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# PE/VC Partnership Agreements Study 2012-2013

From the Editors of

**Buyouts** and **vcj**

Second Edition

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by Austin M. Long III	

### PREFACE

When it comes to partnership terms and conditions, private equity firms had it very good for a very long time. Over the last two years they had 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 worth 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 100s, 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 give 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 four or five years ago. Those still flush with money recognize they're far more important to cash-starved general partners than they were before. Some 250 have also joined the Institutional Limited Partners Association, which provides numerous opportunities each year to get together and discuss best practices relating to 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. ILPA subsequently issued a revision, with some minor changes, in January 2011.

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 some 240 organizations had endorsed the principles, including the influential California Public Employees' Retirement System.

Are institutional investors getting 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 are listening, and this version of our study finds, for example, that nearly one in five North American venture funds promotes their fund terms as ILPA-compliant. 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.

### Recycling Provisions

During the recent financial crisis, and the economic tumult that caused it, many institutional investors had trouble meeting their capital calls. Some investors called their general partners to encourage them to go easy on new investments. Some asked their general partners when they might expect to receive their next distribution, a development that would make it easier to meet their future capital calls.

Such are the vagaries of economic cycles. In fact, most of the time investors prefer that their general partners get as much of their committed capital to work as possible. They may even see a downside to the quick flip that returns oodles of money, but then leaves them with the thorny problem of how to rede-

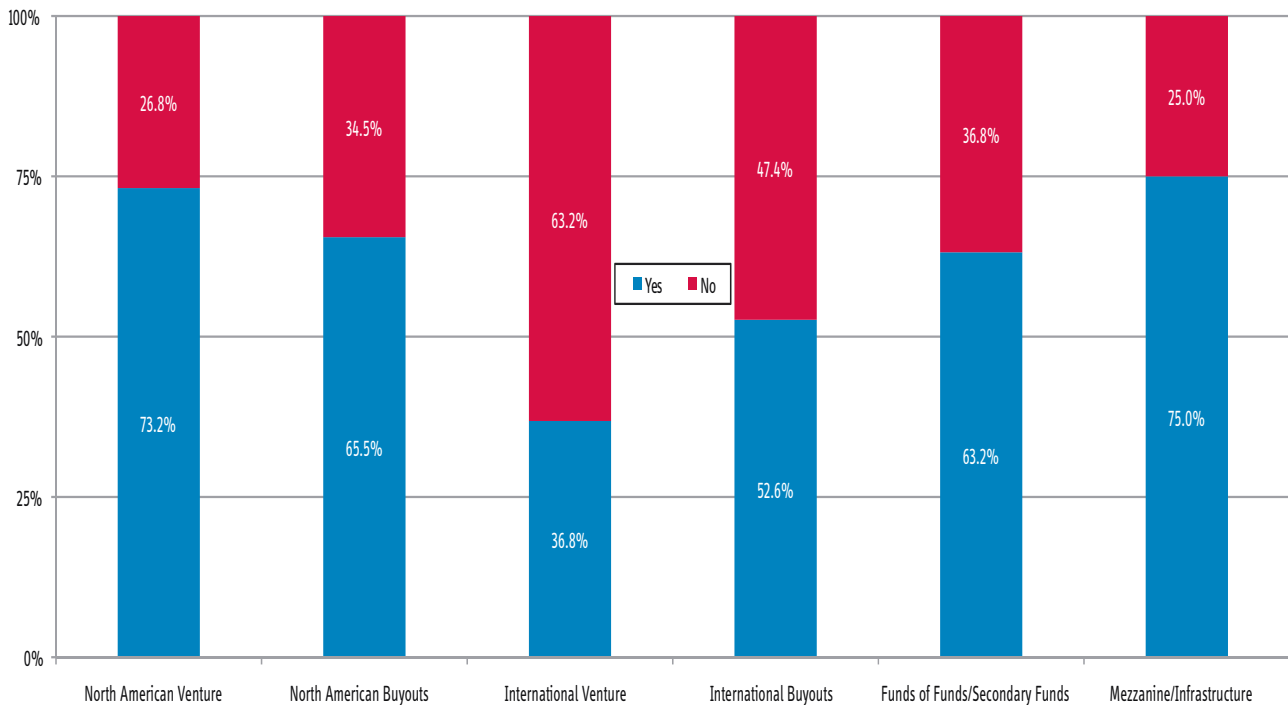
ploy it as effectively. Recycling provisions help solve this problem by letting the general partner take proceeds from an investment that's been realized and deploy them in new investments, rather than distributing the proceeds to investors, or reserving them for fund expenses.

Recycling provisions are popular with limited partners for other reasons as well. Since their management fees are based on committed capital, limited partners in effect get a discounted rate on investments made with recycled distributions. Recycling provisions can also come in handy during bear markets when limited partners find themselves hard-pressed to meet capital calls for new investments.

For their part, general partners like recycling provisions, since they can earn carried interest on the

**Chart 2.7 Does the GP have re-investment, or recycling rights?**

Total Sample = 154, including 41 North American Venture, 29 North American Buyouts, 19 International Venture, 38 International Buyouts, 19 Funds of Funds/ Secondary Funds, 8 Mezzanine/Infrastructure



additional investments. It's a way to boost the effective size of a relatively small fund—one reason recycling provisions tend to be especially popular with venture firms. It also reduces the risk that a particular fund will run out of money, which can be harrowing for a venture firm with a clutch of cash-hungry portfolio companies to nurture.

Chart 2.7 shows that more than two-thirds of the North American venture funds in our sample (73.2 percent) and nearly two-thirds of North American buyout funds (65.5 percent) address this issue by granting the general partner at least some ability to re-invest proceeds from prior investments. Such rights appear to be somewhat less common outside of the United States. Many of those funds that do offer co-investment rights place a limit on the amount that

can be re-invested (Chart 2.8). A limit of 100 percent of committed capital is fairly common, as is 115 percent. Placing a limit on the recycling provision acts as a check on the power of the general partner, ensuring that at some reasonable point the general partner will have to come back to market to raise another fund if it wants to continue making fresh investments. Other checks limited partners might negotiate are allowing recycling only during the investment period (defeating their purpose, in the view of some general partners), and limiting recycling to return of capital, rather than allowing the recycling of profits. Chart 2.9 shows that firms with recycling rights often have the ability to re-invest money in deals disposed of within certain period of time. Common time limits are one year, 18 months and two years.

**Chart 2.8 Is there a limit on the amount that can be re-invested?**

Total Sample = 93, including 29 North American Venture, 19 North American Buyouts, 7 International Venture, 20 International Buyouts, 12 Funds of Funds/ Secondary Funds, 6 Mezzanine/Infrastructure

