

## How Private Equity Funds are Raised, Structured, and Managed

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### Organization of a Private Equity (PE) Fund: Overview

- Sponsored by
  - » Principals who form a management partnership or Limited Liability Company (LLC) to serve as general manager
  - » A financial institution
- Sponsors typically form a second entity, a limited partnership or a LLC to manage the fund
  - » Investors are limited partners in this entity
- The investors and fund managers commit to make capital contributions (capital commitments)
- The fund manager is responsible for identifying and evaluating potential investments, monitoring investments, and recommending sales or exit strategies

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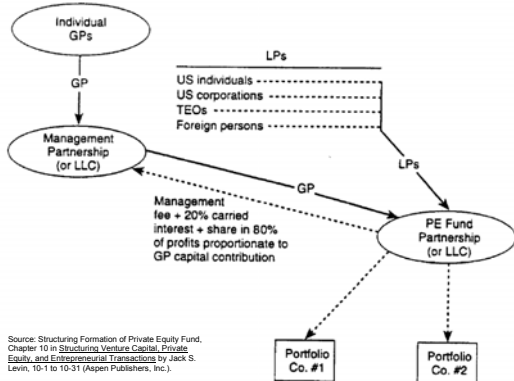
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Source: Structuring Formation of Private Equity Fund, Chapter 10 in Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions by Jack S. Levin, 10-1 to 10-31 (Aspen Publishers, Inc.).

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## Tax Advantages of Limited Partnership or LLC Form for Private Equity Fund

- Partners or members receive flow-through tax treatment for the Fund's **capital gains (CG)**
  - » No federal income tax at PE Fund level
  - » Tax is payable by equity owner (20% by individuals, 35% for corporate partners)
  - » No federal income tax for PE Fund limited partner (member) that is a tax-exempt organization (TEO)

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## Compensation for PE Fund General Partner/Managing Member

- Carried interest
  - » Share of the profits realized by the Fund
- Management fees
  - » Typically 1.5% to 3.0% of capital commitments for a venture capital fund and 1.5% to 2.0% for a leveraged buyout fund
- Transaction fees
  - » Fee income from portfolio companies including 1) investment banking fees, 2) break-up fees, 3) monitoring fees, and 4) consulting fees

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## PE Funds and Agency Problems

- Because investors delegate decision-making authority over their capital contributions to Fund managers, there is the potential for opportunistic behavior on the part of managers.
- Ensuring that the incentives of Fund managers are aligned with investor incentives is of great importance to investors.
- **Pay-for-performance** through Carried Interest is central to this alignment
  - » Carried interest is generally based on cumulative profits rather than transaction by transaction
    - Provides incentives to make all transactions profitable
    - Limits incentives to invest in risky transactions

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## How Profits are Allocated

- **No preferential return:** The industry standard has historically been a 20/80 split – 20% of the net profit is allocated to the general partner/managing member as carried interest and 80% is allocated to partners/members based on their capital contributions.

**Example:** Assume GP/managing member provides 5% of the total capital contributions

The profits allocated to the GP/managing member would equal  $20\% + (0.05 * 80\%) = 24\%$ .

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## How Profits are Allocated (continued)

- **Preferential returns** are becoming more common
  - » **Disappearing preferential return:** 100% of the net profits are allocated based on capital contributions only until the fund receives a specified IRR (e.g., 8% - 12%).
    - Net profits in excess of the specified IRR are allocated disproportionately to the GP/managing member until the GP/managing member has received the carried interest (e.g., 20%) on all net profits. This is known as a **make-up or catch-up**.
    - Any additional profits are allocated as though there was no preferential return.

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## How Profits are Allocated (continued)

- » **Permanent preferential return:** 100% of the net profits are allocated based on capital contributions only until the fund receives a specified IRR (e.g., 8% - 12%).
  - Any additional profits are allocated as though there was no preferential return.
  - This is very uncommon

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## Distribution of Profits

- There are several alternative ways in which profits can be distributed
  - » **Full payout:** Distributions are made according to capital contributions until entire contributed capital has been returned to all partners. Profits are then distributed in accordance with carried interest agreement and capital contributions.
  - » **Distribute net profits first:** Distributions equal to net profits are made in accordance with carried interest agreement and capital contributions. Distributions in excess of net profits are allocated based on capital contributions.
    - A **clawback** provision is typically included if this scheme is used in case, on a cumulative basis, early carried interest distributions are too large.
  - » **Middle Ground:** Profits are distributed in accordance with carried interest agreement and capital contributions as investments are exited once all capital for investments exited to that point has been returned to investors.

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## Distribution of Profits (continued)

- Distributions to limited partners/members can take the form of
  - » Cash
  - » Restricted securities
  - » Freely tradable securities

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## Management Fees

- Cover salaries of principals and other fund operating costs
- Paid quarterly or semiannually
- Often reduced after the funds investment period by 10% per year or to 1% to 2% of the Fund's assets on hand (valued at cost)
- May be reduced to the extent that fees are received by the GP/managing member from portfolio companies
- May be reduced in exchange for a greater allocation of the long term capital gain profits

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## Carried Interest vs. Management Fees

- Management fees at, 1.5% to 3.0% of committed capital, may appear substantial, but Carried Interest can be much larger in a successful fund
- Example: Suppose a PE fund has \$1 billion in committed capital.

A 2.0% management fee would yield annual flows of \$20 million or on the order of \$150 million over the life of the fund, depending on how the management fees are phased out in the latter years of the fund's life.

If the fund earns 25% on committed capital over 5 years, the carried interest would total:

$$[(1.25^5 \times \$1,000,000,000) - \$1,000,000,000] \times 0.20 = \$410,351,562$$

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## Fund Advisory Boards

- The advisory board is typically comprised of three to nine limited partners who are appointed by the GP/managing member
- They do not have a significant ability to influence investment decisions (would affect their limited liability)
- They often have the right to
  - » Approve mark-ups and mark-downs in the valuations of portfolio company holdings
  - » Address conflicts of interests
  - » Approve extensions of the life of the partnership

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