

PE/VC Partnership Agreements Study 2010-2011

First Edition

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PREFACE

When it comes to partnership terms and conditions, private equity firms have had it very good for a very long time. In coming months we suspect they're going to have it a little less good, thanks to both the tight fundraising market and a community of investors that's increasingly vocal and like-minded.

Just how good have private equity firms had it? Consider a hypothetical 10-person firm that raises a debut \$500 million buyout fund on what have been fairly standard terms. Through the five-year investment period, the firm collects a 2 percent management fee, or \$10 million a year. That's easily enough to make millionaires of several of the partners during the first five years. On top of that, the partners get to keep 20 percent of any fees they charge their portfolio companies—success fees, investment banking fees, consulting fees. That could easily add up to hundreds of thousands of dollars more. And that's before the partners get their 20 percent of the profits on their investments.

But surely the investors have insisted on getting all their invested capital back before the partners get to share in the profits, right? Actually, no: The partners only have to return a portion of invested capital, even if that means eventually having to return some excess profits to investors. But the partners have put most of their net worths at risk, right? Well, not really: They agreed to a fairly standard 1 percent GP contribution and funded a good chunk of it with deferred management fees. But the private equity firm must then bear the cost of broken-deal expenses, annual meetings, and reverse break-up fees? No, no, no. Those costs are borne by the fund. But at least the investors can remove the general partner if the members commit securities fraud, right? Of course, just so long as they've been convicted, and there is no possibility of appeal.

We could go on and on and on. Just why investors have been so toothless over the years has been the subject of much debate. Some investors clearly worry that having a reputation as a stickler at the negotiating table could be the kiss of death: General partners simply won't allow them to invest in their funds. In most partnership negotiations, the power on one side of the table is concentrated in the hands of the desirable general partner; on the other side it is dispersed among dozens, if not hundreds, of prospective investors. Only in rare instances have individual limited partners felt strong enough to try to call the shots.

To be sure, small investors can theoretically team up with one another to hold out for better terms. But that's been made difficult in many cases by the short time frames private equity firms have given them to decide, and by the difficulty of finding out who is or isn't considering an investment in a fund. Investors also worry that presenting a united front on terms could be viewed by the U.S. Justice Department as collusion.

Investors have yet to completely overcome these fundamental disadvantages at the negotiating table. Still, they've never had so much power to shape partnership negotiations, nor motivation to use it. As a group institutional investors have far less capital to commit to private equity funds than they did two or three years ago. Those still flush with money recognize they're far more important to cash-starved general partners than they were before. More than 200 have also joined the Institutional Limited Partners Association (ILPA), which provides numerous opportunities each

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year to get together and discuss issues like partnership terms and conditions. More significantly, ILPA in the late summer of 2009 published a set of private equity preferred terms that, were they adopted, would produce partnership agreements of unprecedented friendliness to limited partners (see p.97).

Among the terms on the wish list: return-all-capital distribution waterfalls, joint-and-several liability for GP clawback obligations, 100-percent transaction fee offsets and no-fault divorce clauses that provide for either the removal of the general partner or dissolution of the fund upon a two-thirds vote of the limited partners. At press time, more than 50 institutional investors had endorsed the principles, including the influential California Public Employees' Retirement System.

Will institutional investors get everything they want on the ILPA wish list? No general partner worth investing with would even come close to total capitulation. Then again, general partners will be listening, and no doubt giving ground on many terms they previously considered sacrosanct. Indeed, throughout this study the authors, based on expert advice from our advisory board, note where investors are likely to run into resistance on their wish list, and where they're likely to make progress.

The bottom line is that the next edition of this study is likely to find partnership terms far more limited-partner-friendly than they have been over the last four years.

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