

FEES AND COSTS

The new reality of fees and expenses

Over the past year, private equity firms, their advisors and their LPs have closely scrutinised the treatment of fees and costs at the fund level. As the SEC continues to investigate GPs and their handling of expenses, all parties involved are seeking best practices on terms, disclosure and transparency. Gen II Fund Services brought together some experts to review a few of the current issues facing our industry



Millner: the costs of running a fund have gone up

THERE IS ROOM FOR NEGOTIATION ON DEAL FEES (BUT NOT MUCH)

“The pendulum on fund terms and conditions has swung wildly over the 25 years we have been working with private equity funds. And lately, on fund expenses and deal-related fees, it has shifted toward LPs”, notes Steven Millner, a managing principal at Gen II Fund Services.

“There’s a well-defined set of fees that GPs can charge to generate ancillary income,” says Raed Elkhatib, head of due diligence at Credit Suisse Private Fund Group. “These include transaction fees, monitoring fees, and they’re offset against management fees. Years ago the offset was undefined and an important source of income for general partners. But it moved to a 50-50 offset eight to 10 years ago, then 80 percent. Today, most commonly, it’s a 100 percent offset.”

There is still space for GPs to negotiate. They may be able to arrange an exception to the prevailing 100 percent offset if they can demonstrate a level of performance that supports a lower rate. Such arrangements are particularly important to small funds, where fees are still a vital source of revenue to support the investment programme. “For smaller funds and even some midsize funds, it’s a pretty significant source of income,” says Robert Blaustein, a partner at law firm Kirkland & Ellis LLP. “As pressure mounts on fees or delays arise in the waterfall distributions, this real-time income is really helpful to sponsors in competing for talent.”

But exceptions to the 100 percent rule are now uncommon. Gen II recently surveyed two dozen of its clients raising money and found a similar approach across GPs. “Nearly all of the recent funds we’ve seen start off with a 100 percent offset. It’s not even a negotiating point for many funds now,” notes Millner.

MEANWHILE, OPERATING EXPENSES AT FIRMS ARE INCREASING

GPs are seeing the business of their business change rapidly. Their ability to earn fees is getting squeezed by the market, while inside the office their operating expenses are steadily rising.

“Post-regulation, once private equity firms needed to register with the SEC, the costs associated with running a private equity fund have gone up,” says Millner. “They increased because of higher legal expenses, compliance costs, the costs of dealing with cybersecurity, and greater LP due diligence during fundraising.”

The cost of delivering this information adds up. “Costs certainly have ballooned over time,” Blaustein says, adding that the resources devoted to the improvement of portfolio companies have never been more important or costly. “There is also a greater expectation from limited partners that GPs do more to add value. The days of leverage driving returns are long past us. So there are now larger teams that drive up the cost of running a partnership.”

GPs are seeking ways to rationalise their operating models as the firm grows, because the firm’s infrastructure doesn’t scale well as larger and larger funds are raised. As a result, nearly every growing GP now reaches an inflexion point with the next fund, and that inflexion point demands a hard look at operations and potentially engaging with a third party administrator to handle core operational tasks.

THE PRESSURE TO ADD VALUE IS INFLUENCING FEE-STRUCTURE ARRANGEMENTS

Adding value isn’t cheap. There is the price of attracting management talent, the growing operational infrastructure – and a lot

of PE firms are finding it a challenge to locate the revenue necessary to pay for it all.

Then, piled on top, there are the increasing costs of regulation. Firms have always had CFOs. Now they have a chief compliance officer and a compliance consultant. They work more closely with their law firms. A Gen II survey shows that, where many firms once capped organisational costs at \$1 million, they've now pushed it up to \$1.5 million and even \$2 million – and they're breaching their caps more often than ever.

“And then LPs want to know what you're bringing to the table to create value, in terms of an operating team,” Millner says. “How do you create value beyond financial engineering? That adds a whole new set of costs into the mix. And ultimately someone is going to have to pay for it.”

These pressures are putting a strain on private equity firm budgets, and the consequence is often more intensive negotiation of fees. “What we see more and more in LP documents is a lot more specificity regarding this fee paradigm, about what's included and what's excluded,” Millner says. “Where is there an offset, as opposed to where is there not an offset?”

 **... is your fund optimised for transparency, disclosure and accuracy in a manner that the SEC will approve?**

LPs recognise the importance of value-add services, and they appreciate the fact that costs are rising. But a firm can help its case for more fees if they do a better job of illustrating cost and value-add effect.

“The more direct the link that fund managers can identify, the better,” Elkhatib says. “Here is the cost, and here is the associated value. That's critical going forward. There is a cost to all these services to generate outsized returns in what's becoming a more mature, more competitive market. Let's make a more direct link.”

SO WHAT DOES THE SEC WANT?

The SEC is fiercely pursuing a higher degree of disclosure and transparency in all aspects of private equity. In addition through recent news releases, the SEC has expressed their concern about cybersecurity. How is a firm protecting client data and is there intrusion testing performed regularly? Does the firm's insurance policy and the administrator's insurance policy have adequate coverage for cybersecurity breaches? This will undoubtedly be a component of the next round of presence exams.

The private equity community will continue to learn to work with the SEC and to see them as an enabler of operational best practices. But it will take some time. The SEC has shown its affinity for the hedge fund model of third party administration as a way to effectively oversee fund activity, including transparency on fees and expenses. And accordingly, the hedge fund community outsources operations almost universally to third party administrators. Private equity firms are starting to understand and recognise the value and importance of best-in-class recordkeeping and transparency so that all constituents can easily comprehend fund activity. As evidence of this greater level of focus on quality recordkeeping, industry statistics are reflecting a greater adoption of the third party administrator model than ever before.

For first time funds, the choice is clear – engage with an administrator well before the first close. And for existing GPs, the next fund is a prime opportunity to re-evaluate your operational infrastructure: is your fund optimised for transparency, disclosure and accuracy in a manner that the SEC would approve? ■

HOW IS YOUR CYBERSECURITY COVERAGE?

The SEC recently released an update covering cybersecurity and reiterating the importance of the issue for investment advisors. Among the suggestions are that firms should conduct a periodic assessment of the nature and sensitivity of the information collected by the firm, and the processes used to store, control and protect that information. An effective strategy includes identifying

potential threats and mitigating risk as much as possible. The SEC also suggests strong data encryption and strict control to the access of data by firm employees. With the SEC's continued intense focus on this issue, it's imperative that private funds evaluate their cybersecurity coverage and ensure that their fund administrator has adequate insurance policies in place. ■

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