Revenge of the Clawback – $25B+ Problem?

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A movie we've all likely seen but rarely want to discuss.

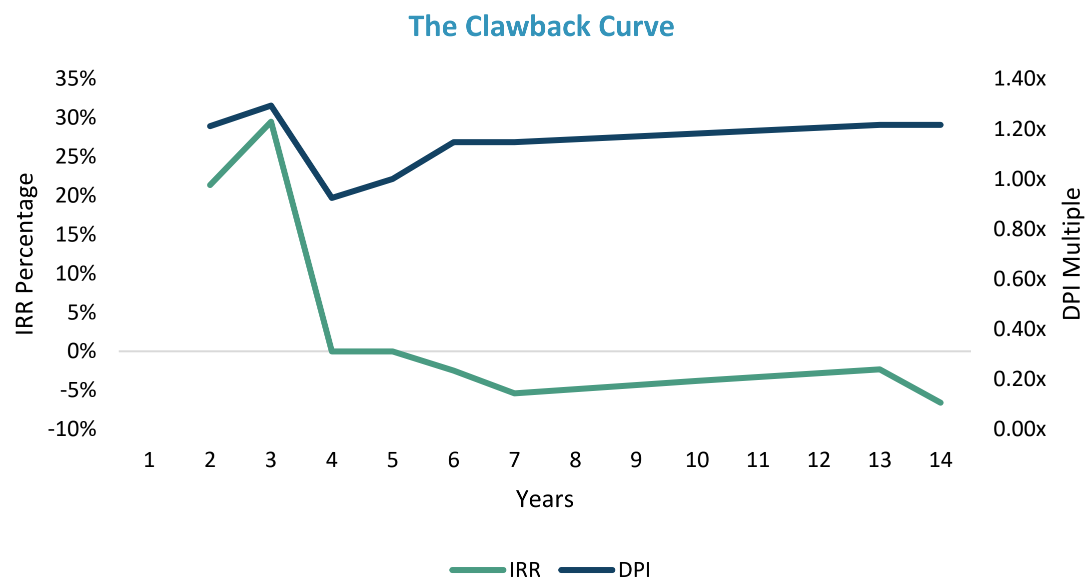
As many likely know, carried interest (carry) distributions come in two forms: "American" (deal by deal – take it as you earn it) or "European" (last out or back-ended). We recognize that this is a bit simplistic as European waterfalls exist in both the US and Europe, particularly in private credit and secondary funds. It's sensible to assume that the American approach is generally more GP-friendly and the European approach is more LP friendly as it prevents GP clawback liabilities from occurring. But we're not here to debate the merits of one structure versus another (as each has its pluses and minuses). We will describe in this paper how the American carry distribution waterfall structure (which is predominant for US-based private equity funds) can create clawback risk. And we will suggest ways that LPs and GPs can mitigate this.

To clarify, a clawback is an obligation of the GP to repay previously distributed carried interest due to subsequent fund underperformance. This occurs when a fund drops below its cumulative IRR hurdle rate after having distributed carry or if the carry distributions exceed the typical 80/20 investment gains split with LPs. This clawback obligation is typically defined as an after-tax obligation to the partnership, usually payable to LPs upon fund liquidation.

Setting the stage

To begin this discussion, we will use a hypothetical fund with an American distribution waterfall to illustrate how a clawback liability is created. As detailed below, this fund starts out well with some early successful realizations, placing the fund well above its cumulative 8% IRR threshold. This allows the GP to take carry distributions that are earned as of year 3.

However, from year 3 onwards, investment performance deteriorates (whether due to industry, economic or idiosyncratic factors). In this hypothetical situation, it appears that somewhere around years 8-10 (as most assets have been realized and the fund is under the cumulative 8% hurdle rate), the remaining assets would require a 3x MOIC or better to make inception-to-date returns increase cumulative IRR above the hurdle rate (an unlikely possibility).



By year 12 (which is the typical end of a US fund's life), returns remain under the 8% hurdle rate on a life-to-date basis and the GP is obligated to repay prior carry distributions to the LPs on an after-tax basis to liquidate or wind up the fund. This creates a difficult dilemma for GPs and LPs alike.

If the GP has successfully raised and invested successor funds, then the resources and motivation likely would exist to make a clawback payment and wind down the fund. But it is our experience that the most likely scenario is that the GP has not been able to raise a subsequent fund with much of its staff leaving for other firms. In this scenario, the GP has limited capacity to fund the clawback and no motivation to exit remaining investments and liquidate the fund. The GP is inclined to "kick the can" forward, with "hope" becoming the new portfolio management strategy. **This is the "horns of the dilemma" for LPs.** In our example, **the fund – and its manager – become true "zombies",** unlikely to make good on a clawback liability in a timely manner, if at all.

Going back to the fund's inflection point at around years 8-10, **this is the time and place where LPs and GPs can take action to help prevent the zombie outcome .** Additional actions can also be taken during the fund formation process to help mitigate the clawback risk.

Now, let's look at industry data to assess the magnitude of the problem.

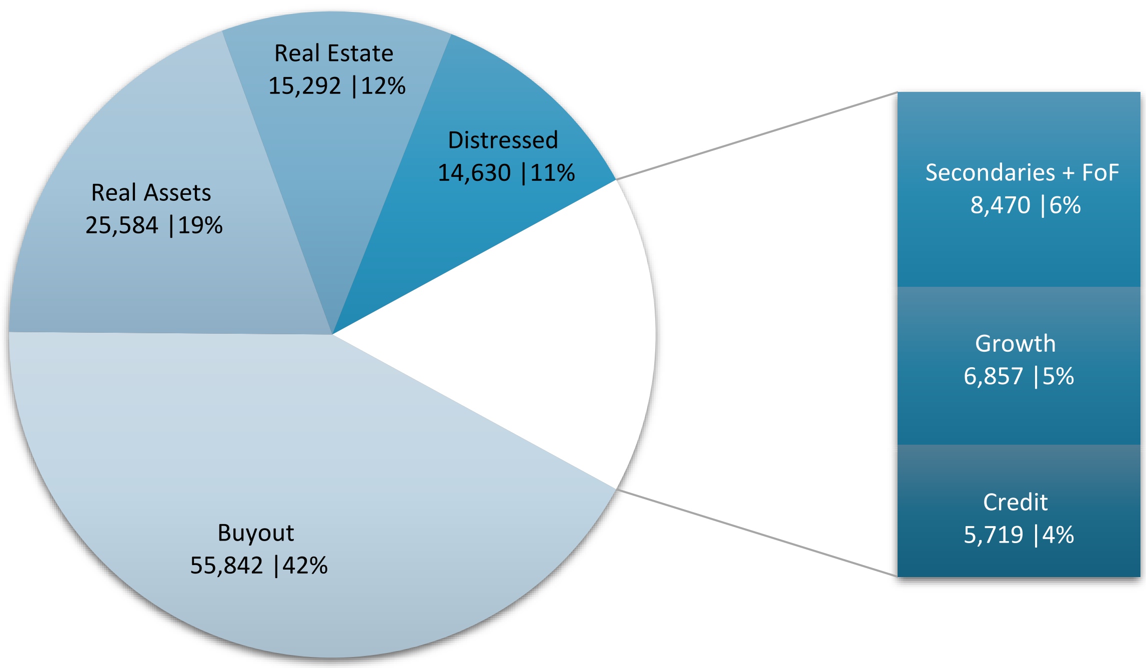
A $25B problem – the close-up

From our analysis of 438 fourth quartile funds raised in the US between 2004 and 2016 for which current performance information is available (potential clawback universe ("PCU"),[1] up to $27.8 billion of fund NAV could be at risk of clawback. The PCU is spread across seven private market strategies: buyout, growth, secondaries, real estate, real assets, credit, and distressed. Note venture funds were excluded

[1]Source: Pitchbook; performance information includes IRR, TVPI, DPI and NAV

from the analysis as they typically lack an IRR hurdle. Within the PCU, buyout represents 42% of total NAV exposure followed by real assets (19%) real estate (12%) and distressed (11%).

Total NAV of 4th Quartile Funds by Strategy (Raised Between 2004-2016, $ in millions)



Source: Pitchbook

PCU Script:

To determine the potential risk of a clawback, we used the following filter:

1. US-domiciled funds
2. Funds that performed above an 8% IRR hurdle at any point during life of fund
3. Funds that made distributions when they were performing above an 8% IRR hurdle
4. Subsequently, same funds experienced erosion in performance and dropped below and stayed below an 8% IRR hurdle

Potential Clawback Risk (by Fund) - Vintages 2012-2015

Analyzing funds from vintages 2012 to 2015 where data is most robust, we identified 146 fourth quartile funds, of which 42 (or 29%) were at risk of clawback. The total NAV of these funds represents 21% of the total NAV of all 4th quartile funds in this period. **By fund count, our analysis suggests that potentially one out of every fourteen US funds is at risk of a GP clawback.**

	2012-2015
Total Number of Funds	584
4th Quartile Funds	146
Funds with Clawback Risk	42

Source: Pitchbook

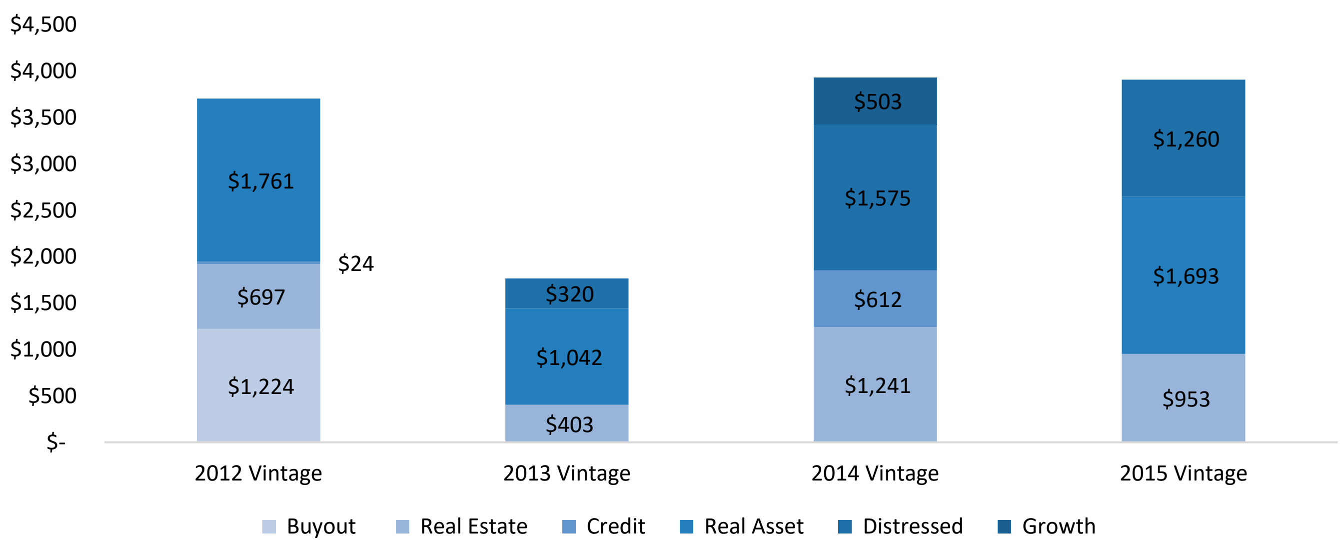
Potential Clawback Risk (by NAV) - Vintages 2004-2016

To scope out the potential industry risk, by extrapolation, we applied the 21% "at risk funds" assumption to all remaining NAV of fourth quartile funds between 2004 – 2016. **This approach indicates that the PCU is up to $27.8 billion of combined fund NAV.** In summary, although it is still early, the PCU for vintages 2017-2020 is approximately $52 billion.

($ in billions)	2004-2016
Total NAV of Funds	$529.6
NAV of 4th Quartile Funds	$132.3
NAV with Clawback Risk	$27.8

Source: Pitchbook

Clawback Risk by Strategy - Vintages 2012-2015 ($M)



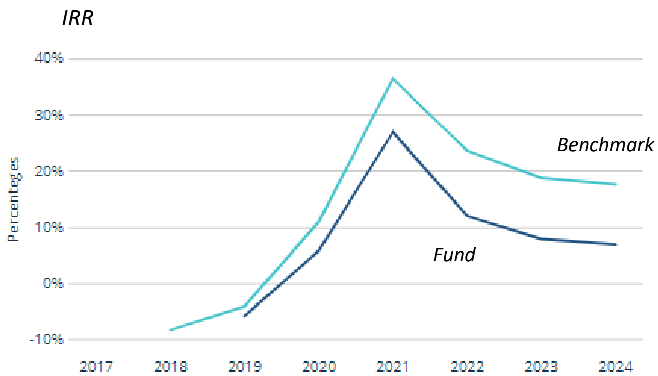
Source: Pitchbook

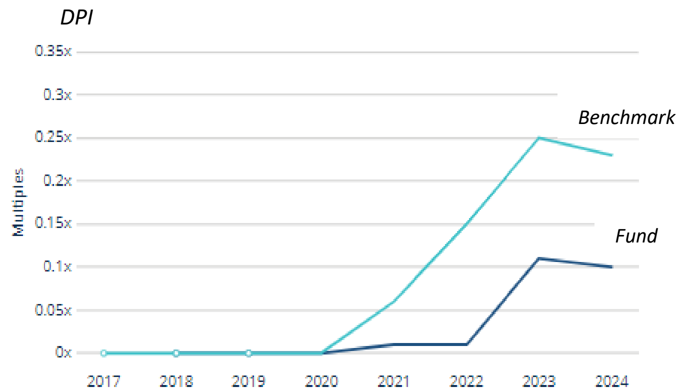
As an observation, we believe newer buyout funds (2017-2020) continue to have the same risk, as demonstrated below with examples of two active buyout funds with established managers. Both feature strong performance in their early years and made distributions. IRR subsequently dropped below 8% in 2023.

Return Profile of Select Buyout Funds (2017-2020) with Potential Clawback Risk

1

Fund I Example – Over $10 billion fund size





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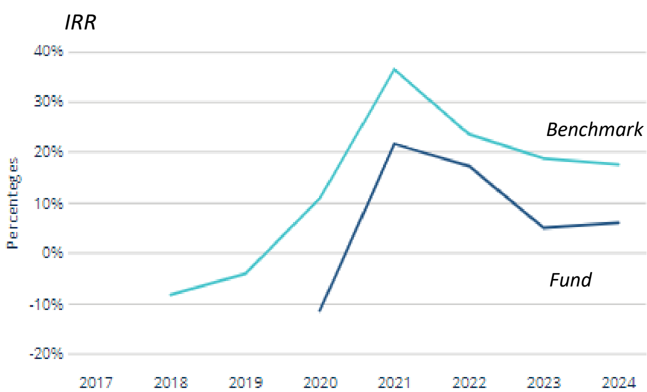
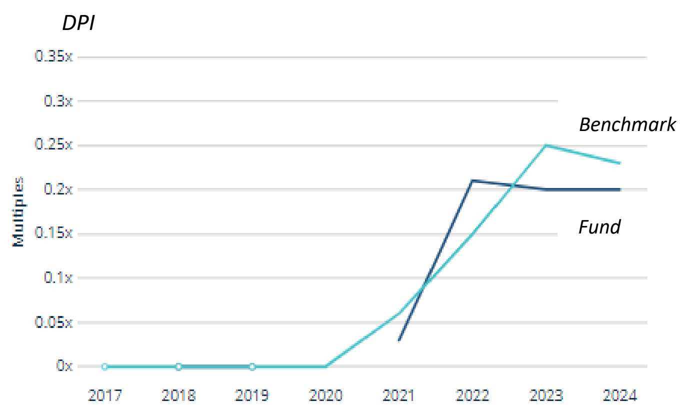
Fund 2 Example – Over $1 billion fund size





Source: Pitchbook

Although it is still relatively early, the significant run up of valuations from 2018 – 2021 has created a situation in which multiple funds across private asset classes between 2017 -2020 years will face potential clawbacks in the future.

How do you prevent the problem?

As all would agree, it is in the best interests of both GPs and LPs to pursue these solutions, which can be addressed during the fund formation stage or over the life of the fund as necessary.

During fund formation process

As fund terms are negotiated, LPs and GPs benefit from including preventative measures such instituting hybrid waterfall structures, setting up clawback reserve escrow accounts, and including "joint and several" GP liability, all designed to ensure timely payback of GP clawback liabilities.

- **Establish a more conservative carried interest waterfall**, including a structure that not only features a full return of investment cost for each transaction, with a continuous makeup from other portfolio investments, but one that also distributes to LPs a full return of fees and expenses in aggregate before carried interest is distributed. In effect, this structure delays the distribution of carried interest until more of the drawn capital is returned to LPs.
- **Joint and several liability** provisions supported by personal guarantees by carried interest recipients or a subset of GP
- In cases where a joint and several liability backed by personal guarantees is not provided, a potential substitution would be a creditworthy guarantee of the entire clawback repayment by a substantial parent company.
- **GP escrow accounts**:
    - **Predefined percentage holdback from each carried interest distribution** (ILPA suggests that 30% of carry distributions are set aside by GPs).[2]
    - **Direct allocation of the GP's commitment** can be directly allocated to a reserve fund, which can incrementally be increased to maintain a reserve cushion
- **Amend the definition of the preferred return**. Although the market standard is to calculate preferred returns on an IRR basis, the preferred return can also be calculated as a multiple on contributed capital.[3] An MOIC hurdle is standard in continuation vehicle structures (discussed below).
- **Eliminate a minimum return hurdle all together.** Coupled with a return of aggregate fees and expenses as stated above, in addition to requiring a significant GP commitment to the fund, this change be the most effective way to align economic interests between LPs and GPs in the long run.

[2] Institutional Limited Partners Association
[3] CITCO – "The Drawbacks of Clawbacks"

During life of a fund

In clawback situations, transparency and working with LPs or the limited partner advisory committee is essential. Therefore, implementing terms that serve to protect LPs should include:

- **Disclosures on a potential clawback situations**. ILPA indicates that clawback liabilities should be disclosed to all LPs at the end of every reporting period and include a plan to resolve any clawback that may surface.[4]
- Establish an **interim true-up** which relieves LPs from waiting until the end of the fund to resolve a GP clawback. The GP would be required to conduct an annual calculation to determine if gains were distributed consistently with the applicable split (i.e 80/20). In situations where an over-distribution of carry came to light, it would trigger a "make whole" payment from the GP to the LPs after a reasonable cure period expires (i.e. 12 to 24 months).
- **Management fee waivers and/or contributions from their capital account**. GPs can utilize the fee waiver or allocate their pro rata GP share of investment proceeds to LPs to reduce the total liability owed to LPs.

How are secondaries impacted by clawback risk?

With the significant growth in the secondary market, the existence of a potential clawback liability in any given fund impacts pricing in an LP-led sale. A buyer may perceive that the clawback is either likely to create an extended holding period of the assets by the GP or simply be uncollectable. Both scenarios would contribute to discounted fund secondary pricing.

However, depending on the size of the LP position being transferred, a secondary transaction also serves as an opportunity for a partnership to resolve the clawback in the process, with the buyer working with the GP to amend the Limited Partnership Agreement ("LPA") accordingly. The trade-off may come with the buyer agreeing to an extension of the fund term, introducing a new waterfall structure to re-align interests or committing a modest amount of dry power to the fund, perhaps through the creation of an annex fund.

Paying attention to clawbacks is also an important consideration in conjunction with GP-led secondaries, including continuation vehicles (CVs) and structured liquidity solutions. With regards to a CV, both existing LPs in the legacy fund and new investors in the CV may be impacted. For the legacy fund LPs, there may be concern that the GP is lifting the better assets from the portfolio, leaving the LPs with elevated risk that the appreciation of the transferred asset(s) would no longer be a resource to cover a clawback should the remaining portfolio drop in value. In effect, even if the GP is not taking liquidity at the formation of the CV and simply rolling 100% of their economics into the CV, they are still "crystalizing" economics based on a specific set of assets, which may not have generated carry if left in the legacy fund. This has recently been referred to as "disaggregation of carry".[5]

[4] Institutional Limited Partners Association
[5] Private Equity International – Side Letter – August 28, 2024

In order to protect the legacy fund LPs, several checks and balances should be considered, particularly during the CV consent process. Much of this is tied to the GP providing transparency to LPs on the remaining assets or taking actions that rectify the clawback situation:

- Asset by asset details on current valuations
- Forecasting of exit amounts and sequencing
- Projections for future fund IRR outcomes based on low case, base case and high case portfolio liquidity scenarios
- Modify waterfall hurdle to a lower rate and possibly add a MOIC hurdle to realign interest with LPs, perhaps in conjunction with a tiered carry structure and extended fund term
- As appropriate, offer to establish an escrow account to provide protection against a potential future clawback, perhaps capitalized or guaranteed by the GP's economics in the CV
- Of course, should a clawback exist at the time in which the CV is being proposed, the GP may consider making a partial or complete true-up payment to LPs as a part of the transaction

New investors in the CV may be focused on the impact of a potential clawback in the legacy fund:

- Potential that the GP is distracted by having to address a clawback in the legacy fund that may not have been likely if the CV assets were not transferred
- Latent misalignment if the GP offers their interest in the CV as legacy fund collateral protection, particularly if the size of the potential clawback is significant. This could potentially influence the manager to extend the normal CV holding period
- Likelihood of a dispute between the legacy LPs and GP should the LPs feel negatively affected as a result of the GP creating the CV structure to circumvent paying a clawback in the legacy fund

It is important to note that, typically, CVs feature both an IRR and MOIC hurdle set between 1.30x-1.75x, which greatly reduces the risk of a clawback compared to traditional funds. In addition, most CVs have lower fees and expenses that are less of an IRR drag on the hurdle.

Structure solutions such as NAV loans can be helpful to support portfolio companies and drive growth later in a fund life. However, the risk exists that the use of leverage may delay payback of a pending clawback. For example, a NAV loan may be used to support portfolio companies that may have limited upside. See Upwelling research on NAV Loans.

Summary

Market periods that experience a significant run-up in valuations followed by a precipitous pullback - as has been the case over the last three years – highlight the threat that GP clawbacks are omnipresent in private equity funds that have an American carry structure. As GPs have been required to utilized mark-to-market valuation practices, unrealized valuations have the potential to mask the potential clawback risks. Our research suggests that there is potential risk that clawbacks exist in one out of every fourteen funds.

As discussed, there are preventative partnership structural solutions that can be applied during fund formation or during the life of the fund to mitigate this risk. However, from a practical standpoint, we believe that the most important step is for GPs to recognize this risk and be fully transparent with their LPs about how they intend to resolve the situation as early as possible.

Investors need to be aware that the presence of a clawback liability may give rise to an elongated fund life as the GP may have little incentive to wind down a fund in a timely fashion. Longer holding periods have historically led to more underperformance (see previous Upwelling research on tail-end funds). Therefore, left tail bias may be higher than anticipated.

For LPs, identifying potential clawback risk and addressing it should be a priority as a part of their overall investment and monitoring responsibilities. LPs should seek to strike a balance between a fair carry distribution structure for the GP while securing appropriate clawback liability protection. When a GP seeks LP consent for amendments and extensions during the life of the fund, LPs should ask the GP to disclose and address any potential risk of a clawback as a requirement to secure their vote.

In closing, to avert the Night of the Living Dead, addressing potential clawbacks early on helps avoid big headaches for LPs and GPs in the future. Secondaries can serve as an important tactical "tool in the shed" to utilize in this process. This sets the stage for a successful sequel, ideally outside of the horror genre.

About Upwelling Capital Group

Founded in 2011, Upwelling Capital Group LLC ("Upwelling") is a registered investment adviser that provides customized strategies and solutions to enhance the overall returns for premier alternative investments. Upwelling specializes in providing secondary liquidity solutions across asset classes and capital structures. Principals have cumulatively overseen over $50 billion in global private equity commitments and have successfully managed over $5 billion in legacy, tail-end commitments, transfers, and workouts for leading institutional investors. Securities offered through BA Securities, Inc. Member FINRA / SIPC