How do we get out of this misaligned mess?

GPs and LPs both need to be realistic and flexible to reconstruct alignment in the most challenging situations




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Private equity is the most powerful way to create value in the investment world. In the ideal state, LPs, GPs and portfolio company management teams have a common bond: each is accountable for creating value for their stakeholders. At the core of these multi-party relationships are the incentives put in place through the limited partnership agreements that allow GPs to prosper through carried interest participation, assuming performance exceeds the hurdle rate.

Hurdle rates range from 7-9 percent in a typical PE fund, mirroring actuarial rates for pension plans and generally aligning with a typical endowment or foundation payout rate plus CPI (a common institutional benchmark). Although LPs and GPs typically reference targeted returns of 20 percent with their stakeholders, conservative asset allocation models used by institutions usually apply a small premium over these rates to estimate future PE program returns.

Win some, lose some

Investment returns are driven by portfolio companies, where budgets are designed to drive value creation. When things go as planned, all parties win: great companies emerge with sector-beating growth. A string of winners in a fund leads to high returns, creating wealth for the GP and high returns for LPs and their beneficiaries.

When events lead to unfavorable return outcomes, however, the hurdle rate becomes an impediment, driving misalignment. Unfortunately, such misalignment will be exacerbated today given the combination of major secular changes coupled with industry leverage and record purchase prices paid in the period leading up to the pandemic. The industry is bracing for moderate to significant portfolio writedowns in Q2, which will bring this issue into the forefront.

Vintage matters

Fund performance is driven by a variety of factors, including industry exposure, leverage, availability of capital and the age of the fund. On the last point, one can bifurcate the challenges into two categories: old funds raised in or before 2013, and newer funds raised since 2014. According to Pitchbook, there are 3,453 PE, venture capital, private credit and other related funds that were raised in or before 2013 representing more than $375 billion of remaining NAV. Most hold more than $100 million in value. Meanwhile, Pitchbook data show more than 2,400 funds have been raised since 2014. Many are relatively recent funds, and most are more than 50 percent invested.

Due to covid-19, we are likely to see a wave of funds that either drop below the hurdle rate on a permanent basis, or never achieve returns close to their hurdle rates given early losses. Older funds will be faced with GP clawback liabilities and/or simply not have the capital to support their portfolio. For the newer funds, the use of fund-level financing lines used to provide a "hurdle holiday" will detract from performance as the lines are paid down by LP contributions while underlying company valuations are cut.

The question here is not whether GPs should have credit lines secured by LP commitments or whether deploying funds within a two-year window is viable – they have both benefited LPs and GPs over the past 10 years. The fundamental issue is to find ways to keep managers engaged when the prospects for carry are remote based on hurdles from an obsolete LPA.

Facing the facts

Both LPs and GPs need to be flexible and recognize the facts:

1 All partners need to be engaged in addressing re-alignment

GPs need to demonstrate a win-win outcome. They need to be conciliatory to investors who are unhappy with their proposed changes. LPs must remember that their role in a partnership means they are obligated to understand the facts (assuming all are presented). They need to be open-minded toward solutions that amend the original fund terms and pave the way for future value creation.

2 GPs must present LPs with a well thought through action plan if they are looking for more capital or changes to their LPA

They must explain how they intend to triage, mitigate risk and maximize value in a tough economic environment. If not, LPs may simply say no and seek alternative solutions (secondary sale or, in worse case, GP replacement).

3 A range of issues will be on the table

These could include fund extensions, requests to extend investment periods, increased investment concentration limits, a waiver or deferred payment of GP clawbacks, an ask to reduce the hurdle rate, a reduction of fees and incentive fee rates, changes to key man provisions, the opportunity to bring in outside capital to invest alongside or on top of the LPs, distribution requests for publicly-traded or highly liquid private in-kind securities, or new contributions by GPs to add capital to newly reconstituted funds if LPs are asked to do the same (or make other concessions).

4 LPs must realize this is not a sinister action

Hurdles are common across the industry. The consequences of hurdle rates are controllable in some instances, but not in others. In the case of PE, each LP must consider the long-term best outcome for the remaining management of impaired funds. Drawing a line in the sand that any request to augment the hurdle will be rejected could be the least effective way to ensure the best portfolio outcome.

5 GPs need to be reasonable about outcomes

Major concessions on management fees and scaling carry structures can help GPs to win over skeptical LPs. Investors have been generous in the economics made available to PE managers in recent years. GPs must recognize that they are going to have to work hard and may not achieve great wealth-creating outcomes in their last fund or two. Nonetheless, they must maintain pride of ownership. Now, perhaps more than ever, GPs have an opportunity to demonstrate their true value creation capabilities, including work in salvaging a challenged portfolio.

6 Outcomes may not be binary

(ie, a fund either performs or is left for dead). There are many solutions through which GPs can access capital for challenged portfolios, albeit in senior securities to the fund equity. Under the right structure and incentives, this could allow a manager to live to fight another day. Although it may not be ideal for LPs, it is better than an elongated fund extension without alignment.

7 LPs have the power – directly or indirectly – to drive changes

If they fail to act, LPs open the door for other parties to impact the outcome. LPs should consider leading or co-leading fund restructuring and utilize advisors and capital partners that can help them achieve the best investment results, which could be significant. ■

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