Waterfalls: Behind the smoke screen

Setting the right foundations – what is carried interest and why does it exist?

The Bright Alternative

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Introduction

The distribution waterfall is one of the key components of the private markets model. But how do waterfall calculations work in practice and why is this crucial mechanism so important?

In private markets investing, a distribution waterfall is a way to allocate the capital gained by the fund between the limited partners ("LPs") and the carried interest partner ("CIP") which is typically the general partner ("GP"), investment advisor or other parties deemed to be responsible for value creation. When distributing capital back to investors, hopefully with significant added value, this amount is allocated based on a waterfall structure previously agreed in the limited partnership agreement ("LPA"). The structure is designed to encourage key individuals who earn carried interest to maximise the performance of the fund.

There are typically four tiers in a distribution waterfall schedule: (i) return of capital; (ii) preferred return; (ii) the catch-up tranche; and (iv) carried interest.

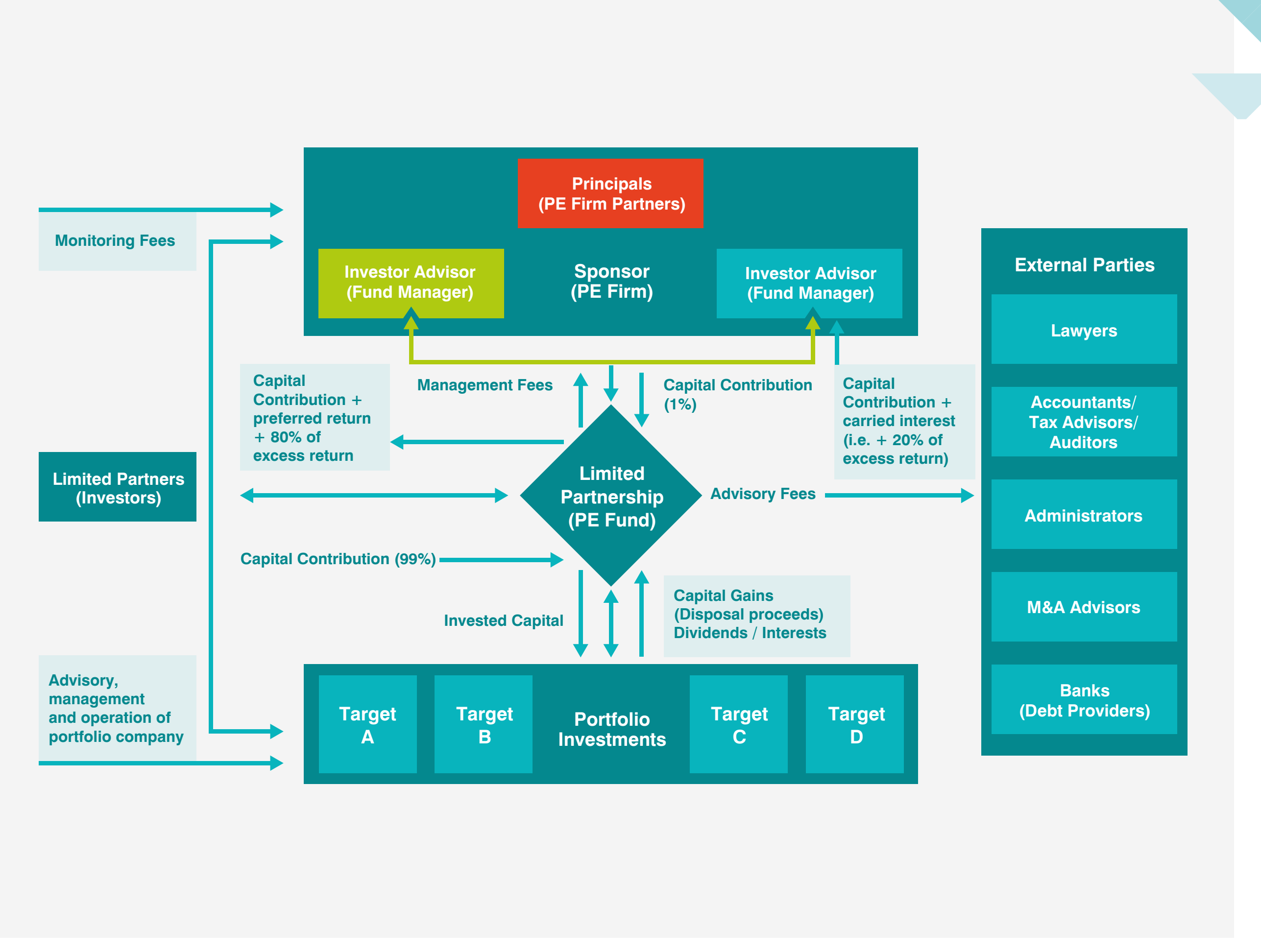
Carried interest is extremely important to a fund manager and the calculation process needs to be efficient and accurate to ensure a smooth distribution. There are many parties involved so collaboration and organisation from the outset are essential.

What we'll cover in this guide:

What is carried interest?

Carried interest is a share of the profits of a fund calculated in line with set clauses of the fund's Limited Partnership Agreement ("LPA"). Typically, this is paid to the individuals at the Investment Manager who form the management team and other key parties. Dependent on the model that is used, it's not paid until several years into the life of the fund and it's directly related to investment performance so it can be a good long-term incentive. The relevant clauses in the LPA are drafted by the funds legal counsel and the funds administrators are responsible for setting up the calculation.

Carried interest is an industry standard in the alternative asset space. It would be unusual to see a fund without a carried interest provision. The Carried Interest Partner (CIP) can either be a specific vehicle set up for this purpose only or the Carried Interest Partner may hold an interest directly in the fund. The percentage of gains allocated to the Carried Interest Partner is usually 20%. There can be many variations in a carried interest model which affect the timings of a fund getting to 20%, but if a fund performs very well the outcome is approximately the same.



Diving into the detail – some key definitions

Preferred return/hurdle rate

This is the return given to Limited Partners before any carried interest is paid. In most circumstances, this is 8% of the capital invested but there are variations. It's often a misconception that this is a guaranteed return but that is not the case if there is not enough cash available.

1

European model

This is one of the two types of carried interest models. In this model carried interest is calculated on a whole fund basis considering all investments. The preferred return needs to be achieved for the fund as a whole and not for an individual investment. It can take longer to receive carried interest in the American model.

2

American model

Another name for this model is the deal-by-deal model as you would look at each investment on a standalone basis and if preferred return was reached for that investment, then carry would be paid out as exit proceeds for that investment are received.

3

Clawback

Clawback provisions in private investment fund agreements are designed to require the carried interest partner to return any excess distributions of carried interest if such distributions exceed the share of profits agreed in the LPA. A clawback provision would be expected in an American Model if preferred return isn't met on an overall basis. It may be required if you have very successful investments at an early stage, but later investments don't perform as well, so on an overall basis, too much money has been distributed to the carried interest partner. To avoid the inconvenience of calling money back from the carried interest partners, an escrow account is often used. This holds the carried interest funds until the point where they cannot be clawed back.

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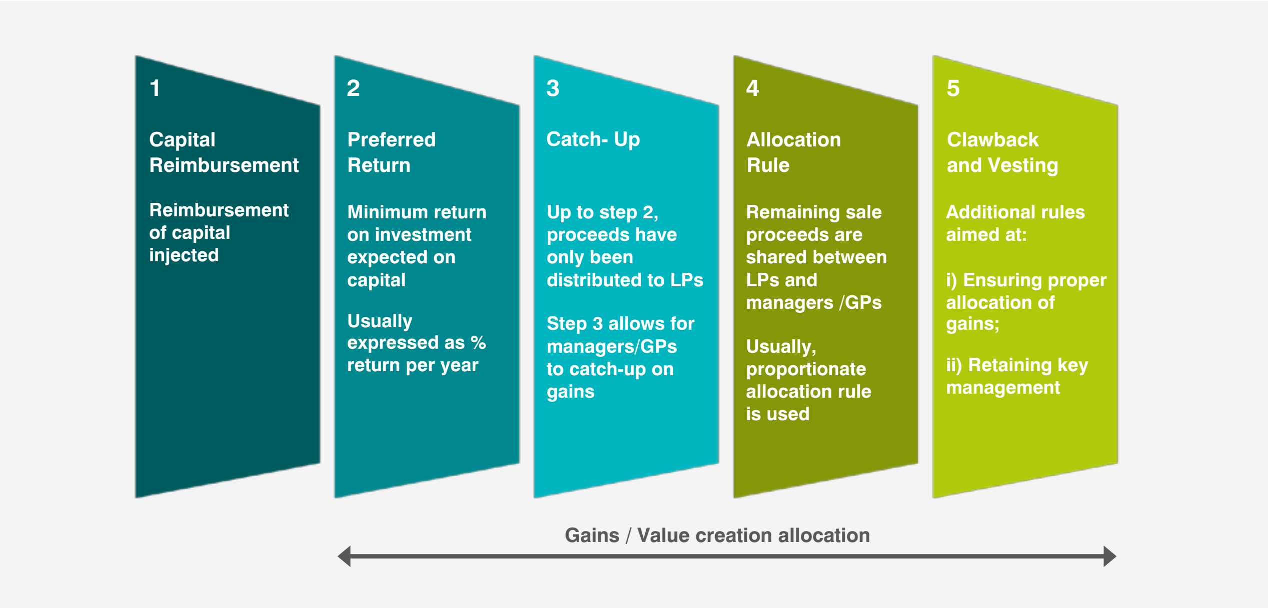
A typical cash flow movement



This diagram shows the typical steps you would have in a carried interest calculation. The steps are explained below:

1. **Capital reimbursement:** Usually the first clause in a carried interest model will note that the first priority in allocating any gains will be to pay back the Limited Partners for the capital they have paid into the fund.

2. **Preferred return:** The next clause is allocating the preferred return; this is generally seen as the amount to compensate the Limited Partners for the risk of investing their money in the fund. You will notice that this is a lot higher than the amount they would get if their money was in the bank or invested in government bonds. As mentioned previously, this is typically set at around 8%. However, it could be that a new fund (without a strong reputation) may have to compromise and have a higher preferred return to make themselves more attractive to investors. The higher the preferred return rate, the less there will be to distribute to the carried interest partners.

3. **Catch-up:** After the Limited Partners have been paid back their capital contributions and received their allocated preferred return, the carried interest partner will then receive some money.

The mechanism for this catch-up, does vary from fund to fund. Some examples of typical catch-up clauses are:

- 100% to the Carried Interest Partner until they have received 20% of all cumulative distributions
- 80% to the Carried Interest Partner and 20% to Limited Partners until the Carried Interest Partner has received 20% of all cumulative distributions
- 50% to the Carried Interest Partner and 50% to Limited Partners until the Carried Interest Partner has received 20% of all cumulative distributions

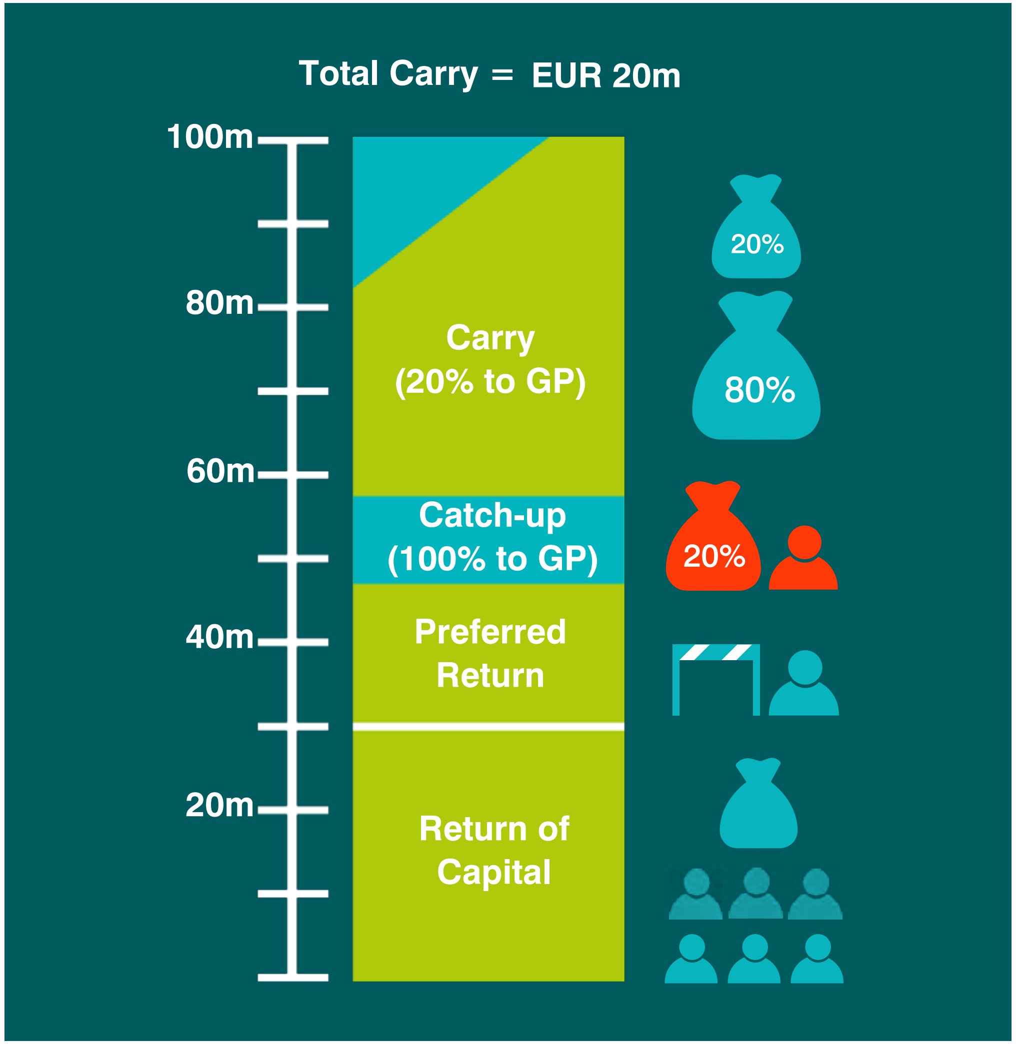
With the examples above, the first one results in the Carried Interest Partner receiving money sooner than the others, but if there are enough funds to complete this step, the amounts distributed to the Carried Interest Partner will be the same. The catch-up mechanism could be dependent on the type and expectations of Limited Partners. However, most professional investors to alternative asset funds understand that they may not receive regular distributions.

4. **Allocation rules:** When the catch-up phase has been completed, the next stage is allocating the remaining gains in a set proportion between the Limited Partners and the Carried Interest Partner. Typically this split is 80% to the Limited Partners and 20% to the Carried Interest Partner.

5. **Clawback and vesting:** This step checks that on an overall fund basis, the Carried Interest Partner has not been over paid.

A typical cash flow movement

Below is a very simple example laying out the above steps. In this example the catch-up stage is 100% to the Carried Interest Partner until they have received 20% of all cumulative distributions and there is no clawback required.



Sample Case 1

Fact pattern

- The Fund purchased an investment for 30M
- Exits investment for total proceeds of 100M after five years

Distribution Waterfall

Per LPA, Capital Account allocations and distributions should be made as follows:

Step 1 100% to LPs until they have received back their contributions;

Step 2 100% to LPs until they have received 8% Preferred Return compounded per annum;

Step 3 100% to the GP until the GP has received 20% of all cumulative distributions; then

Step 4 80% to the LPs and 20% to the GP.

Waterfalls in practice – examples of complexity

There can be many different complexities in a carried interest calculation. Some examples include:

Parallel fund structures

When there are two or more parallel funds the LPAs can be written in such a way that if a Limited Partner invests in multiple funds their investment is viewed as being in one fund which Limited Partners may prefer. Limited Partners may invest in the different funds in different proportions, so this leads to each Limited Partner having their own calculation. Setting up calculations in a way that they can be accurately maintained is key.

Complex catch-up clauses

There can be very complex catch-up clauses, in which allocation of the catch-up alternates between the Limited Partners and the Carried Interest Partners multiple times. The aim of this approach is to ensure both parties receive a distribution of funds earlier in the life of the fund.

Investor side letters

There are cases where side letters may be requested by influential Limited Partners, which give them the rights to have a different percentage allocation to the standard carried interest allocation. Examples include 15%, 10% and even sometimes 0%.

Compounding of the preferred return

Each LPA can have different clauses noting how to compound the preferred return. Some variations include:

- On the last day of each calendar year (which could be on a 360 or 365 day basis)
- On a quarterly basis on the last day of every quarter
- On the day of the first drawdown each year

Over complication in some cases is beneficial but it can mask the underlying calculation.
Often stripping out complexity can lead to the best result with all parties being clear on the outcome and a calculation that is easier to maintain accurately and efficiently.

What could go wrong and how to keep things on track: It's all about organisation and experience

Different interpretations of clauses

If the clauses in the LPA are ambiguous, different parties could interpret these in different ways. When there is a difference of opinion this could cause delays or incur costs for a second opinion from legal counsel.

To avoid any issues agreeing on the interpretation of the clauses, and setting up the model correctly at the start of the fund is key. If there are any ambiguous clauses they need to be clarified. It is beneficial to allow the administrator to review the carried interest clauses in the LPA before it's finalised so any adjustments can be easily made. Occasionally a carried interest model doesn't reflect the original intentions of the fund manager and the LPA might need to be restated which is time consuming and may incur costs.

Human error

When calculations have been agreed by all parties and distributions are made based on the calculations, there could still be a mistake due to human error. This could lead to tax implications if an error goes unnoticed and the Limited Partners or Carried Interest Partners declare an amount on their tax return which is incorrect, then there may be cost implications if a tax return needs to be restated.

To reduce the risk of human error the carried interest calculation should be set up at the start of the fund's life even if there aren't enough gains to pay carried interest until several years later. This calculation should be maintained throughout the life of the fund and a strict review and approval process needs to be put in place to ensure the calculation is accurate. Sticking to a timetable for this is important as it is likely there will be multiple reviews at the administrator by qualified staff members and potentially in house technical teams. In addition, the fund manager will review the calculation.

It's very tempting to leave the model set up until further down the line but at this point there will be more time pressure and it's difficult to make changes. Some financial statements include an accrued carried interest figure so updating the calculation on a quarterly basis may be a requirement. Some fund managers require an external review of the carried interest calculation by an external carried interest specialist.

Delay in distributions

If there are issues agreeing on the figures this could lead to delays in the distribution. Often the LPA will have a clause noting that any funds received should be distributed to Limited Partners within a certain number of days, therefore there is potential that this clause could be broken. In addition, often an Agreed Upon Procedure review is required by an external party before a carried interest distribution is made so the preparation of the calculation needs to be very efficient to factor in the time for this review. To avoid delays it's important to set up the model at the start of the fund and constantly maintain it, so it is ready to be used at short notice.

Loss of investor confidence

Carried interest is a really important area to clients and investors so it needs to be right. Any errors can have an impact on investor trust but if everything is well organised, accurate and all parties work together the process will be smooth and efficient.

Final thoughts…

Carried interest calculations have varying degrees of complexity so it is key they are given appropriate consideration at the fund's inception. Many parties are involved with the process so a collaborative approach from the outset is crucial.

Get in touch

If you would like to discuss your carried interest obligations, as well as how Aztec can support you, please talk to either your usual Aztec Group contact or get in touch with our Technical Team:

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