Alignment of Interest in the Private Equity Industry

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Executive Summary

In 2009 the Institutional Limited Partners Association (ILPA) assembled “The Private Equity Principles” as a positive effort to better align the interests of LPs and GPs. These principles resulted from the way the industry has evolved during the credit crisis and practices that some perceive as reflective of misalignment. Our objective in this document is to develop an economic foundation and a framework to better understand where the interests of GPs and LPs are currently misaligned as well as suggestions to mitigate those misalignments. This allows for an informed and targeted analysis of the ILPA PE principles. Our ultimate goal is to provide LPs with a better understanding of the challenges they face in relation to GPs and in so doing provide them a set of clear objectives as they consider which principles provide the greatest benefits to them.

The analysis in this document supports the following main conclusions:

1. The financial incentive structure between GPs and LPs primarily breaks down when a fund is performing poorly. Accordingly, contractual mechanisms to prevent this break down should take into account the contingent nature of the misalignment.

2. Agency incentive conflicts resulting from activities that generate fee income (deal fees, monitoring fees, consulting fees, etc.) can be an important source of misalignment and contracts should be structured to either avoid or closely monitor them.

3. To preserve the improvements in interest alignment currently underway, the PE market would be served well if it would transition to a clearing mechanism in which top performing GPs are rewarded with increased carried interest. The goal should be to de-emphasize management fees as a compensation channel for the GP and in the best of all worlds it should be reflective of actual costs incurred by the fund. This will avoid undue incentive for GPs to accumulate larger funds just to take advantage of the potential for profit from management fees.

The analysis in this document is qualitative in nature. We are developing models that can more precisely measure the magnitude of misalignment and quantitatively identify observable measures of scenarios when misalignment is at its worst. We expect that such analysis will draw more nuanced and precise conclusions and aid in developing improved contracting mechanisms. We look forward to working with the PE community to further enhance this analysis.
Introduction

Many of the challenges currently facing the PE industry and underlying the concerns of LPs had been building prior to the recent market turbulence. In its earlier stages of development, the PE industry was simpler in that there were far fewer players, commitments were much smaller and GPs were pure private equity providers. Now, the number of players has mushroomed, the commitments are staggering, many major GPs run multiple funds with different strategies with different groups of LPs, and GPs have added to their business model by providing services such as investment banking and consulting. To attain their vast size, several GPs have added significantly to their partner ranks and changed their decision making process accordingly so that the traditional trusting personal relationship between LPs and GPs has been diluted. In addition, some GPs have altered their ownership model by going public. All of these changes were bound to lead to a questioning of the traditional relationship between LPs and GPs.

Specifically, LPs have been concerned with a number of industry trends, including

1. **Fund size.** As the supply and demand dynamics allowed, GPs had been trying to raise ever larger funds. LPs have two concerns. First, because management fees increase proportionally with fund size, while a fund’s operational costs (which management fees are intended to cover) offer economies of scale, the resulting increasing profit from management fees alone will drive GPs to raise as large a fund as possible. Second, LPs question whether there were ever sufficient investment opportunities of the type where PE firms thrive to justify large funds. The concern is that this may not only have caused GPs to expand into strategies and investments that were less profitable, it may also have led to investment strategies that depended on increased risk taking to generate returns.

2. **Leverage.** Most PE investments appropriately involve a degree of leverage. However, until the market correction in 2007, leverage ratios had been steadily increasing to levels that proved ultimately unsustainable. In this context, many LPs have been asking if they were getting anything more than a leveraged S&P500 product. This is important as it puts into question (i) the extent to which GPs were incentivized to over-leverage portfolio companies and thereby add undue risk to take advantage of the one sided nature of their payoffs from carried interest, and (ii) if GPs had been adding value over and beyond leveraging a firm.

3. **Fee income.** Some GPs charge the companies that they acquire fee income rendered to them (e.g. deal fees, monitoring fees and consulting fees). Those fees typically get split between the fund and the GP. Effectively, for the portion of fees captured by the GP, upon the acquisition of a portfolio company and execution of the services, money flows directly from the LP to the GP. LPs have two concerns: (i) GPs may be incentivized to buy companies which generate large services fees and (ii) GPs may be incentivized to charge above market prices for such services. In addition, the drive for fee income can undermine the needed trust between the LPs and their GP.
Underlying many of these concerns are GP incentives. Specifically, GPs autonomously make investment and management decisions on behalf of the partnership. That being said, the GP’s ultimate goal is to maximize their profit from the partnership. How they make profit (and thereby their incentives) are defined by the terms in the LPA. In addition, the LPA sets out any rights LPs have in monitoring or limiting GP activities. So the focus of our analysis is on the terms and conditions set forth in the LPA. This LPA is a pure example of a principal/agent relationship which has been extensively studied by economists. In a principal/agent relationship, principals (LPs) delegate economic decision-making to agents (GPs) and their relationship is governed by a contract (LPA). Against this backdrop, economists have recognized that properly structured LPAs and appropriate monitoring provisions are critical to bringing GP interests as close as possible to alignment with those of the LPs. The key in putting together the optimal LPA (which is where the ILPA PE principles come into play) is to (i) understand the GP’s incentives resulting from a typical current LPA, (ii) put contract and governance structures in place to mitigate conflicts of interest and (iii) ensure that a proper amount of verifiable and reliable information is available to maintain the integrity of the relationship.

In reality, it is almost impossible to have perfectly aligned interests. LPA terms and LP monitoring are limited by their costs of implementation and the impossibility of measuring all dimensions of performance. There is also the risk of excessive LP micromanagement. That being said, there are still significant improvements in incentive alignment, LP protections and monitoring that can be made in an LPA.

Interest Alignment – Financial Conflicts

In this section and the next we will analyze conflicts of interest in the PE industry. It’s helpful to categorize the suspect conflicts of interest into two categories: (1) conflicts that grow directly out of the financial terms of the LPA (“financial conflicts”) and (2) conflicts that grow out of related business activities of the GP (“agency conflicts”) that are currently not controlled by the LPA. In each of these cases the incentives we refer to are short term in nature and actual GP choices are also influenced by long term considerations such as reputation. We will discuss this tradeoff at the end of the next section.

Let’s begin with the financial terms in an LPA. There are three main channels of GP compensation: (1) carried interest, (2) management fees and (3) equity interest. Each of these channels generates unique incentives for GPs and we will start by analyzing them separately. Next we will analyze the incentives of the whole as assembled in a LPA considering which incentives dominate and the impact of their interactions.

We recognize that there are an almost infinite variety of LPAs. However virtually all LPAs contain these three components and vary principally by magnitude and conditions that define the waterfall. All of the variations in waterfall provisions can be viewed as defining the conditions under which GPs begin earning carried interest. In our analyses we will cast carried interest in LPAs as an option on fund cash flows where the waterfall provisions define when the option is in-the-money. In this sense, carried interest exhibits certain qualitative features that are characteristic of options as we will discuss below. As we mentioned earlier, sophisticated
quantitative analyses is required to more precisely understand the contract variations and the resulting quantitative nature of GP incentives. Nonetheless, this qualitative analysis is quite useful in understanding the nature of GP incentives.

1. **Carried Interest.** Carried interest is a form of performance-based equity in which GPs earn a portion of the profits after LPs have been repaid their capital (which includes the management fee) and a “preferred” or “hurdle” return. Since the payout of carried interest occurs only after the hurdle is met and the fact that there is no downside for GPs, carried interest has cash flow characteristics similar to those of a call option.

As with any option, the value to GPs of carried interest is primarily related to a combination of (1) the expected performance of the fund’s investments, (2) the volatility of the underlying asset cash flows, (3) the time to expiration of the fund, (4) the size of the LP’s capital commitment plus hurdle return, and (5) the timing conditions of payout (the waterfall). The incentives generated by carried interest can be deduced by identifying the GP incentives resulting from each of these value components. With the exception of volatility and the expected return on investments, the other components are not directly controlled by the GP and therefore do not impact the investment behavior of the GP. In the case of expected return on investments, the value of carried interest is maximized by GPs choosing investments with the greatest net present value. In this case, the interests of GPs and LPs are aligned. The challenge to incentive alignment is with regard to the volatility of the investment cash flows.

When looked at in isolation, carried interest provides an incentive for GPs to increase the volatility of the portfolio, since they benefit from the upside but face limited downside. This can distort the choices of investments relative to those that would be “optimal” in a risk reward framework. This is a conflict of interest in that it misaligns the risk appetites of the LPs and GPs.

The severity of the misalignment in risk appetite depends on the prospects of the fund. For qualitative purposes, we will highlight three scenarios to demonstrate how the incentive misalignment depends on expected fund performance. We define the scenarios as (i) deep out-of-the-money, (ii) at-the-money and (iii) deep in-the-money. These scenarios are characterized by expected investment performance over the life of the fund where the GP (i) expects to not be able to repay the LPs their capital plus hurdle and not receive carry, (ii) expects to just be able to repay the LPs their capital plus hurdle and not receive carry and (iii) expects to be able to repay the LPs their capital plus hurdle and receive a significant amount of carried interest, respectively. It is important to highlight that these scenarios are based on the GP’s expectations of fund performance and the resulting expected carry distributions.

Like any option, the sensitivity of carried interest to the volatility of the portfolio value is greatest when the fund is expected to barely reach the point where carry is paid (at-the-money scenario). In contrast, the sensitivity of carried interest to volatility is weak in the other two scenarios. To demonstrate, consider first when the fund is expected to perform
well, i.e. the in-the-money scenario. In this case, like any option, carried interest functions like a pure equity interest in the fund and aligns the interests of the GP and LP almost perfectly. Conversely, at the other extreme, when the fund is expected to perform poorly, the out-of-the-money scenario, the chances of the portfolio cash flows reaching a state in which carry is paid are slim. In this scenario, the value of carried interest is very low and there is very little GP incentive derived from carried interest. The key implication of this analysis is that LPs should be most concerned and vigilant with regards to the riskiness of GP investment choices when the expected performance of the fund is close to the at-the-money scenario.

As an aside, the misalignment in risk appetite resulting from carried interest supports LP concerns regarding leverage. Leveraging portfolio companies is a common channel for GPs to increase the volatility of the portfolio and, given the asymmetric payoff of carried interest, leverage clearly benefits the GP more than the LP. However, one cannot use this analysis in isolation to determine the implications of leverage. Leverage also gives GPs access to debt capital that enables them to optimally use scarce equity capital to secure a larger portfolio when there is an abundance of quality investment opportunities. In addition, considering taxes and market conditions, debt can be a much cheaper form of capital than equity and leverage can increase the performance of the fund.

2. Management fees. Management fees serve as a means to fund the ongoing operations of the fund and are typically charged as a percentage of committed or invested funds. Since management fees are unrelated to a fund’s performance, they have little impact on the incentives faced by GPs with regard to the quality of their investment choices. The challenge with management fees is their lack of direct connection to fund costs. In isolation, the presence of management fees creates the incentives for GPs to minimize costs in order to maximize the resulting profit. These incentive effects exist even when management fees are at or below the actual costs. On the other hand, LPs’ interests are served best by a lot of attention and resource commitment to the management of investments. Consequently, the interests of GPs and LPs are completely misaligned with regard to management fees.

As an aside, in addition to the incentives described above, management fees provide an incentive for GPs to raise ever larger funds. This can be clearly demonstrated by the observation that there are significant economies of scale in managing funds. Management expenses have a large fixed component and a relative modest variable component. As funds grow larger, for a fixed management fee (say the standard 2%) the proceeds from management fees grows proportionately while costs do not.

This is very important in understanding the development of the private equity industry historically. As we will discuss below, there are opportunities for altering the GP compensation model going forward so that as the industry recovers, we do not return to an equilibrium in which high quality GPs, incentivized by the profits made off of management fees, largely capitalize on their market power by raising larger funds.
3. **Equity Interest.** Finally, GPs are also expected to make personal investment commitments to funds. This compensation channel by itself aligns the GPs incentives perfectly with those of the LPs. In fact, GP equity investments give them limited partner interests just like their LPs. Sometimes GPs pledge equity in the form of waived management fees. This is especially prevalent for managers who have not accumulated sufficient wealth to be able to invest their own money into the fund. At first glance it would appear that the source of the funds is irrelevant since the resulting equity interest is the same regardless of the source of the funds. However, in practice behavioral finance suggests that the equity interests would be more aligned with LPs if in fact the source of funds came from the personal capital of the GPs. If a GP has insufficient wealth to make such a commitment to equity interest it can be facilitated by a loan to the GP. The bottom line is that GPs should make a meaningful commitment to equity out of their own personal wealth.

Next, we will put the three components together to analyze the resulting incentives. We know that the incentives from carried interest are scenario dependent and we have described three scenarios to illustrate this. It turns out that the interactive effects on the incentives from the three financial terms are also scenario dependent. So in analyzing the incentives when the terms are combined, we will again consider the same three scenarios.

We will take the best case first, that of the in-the-money scenario. As we had shown earlier, carried interest in this case becomes just like pure equity and hence interests are aligned. Next consider the incentive effects of management fees in this scenario. In reality, management fees are a form of paid in capital for LPs. When the fund performs well and carried interest is in the money, all capital (including management fees) has been returned to the LPs and therefore management fees become a non-factor. And finally, the equity interest of GPs always aligns their interests with LPs. So the implication is that in the in-the-money scenario, the financial interests of LPs and GPs are perfectly aligned.

The misalignment of financial interests occurs in the other two scenarios. Consider first, the at-the-money scenario. In this case, the GP is incentivized to take on added risk to increase their expected returns from carried interest. This may be mitigated to some degree by the size of the GP’s equity interest because the GP is exposed to downside risk through that interest. Finally, considering management fees in this scenario, the misalignment of interests described above still exists. However, the magnitude of the potential profit from carry together with the equity interest fully incents the GP to optimally manage the fund. So the combined GP incentives in the at-the-money scenario depend on the magnitude of the GPs equity interest in relation to the potential profit from risk taking as realized in the carried interest. If the GP equity interest is not significant enough, the GP is financially motivated to take on added risk in this scenario to take advantage of the asymmetric payoff of carried interest.

Finally, consider the GP’s financial incentives in the out-of-the-money scenario. When a fund performs poorly, like many of the legacy funds in the market today, the GP has little prospect of receiving any distributions resulting from carried interest. Therefore, considering only their short run financial interests, the GP is incentivized to maximize their profits resulting from
management fees. They do so by minimizing expenses associated with operating the fund, since any of those costs are born on the margin entirely by the GP. And considering that any detrimental effects on the performance of existing assets are born entirely by the LPs (since there is no prospect of carried interest distributions) there is little investment concern in doing so. This misalignment of interests may again be offset to some degree by the equity interests GPs have in the fund. So, like the at-the-money scenario, if the GP equity interests are not significant enough, GPs will be financially motivated to maximize the profit from management fees in the out-of-the-money scenario.

There are some very specific GP actions that LPs should be concerned with in this scenario. For example, management fees in the later years of the fund cycle are typically levied on the basis of invested capital and thus are realized by the GP as long as the investment is outstanding. So, to maximize management fees in this out-of-the-money scenario, GPs may hang on to investments longer than they should. In addition, for the same reason, GPs have every incentive to fully invest committed capital regardless of the quality of the investments. In addition, the lack of carry incentives may cause GPs to redirect the attention and energy of the investment professionals at the fund towards more profitable activities, such as raising a new fund, or focusing their efforts on other existing funds that do have the potential for carried interest (we will expand on this in the next section). In this case, it would be best for LPs if the investment period were terminated and the existing assets were properly managed to maximize whatever value remains. However, as we mentioned earlier, these may be exactly the opposite of what best serves the GP.

The table below summarizes the preceding analysis and clearly demonstrates that the alignment of interests depends on the expected performance of the fund.

<table>
<thead>
<tr>
<th>Fund performance</th>
<th>Poor</th>
<th>Average</th>
<th>Excellent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management fee</td>
<td>Poorly aligned incentives</td>
<td>Poorly aligned incentives</td>
<td>Neutrally aligned incentives</td>
</tr>
<tr>
<td>Carried interest</td>
<td>Neutrally aligned incentives</td>
<td>Poorly aligned incentives</td>
<td>Strongly aligned incentives</td>
</tr>
<tr>
<td>Equity interest</td>
<td>Strongly aligned incentives</td>
<td>Strongly aligned incentives</td>
<td>Strongly aligned incentives</td>
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A few conclusions emerge from this analysis. First, when a fund is performing well, the carried interest option is deep in-the-money, and the interests of GPs and LPs are well aligned. Provisions to better align the interests of LPs and GPs should target conditions under which the fund is not performing well. LPs should include provisions in the LPA that allow them to more closely monitor investments in scenarios such as the at-the-money scenario. For example, LPs may want to ask for more detailed information on investment choices when a fund is not performing well. In the extreme, LPs might retain the right to unilaterally terminate the
investment period, conditioned on observable factors that reflect the state of existing investments and the future prospects of new investments relative to the GP’s expectation of receiving carried interest.

Second, LPs should be most concerned about management fees when funds perform poorly. This can be mitigated to some degree by maintaining lower management fees that more closely track actual expenses. However this does not solve the problem entirely because of the disconnect between management fees and actual operational costs. For example, as indicated before, GPs will still be motivated to reduce expenses when the fund is deep out-of-the-money even with lower management fees. Some have suggested having LPs actually monitor fund expenses. Done unconditionally, this can be dangerous in that it might lead to micromanagement of the GP and negatively impact a GPs ability to do what they do best, make and manage quality investments. As we indicated earlier, the interests of GPs and LPs are perfectly aligned when funds perform well.

We suggest a targeted LP strategy. LPs would be well served to reserve the right to monitor management expenses in out-of-the money scenarios. To do so, they should include provisions in the LPA that entitle them to information and input into fund management activities conditioned on observable factors that reflect the state of current investments. In the extreme, LPs may want to reserve the right to terminate the GP’s contract under these conditions as well.

Third, a large GP equity interest goes a long way towards mitigating conflicts of interest between the GP and LP. In the best of all worlds, GP equity interests would be significant enough that the resultant interests dominate any misaligned interests that may come from other provisions.

**Interest Alignment – Agency Conflicts**

Next, let’s consider agency conflicts. Agency conflicts generally refer to a contracting situation in which the agent (a GP) receives additional “private” benefits from their actions on behalf of the principals (LPs). In our setting we interpret agency conflicts as the potential for conflicts of interest that might result from a GP’s related business activities. Here we will discuss two such conflicts that are important. The first of these relates to services that GPs provide and sometimes charge directly to the fund or indirectly to the portfolio firm acquired on behalf of the fund. The other potential for a conflict of interest might arise because of decisions made by the GP that affect multiple funds under their control.

1. **Fee income.** On the surface, there appears to be nothing wrong with a GP charging a fund for services rendered when in fact those services are required in the normal course of business. The challenge is with the potential incentives this might create. There may be decisions that when taken by the GP on behalf of the LP could generate profit opportunities for the GP that are not shared by the LP. For example, the short term interests of a GP might be driven by the desire to collect deal or consulting fees. Also, there may be a lack of “checks” on the magnitude of fees. Typically when services are purchased from a third party vendor, fees are competitively determined. This may not be so when the GP is the sole provider of services to their funds.
There are some relatively simple fixes for these types of agency costs. For example, if the LPA provides that fees for all services provided by the GP are paid directly to the fund, these fees would benefit both LPs and GPs. Alternatively, LPs could establish a governance structure to properly monitor such activities. At the extreme, the LPA could simply eliminate the potential for the LPs to provide services for fees.

2. Conflicts of interest across funds. At any given time, a GP can be simultaneously managing multiple funds with different investors in each. There may be an incentive for GPs to manage multiple funds to their own advantage. For example, if a given fund is severely underwater and the likelihood of a payout of carried interest is slim, the investments of that fund may receive diminished attention from the investment professionals, which is clearly not in the interest of the LPs. Another form of conflict might occur if two different funds controlled different security interests in the same company. For example if one fund invested in equity ownership and another fund invested in debt of the same company, the management incentives for the GP might be conflicted. This last example has been especially prevalent during the market upheaval of the last few years in which GPs raised funds to acquire the debt of highly leveraged companies (including companies in which that same GP had an equity interest) in the secondary market for a fraction of its notional value. A final example of a conflict across funds would be the GP’s incentive to raise a new fund as soon as possible to collect additional management fees. This is typically not in the interest of LPs of existing funds, since in the process of raising a new fund, the GP has a tendency to liquidate good investments early to establish a track record and free up cash for LPs. In addition, fund raising is a time consuming activity that may distract senior investment professionals from managing existing funds to their fullest potential.

The severity of these type of agency conflicts depends on the performance of the fund (similar to the financial conflicts) and on the relative performance of different funds. To the extent that conflicts of interest across funds play a role, there are two sets of practices that may alleviate this problem. First, having different sets of a firm’s principals run different funds, such that their compensation would be predominantly determined by the performance of one fund alone, might partially solve these problems. However, such a structure might not always be easily implemented in a real-world setting. For example in funds with one dominant owner, it would be hard to separate the economic ownership of these funds. Second, giving LPs the right to monitor GP activities across their funds might alleviate these problems as well to some extent. However, such monitoring would require the trade off of potentially diverging interests between the LPs of different funds, which is not a straightforward exercise. In addition, as we indicated before, LPs should be careful to not to micromanage their GPs. One point to highlight here is that again GP and LP interests are mostly misaligned in the case of a poorly performing fund. Thus conditional LP governance provisions in the LPA to protect against these forms of agency conflicts may again make the most sense.
Beyond the discussion on financial and agency conflicts as seen in the typical LPA it is important to highlight that there are longer term considerations that play a key role in aligning the interests of GPs and LPs. GPs are typically in the business for the long term and their ongoing relationship to LPs (which can be characterized as their “reputation”) is of the utmost importance. To the degree one can put a value on reputation, GPs put that reputation on the line with each fund they develop and the resulting downside risk is probably substantial. In a sense, reputational risk is a form of “equity” interest that helps align everyone’s interest. That being said, there is still good reason to understand the potential short term conflicts of interest.

The considerations of reputation are not inconsistent with adding provisions to the LPA to mitigate misalignment of interests. With few exceptions, the types of provisions that are being considered provide the opportunity for LPs to exercise their rights of protection. In practice, LPs can determine not to change anything in relation to their GPs if the level of trust, historical value of the relationship and confidence in the GP overrides concerns about these incentives. For example, if the LPA contains the rights of LPs to remove the GP, this right needn’t be exercised if in the LP judgment, the GP continues to be the right entity to manage the fund.

**Market Power and Pricing in the PE Market**

In the previous two sections we have highlighted the various sources of misalignments of interests of GPs and LPs. Looking back historically, market dynamics have led to many of these challenges and it is entirely possible that future market forces could undue whatever advances are made today.

In the PE market, the excellent performance of funds early in the cycle led to the current situation. For example, with the relatively fixed nature of compensation terms (the standard 2 and 20), quality fund managers increased their value by offering larger funds. Increasing size took advantage of fixed management fees to offer substantial profits from these fees. In practice all parties were aware of this and did not object to superior funds earning sizable management fees as long as these GPs also generated good returns for the LPs. However, as the market turned, the adverse incentive effects of management fees became clear and in hindsight not enough weight was put on the concerns regarding increasing fund size.

Going forward, as the PE market recovers there will once again be market clearing forces that allow high quality managers to earn higher returns. We suggest that LPs be proactive in defining the terms that can best add value to GPs without further distorting incentives. In particular, we advise that where demand for a GP exceeds the optimal size of the prospective fund, that increases in carried interest be the market clearing device. Though carried interest is not a perfectly aligning incentive, the adverse incentives are not as severe as the current market clearing device: large fund sizes.

The market dynamics over the last two years have given LPs an unprecedented opportunity to remake the industry to work better. Many have used that opportunity to prohibit or much more closely monitor activities that lead to agency conflicts and demand overall lower fees: lower management fees, lower carried interest fees, higher equity interest contributions and increasing
fee offsets. Although fee pressures are logical given the supply and demand dynamics in the market today, some of their effects may be temporary in nature, in the sense that when the market dynamics revert back to what they were five years ago, there is no reason to believe that some GP practices will not do the same. The analysis in the previous two sections suggests additional ways to change the industry to create win-win situations for both GPs and LPs.

1. **Market clearing mechanism.** Supply and demand of capital will eventually determine the pricing in the private equity market. GPs that perform well will command a premium relative to those who perform poorly. That premium can come from a number of different channels: higher management fees, higher carried interest, more money under management, more fee income, less oversight, etc. The market clearing mechanism in the industry up until today has been primarily the amount of assets a GP has under management. That is, the assets under management vary dramatically in the industry and are indicative of the success and market power of the GP, whereas other channels have been used much less to clear the PE capital markets. In particular, the management fee and carried interest have been fairly uniform in the industry at two and 20 percent, respectively. A market mechanism in the PE industry that clears through a GP’s assets under management is suboptimal for a number of reasons. First, it causes GPs to raise more money than they would be able to invest optimally; that is, the assets under management exceed the capacity of the GP, resulting in less profitable investments decisions. Second, given that management fees are determined on the basis of assets under management it increases the importance of realizing profits on the management fee, misaligning LPs and GPs. It would be beneficial for the industry to transition to a market clearing mechanism based on carried interest, which would prevent the two negative effects associated with market clearing based on the amount of assets under management.

2. **Management fees reflective of operating expenses.** To prevent the distortive effects of profits made off of the management fee, it would benefit the marketplace if management fees would reflect operational costs. Clearly, as indicated above, this change cannot be made in isolation since the marketplace will need to have a degree of flexibility for good GPs to exert their market power (which currently takes place through fund size).

3. **Downside potential for GPs.** GP economics in this industry have been dominated by upside potential with almost no downside risk. As a result of these attractive economics, the market has seen many new entrants, many of whom will not be successful. In addition, as shown before, the upside potential with no downside risk may cause excessive risk-taking induced by the option-like payoff of carried interest. The introduction of losses on the part of the GP when the fund performs poorly will go a long way towards mitigating these two undesirable effects. Effectively, carried interest in combination with downside potential results in cash flows that are similar to those resulting from an equity interest. There are many ways to introduce downside risk for the GP, including (i) have the GP bear a significant fraction of the operating expenses of the fund (i.e. the management fee would cover less than the operating expenses of the fund),
(ii) have the equity interests of the GP be subordinated to the those of the LPs by putting the GPs in a first loss position when a fund does not return all committed capital (effectively changing the waterfall) and (iii) have the GPs personally guarantee the loans which leverage the investments made by the GP.

**Unintended Consequences**

Effectively the enforcement of interest alignment fundamentals serves as an investment screen for LPs since only those GPs for whom these fundamentals are binding will resist making changes to their current contracting framework. GPs whose long run reputational concerns or equity contributions incent them to behave appropriately already will have no problem accepting the interest alignment fundamentals.

It is critical that any implementation of the interest alignment fundamentals does not have unintended consequences. For example, the following three cases come to mind:

1. **Transparency.** An understanding of the GPs investment choices and the monitoring of those choices can appropriately constrain the GP from making unaligned investment decisions. A straightforward example is for the LPs to ensure that the GP only employs investment strategies specified in the subscription agreement. However, although transparency is a critical feature, it must be approached carefully. Specifically, one should not confuse transparency with control. In a well aligned and well functioning relationship between LPs and a GP, the GP brings the expertise and judgment to make and manage investment decisions. It behooves LPs not to engage in such a partnership if they are not convinced of the potential for GPs to create significant value through their unique expertise. In such an arrangement, the role of transparency should be to assure that the terms of the LPA are being appropriately followed. Transparency should not be used as a means to second guess or micro-manage the GP.

2. **Market equilibrium.** The movement away from management fees towards a compensation structure more focused on carried interest with some potential for downside clearly better aligns all parties and gets us closer to an equity-like contract arrangement. However, this will not solve all alignment problems. With an increased focus on carried interest GPs are (at least in the short run) incentivized to take even more risks than they otherwise would, since carry is like an option. Consequently, provisions that create downside risk for the GP, for example through a meaningful GP equity interest, or appropriate risk control and monitoring by the LP (taking into account the costs that such mechanisms impose on the partnership as explained in the previous paragraph) are critical.

3. **Market transition.** The current market dynamics have allowed LPs to demand lower management fees. If the PE market clearing mechanism keeps taking place through assets under management, the short run effect of pressure exerted by the LPs to lower management fees is to incent GPs to raise larger funds to compensate for lost income which forms the basis for running the firm on a day-to-day basis.
Conclusion

This document provides an analysis of the market dynamics between GPs and LPs. The framing of the issues on a higher level as outlined in this document can greatly clarify and streamline such an analysis. The analysis in this document is qualitative in nature. We are developing models that can more precisely measure the magnitude of misalignment and quantitatively identify observable measures of scenarios when misalignment is at its worst. We expect that such analysis will draw more nuanced and precise conclusions and aid in developing improved contracting mechanisms. We look forward to working with the PE community to further enhance this analysis.