with running the fund such as management fees, organisational expenses and operational expenses will then reduce this gross return, to a net return. The carry attributable to the GP must also come out of this net return to get to the net-net (or nett) return which is actually attributable to investors, and therefore the only one that really matters.

The impact of these costs also depends heavily on the deployment rate of the capital into investments. The example shown above assumes consistent deployment over a four year period up to 80% of commitments, i.e. 20% of commitments invested into deals each year for four years. Shifting this deployment later in the investment period can reduce net returns between 0.5-1% annually over the fund life.

All in all, fees and costs typically consume 15-20% of capital committed over the life of a fund. The illustrative example below is based on a R1 billion fund with a 2% management fee (plus VAT). It further assumes a four year deployment cycle, organisational costs of 0.5%, annual running costs of 0.25%, deal costs of 2% of transaction values, 10% hurdle with a full GP catch-up. In this simplistic scenario, gross returns are dragged down by just over 4% before any carry. Gross returns must reach around 14% before the 10% hurdle is reached resulting in carry. The effect of the catchup is dramatic in widening the gross to net conversion, and by the time gross returns reach 16%, the gap has widened by a further 1.5% after this, based on an 80:20 carry split, the gap continues to widen, but at a slower rate. At the point where the fund reaches planned gross returns of 25%, the gap reaches 6.5%, meaning a net return of 18.5% for investors. It must be noted that this is a fairly conservative scenario and that costs can run higher, particularly in smaller funds.



What can be done to improve the conversion?

It is clear that managing the economics of the fund can make a significant difference to the outcomes for both LPs and GPs as greater efficiency improves the economics of both. So what can be done and where can the biggest gains be made?

Reduce/defer fees

Easily the largest single factor in the gross to net conversion is management fees. Reducing or deferring actual fees drawn from investors can have a significant impact on the drag caused by fees. Some of the ways this can be done are:

- Use of a fund finance facility to provide liquidity to pay management fees. This allows the fund to draw fees from a bank at an interest rate well below most fund hurdles. This defers or in some cases avoids having to draw from LPs for fees, and therefore deferring the start of the IRR clock on such draws.
- Use sculpted or stepped fees to keep initial fees lower. This promotes efficiency as in most cases this will better match fees to manager expenses. Please see more on this in our other paper: www.27four.com/privatemarkets/allthepiecesmatter
- Use offsets/creditable fees from portfolio companies to settle management fees rather than draw from investors. This is done to a much greater extent globally than in South Africa, and in many instances can significantly reduce actual fees drawn to the extent that in developed markets effective fees are closer to 1%.

Reduce fund costs

There are certain fund operating costs that are difficult to do anything about, such as audit costs and investment committee costs. However, there are some areas which can be addressed:

- In some instances, fund setup costs can be better contained through better co-ordination of LP processes and understanding key LP concerns prior to legal drafting. Agreeing upfront the key commercial terms should greatly reduce legal costs.
- Wherever possible, due diligence costs should be pushed into portfolio companies as part of the funding package.

Accelerate deployment

Fees based on committed rather than deployed capital cause a significant drag on returns, since the effective percentage of actual invested capital is significantly higher than the percentage quoted. The way to minimise this drag is to deploy capital quickly in order to better match the fee level to invested capital for a longer period, by starting the capital working to offset fees earlier. Clearly there is a balance to this, and we are not advocating reckless deployment. However, speed of deployment is a legitimate consideration in the delivery of improved net returns. As GPs, having pipeline opportunities that can be executed on in a relative short timeframe after first close can help reduce the drag on returns from fees and costs.

Restructure carry

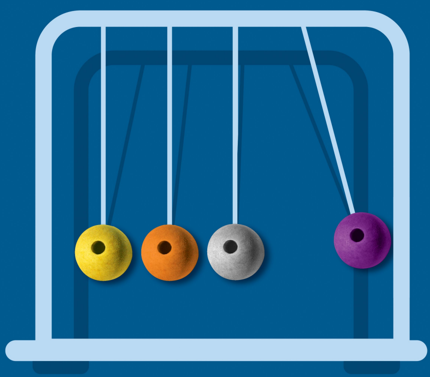
We have written previously about the benefits to alignment of LP and GP through using shared catchup (www.27four.com/privatemarkets/allthepiecesmatter). We won't restate the argument here but note that a shared catchup provides significantly better net outcomes for LPs in scenarios where gross returns are above the fund hurdle, but insufficient to offset a 100% GP catchup. Use of a full catchup is a major detractor from net returns, and our view is that it will only be retained where fund managers are consistently proving their ability to deliver the highest gross returns. For everyone else the market is shifting to promote stronger alignment.

Recycling of capital

Recycling of capital is another way to reduce fee drag, as in effect it allows a greater amount of capital to be used without adding fees. Depending how it is used it can also up the percentage of committed capital actually used for investments versus that percentage used to settle fees and costs. This creates a broader base over which costs can be spread and reduces the gross to net conversion loss. For example, recycling 20% of fund capital effectively allows 100% of commitments to be used for investments and dilutes a quoted 2% fee to 1.67%, tightening the gross to net conversion.

Conclusion

To sum up, we believe that LPs will continue to focus more on the gross to net conversation to ensure their fund managers are doing all they can to deliver full value from the gross returns they generate on investments. We would urge GPs to spend more time on this issue and apply their skills to minimising this gap for their own benefit as much as that of their LPs. In the end it is the net return which LPs will compare to what they can get from other asset classes, and it must make sense, with a margin of safety for risk and illiquidity, to choose private markets investments as a valuable part of an overall portfolio. LPs will not continue to invest if they keep getting "forty degree days" as a net return.



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

ALL THE PIECES MATTER

More research papers in this series

Recently published:

- **All the pieces matter**
- **Improving commercial terms**

Look out for our thought leadership pieces on:

- Reporting: What matters to investors?
- Originating pipeline and demonstrating track record: Convincing investors
- Team matters: Building team diversity

WE LIVE INVESTMENTS™

www.27four.com info@27four.com @27four +27 11 442 2464

27four Investment Managers