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Private Funds CFO

Carry, waterfalls and incentives

ISSN 2632-6418 • ISSUE 6 • DECEMBER 2019/JANUARY 2020

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Insight

Carry, waterfalls and incentives
Most firms still rely on traditional systems for calculating carry, but the need for transparency is driving automation

1

Excel still excels

The waterfall is the most complex calculation in the private equity industry – and the most important. Within several general models for calculating carried interest, firms use an infinite variety of different adaptations – sometimes operating different structures across funds and even within funds themselves. “We see firms that may have multiple variations of already complex waterfalls across 80-100 different funds,” says Scott Pearson from EWM Global. The fact waterfall calculations are so bespoke means it’s hardly surprising that firms are cautious about moving away from their internal systems, which are almost always based on Excel. Our annual survey of CFOs shows just 6 percent have automated their waterfall calculations. There is widespread trepidation about whether automated systems can account for the nuances contained in firms’ spreadsheets. CFOs are also concerned by the cost, particularly at smaller firms. Even so, 10 percent of firms in our survey are planning to automate – and automation is likely to cascade if concerns over functionality and cost can be addressed.

Key person, key problem

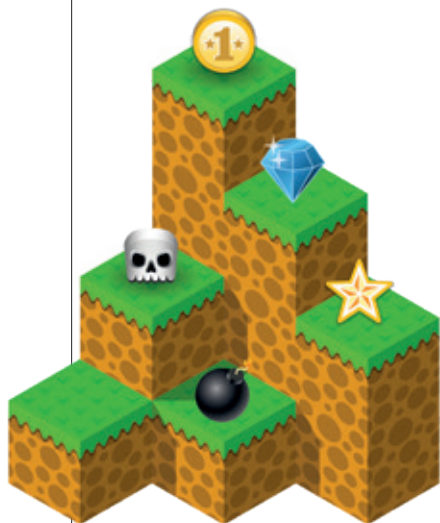
Studies show Excel spreadsheets are not as reliable as CFOs might think. “Excel has the advantage of familiarity,” says Joe Hayward, tax and financial manager at ECI Partners. “But it does have limitations in that it can be difficult to prevent errors creeping in.”

Small mistakes in entering data, formulas or formatting cells can mean disaster for a firm’s reputation.

A growing number of CFOs appear willing to consider automated alternatives. In particular, firms might need to consider automation due to auditing requirements and succession planning. At many firms, a single ‘key person’ has knowledge and control over critical waterfall calculation methods.

“The administration of our carry and co-invest plans has been highly manual and owned by one person for a number of years,” says Seth Berger, chief financial officer at AEW Capital Management, which has recently automated carry plans. “As our business has grown over the years with additional plans, the ability to maintain clean, consistent record-keeping has been outlived.”

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Team members want transparency

As well as creating a business continuity risk, the tendency for Excel systems to be controlled by gatekeepers means that team members cannot easily work out the status of their own carry allocations.

Equally, automated systems are built with collaboration in mind. Unlike Excel, LPs can easily dive into waterfall calculations, without fund managers needing to share their entire model. And the actual process of automating – though sometimes painful – ultimately offers potential benefits for firms.

“They are forced to reassess LPAs and the way waterfalls have traditionally been calculated,” says Riyaz Gadiwalla, head of product strategy at EWM Global. “Sometimes complacency has crept in and things are being done in a certain way, simply because that is the way they have always been done.”

“As our business has grown over the years with additional plans, the ability to maintain clean, consistent record-keeping has been outlived”

Seth Berger
AEW Capital Management

Optimizing carry

Firms that use Excel for their waterfall calculations value the familiarity and relative simplicity. But in simplifying their models, to make them easier to repeat in Excel, they may be missing out on carry. “Simplifications end up overstating the preferred return, when compared to an automated system that is carrying out a far more detailed and complicated calculation,” warns Pearson.

On pages 21-23, EWM Global's Robert Hagmeier illustrates this point with a mathematical comparison of two ways to calculate carried interest. The fixed date compounding method, where firms compound all their fund's outstanding capital on a certain date, is simpler to operate in Excel. But using an automated system to calculate separate preferred return accruals for each capital call on their respective anniversary date is more accurate and results in a lower hurdle value. This avoids a time-value loss and means partners can be paid on their carry earlier. And for a marginally profitable fund, writes Hagmeier, it can “prove the difference between partners receiving a small amount of carry or none at all.”

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Slicing the pie

Regardless of which waterfall method is used, deciding how to split carry between team members is often contentious. Private equity recruiter Gail McManus has compiled data showing how founding partners tend to take the vast majority of the carry pool in first-time funds. Although their share is naturally diluted as their firms grow and they promote more partners and directors, the problem of how to allocate carry only gets more difficult.

“Resentment can sometimes build up among the cohort that feels it is delivering the bulk of the workload in a fund,” writes McManus. But “founders may well feel that they are only just getting the rewards of their years of effort in funds three and four.”

Firms typically use complex formulas to allocate the carry share of executives who leave the firm before the end of a fund, distinguishing between ‘good’ and ‘bad’ leavers. Unsurprisingly, “the consequences for being a bad leaver (or being downgraded from a good to a bad leaver) are uniformly bad,” notes Christopher Good, a partner at Macfarlanes. But even ‘good’ leavers are unlikely to be fully satisfied with their package, since allocation rules are “written so as to incentivize the executive to stay for the duration of the fund's investment period.” ■

EWM Global has been interacting with finance and operational professionals across the private equity industry for almost 20 years. During this time, we have met with a great number of CFOs ranging from small one- or two-fund shops to those with hundreds of funds in their portfolios. However, even with the advances in technology over the past five to 10 years, we still come across very few private equity firms that have embraced digital transformation.

Interestingly, we find that the majority of private equity firms still manage critical in-house administration processes manually. For the most part, these sophisticated investment professionals spend hundreds of millions investing in portfolio companies to reshape them to increase their value; in many cases by digitally transforming their internal processes. When it comes to managing their own key administrative processes, it is all the more surprising that these same GP firms have ignored automation for such a long time.

Seamless dataflow

Now, finally, the tide seems to be turning. We see more private equity firms seeking help to find and implement technology that helps them to digitally transform and manage their carried interest, co-investment programs and waterfall calculations. These processes can be fully automated and digitally linked with internal or external data sources resulting in easy-to-manage, seamless and robust dataflow.

However, we do understand that automating processes is not an inconsequential decision. Knowing the pain of implementation as well as we do, it is not surprising to us that CFOs and their administration managers are concerned about digital transformation being too time and labor intensive.

In this issue, we endeavor to answer the many questions we receive when we talk to these firms about their plans to automate and digitize their processes. We talk about how GPs can break free from the limitations of spreadsheets and highlight, from our experience, the primary business risks which result from manual processing. Digitization

The CEO's view The tide is turning for transformers as private equity firms finally embrace digital technology



Expert analysis by **Wolfgang Schroter** of EWM Global



“There seems to be a common consensus that in-house admin processes will, eventually, have to be entirely digitized”

through a platform approach does not have to result in a black-box, which is of particular importance for processes such as waterfall calculations. The following pages look at the headwinds facing the sector, how current admin systems are faring and the challenges they are bringing as GPs scale-up.

In the article featuring our mathematical analysis, we show how firms can optimize their waterfall through an automated system. We compare two

commonly used European waterfall models and look at their impact on a hypothetical fund. The findings are stark.

We are delighted to have the perspectives of multiple CFOs and industry experts in this publication. In their interviews, it came as no surprise that there were commonalities around the vital importance of carried interest and co-investment programs, and the role they play for firms. Opinions from some of the experts featured in these pages seem to agree that carried interest isn't going anywhere despite political discussions on this topic. And, overall, there seems to be a common consensus that in-house admin processes will, eventually, have to be entirely digitized.

Digitization hasn't run its course yet. GPs now have an opportunity to embrace the potential of new technologies for their own organization.

We hope you enjoy this insightful issue of *Private Funds CFO*. ■



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Private Funds CFO

Published 10 times a year by
PEI Media. To find out more about
PEI Media visit thisisPEI.com

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Printed by Hobbs the Printers Ltd
hobbs.uk.com



Editor's letter

Redefining the debate over waterfalls



Graeme Kerr

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When EWM Global came to *Private Funds CFO* in the summer with its idea for a supplement about carry and waterfall payments, I had my doubts. Twenty-eight pages devoted to the complicated calculation that governs who gets what in terms of returns, and whether that process should be automated, seemed a tad ambitious. I mean how much is there to say about this most arcane of issues? And how can you sustain reader interest in something that, at first sight, doesn't sound the most compulsive of page turners?

Well I'm delighted to say that I was 100 percent wrong. In truth we could have filled another 28 pages to give full justice to a subject that is the lifeblood of the private equity model. The waterfall calculation governs the alignment between LPs and GPs and so governs how returns are decided. That much I knew. What I didn't realize was how the issue of automation of this crucial calculation took us to the core of another vital question facing CFOs: how much faith should they place in technology?

We've done a number of CFO surveys on this subject in recent years and the response is surprisingly mixed: the waterfall is not complex enough to require technology, say some CFOs. Others argue the polar opposite – that the calculations are too complicated to cope with the myriad of bespoke arrangements across different LPAs. The one point of agreement seems to be the faith in the familiar: Excel spreadsheets. Stick with what you know, right?

EWM Global presents some very convincing arguments as to why that view is mistaken: that changes in complicated regulation and tax structures require a solution beyond spreadsheets, and that LP demands for transparency necessitate a more sophisticated approach. There's a human dimension, too. The carry calculation takes you to the heart of what really matters to many: remuneration. Private equity recruiter Gail McManus looks at how the spoils should be divided, and asks which provides the greater incentive: cash or salary; while Dominic Elias of Investcorp considers co-investment options.

There's plenty more, too – we really could have doubled the issue size and still had more to say – but profound thanks are due to EWM Global for suggesting the whole idea in the first place.

Graeme Kerr

Graeme Kerr

“ The carry calculation takes you to the heart of what really matters to many: remuneration ”

The EWM view Fund managers must break free from spreadsheets to maximize performance



Expert analysis by **Kelley Gustafson**, chief client officer and **Lee Khandelwal**, chief technology officer of EWM Global

Technology has fundamentally changed the business world and private equity is no different. Digital transformation provides an attractive investment opportunity for many firms. Yet there can often be a disconnect between having a forward-thinking investment strategy and applying it to the adoption of new technologies for the firm itself. This publication addresses how technology can be used to help with one of private equity's other key pressures – attracting and managing talent.

Changing times

This year's *Global Private Equity* report from EY highlighted four key priorities for private equity CFOs: technology, talent, outsourcing and talent management. But our experience at EWM Global tells us that firms are missing out on opportunities to address these challenges. The systems firms are using today are simply not good enough to keep up with the demands of arguably their most valuable asset: their people.

Private equity has undergone a staggering transformation in the decade since the global banking crisis. What was once a relatively niche and informal corner of the international financial ecosystem has blossomed into a major destination for investment. Institutions are increasingly turning to alternative sources of revenue amid a sustained paucity of yield across traditional markets.

This growth, which shows little sign of slowing, has been accompanied by a necessary increase in sophistication as the industry matures. With regulators and LPs alike hungry for far more

frequent and granular data on alternative investments, the old days of emailing a brief PDF report once a year are largely gone. Far higher regulatory scrutiny, along with the need to impress ever more discerning investors, has led what was once a comparatively low-tech sector to start embracing change. Firms are adopting digital investor platforms and other third-party tech solutions to make information secure, comprehensive, reliable and accessible.

Yet, while change, in this instance, is a good thing, it has also been overwhelmingly geared to the side of investors and investments. Firms have understandably had to focus most of their transformation time and attention on adapting to new reporting regimes such as AIFMD and MIFID and drastically improving investor communications. This has left some of their most vital transformation opportunities untouched. Worryingly, those opportunities are those that benefit their members.

The systems in place at most firms continue to resemble the pre-crisis private equity industry of old.

Carried interest plans are usually

“Virtually every client we on-board has errors in their spreadsheets, some tiny, some significant”



dealt with in-house, and typically revolve around nothing more sophisticated than a collection of Excel spreadsheets. In cases where third parties such as fund administrators do lend assistance, systems still tend to be highly manual and spreadsheet-orientated.

These antiquated systems carry significant risk. Virtually every client we on-board has errors in their spreadsheets, some tiny, some significant. These systems can be very messy and time-consuming from an administrative perspective. Two or three seemingly simple spreadsheets soon balloon into 20 or 30 as investments are realized and new funds launched.

The manual element of spreadsheets means that information can be incorrectly inputted and altered, or irregularly updated, which puts untold – and we would argue unfair – pressure on HR and finance to ‘get it right.’ Beyond the risk of human error, there is another human risk – that often the complexity and lack of documentation means that only one or two individuals truly know how to operate their ‘system.’ This might seem unproblematic – until that individual is promoted, or leaves.



Churn on the member-side leads to additional complications in ensuring that forfeited carry points are properly reallocated. Points can easily be misallocated or orphaned, and these mistakes can multiply to the point where millions of dollars risk being misallocated or lost.

Changes in complicated regulation and taxation structures, both over time and between territories, add yet another dimension of complexity. The risk to proceedings only increases if all the calculations are sitting in a master (or dare we say it, monster) spreadsheet.

Again, we ask, why does it matter? This is not just about making sure a firm's systems are running smoothly. It is also about ensuring their people know the true value of their package.

The art of the possible

Firms that do not start to look at this side of their operations could find themselves at a disadvantage compared to first movers. Attracting and retaining the right staff is a crucial element to success in the world of private equity. Getting remuneration systems right can therefore lead to considerable upside.

“Regulatory scrutiny, along with the need to impress ever more discerning investors, has led what was once a low-tech sector to start embracing change”

With competition for the most talented professionals growing increasingly fierce, ensuring that carry systems are reliable and correctly administered provides transparency. It also allows team members to understand the value of their allocation.

Having a system that allows members and administrators to see, at a glance, an up-to-date snapshot of the current status is becoming increasingly the norm. We have already seen the shift from requiring an annual to a quarterly update. We expect, in time, that members will want

to know where they stand at any given moment in time. They receive this in other parts of their life, from Facebook to Amazon, so why not from their firm?

Digitized platforms automate the process and provide users with convenient access to information whenever needed. They can capture carry plan rules such as allocation and reallocation of carry, vesting, partner termination rules, valuation changes and payout information in a transactional database, rather than offline through disconnected spreadsheets.

A digital platform can be adapted for the unique set-up that every firm creates. These truly bespoke systems ensure that all the detail in the complex spreadsheet is managed more readily online. Not only does a system reduce the propensity for error, but it also provides a vital audit trail. This, after years of movements and transactions, is virtually impossible without systematic management of the data.

What should firms look out for? Given the sensitive nature of the data, information security is key. Systems should be secure from unauthorized access by external parties, through methods such as two-factor authentication and encryption in both rest and transition states. They should also deliver rigid partitions of information within the teams to prevent unauthorized access to other people's information. Executive participants should have access to all their carry and GP information, from LPAs and subscription agreements, to vesting, valuations and historical data. Some systems can capture electronic signatures for documents and bank account details for future distributions.

Those we see working with these systems most successfully use them as part of talent acquisition, onboarding and ongoing management - rewarding members with information and understanding to build trusting long-term relationships. Our hope is that in embracing outsourced technology solutions that support talent management, forward-thinking GPs will be able to break free from the limitations of spreadsheets and focus on delivering value. ■



Is it time for private equity to embrace technology in this last bastion of manual process? Amy Carroll explores the pros and cons

Automating the



waterfall

Private equity firms are masters at transforming the companies in which they invest. In an era of rock-bottom interest rates and sky-high valuations, driving fundamental operational change has become essential to delivering returns.

At the heart of almost every private equity investment hypothesis today lies a transformational digital strategy. Indeed, many firms have hired dedicated digital expertise to boost the performance of their underlying portfolio companies.

And yet, these same private equity firms have proved remarkably reluctant to apply a digital lens to their own businesses. The asset class continues to lag far behind other industries when it comes to embracing automation.

This is gradually beginning to change, however. A proliferation of complex regulation, along with the trend of limited partners growing more sophisticated and demanding, means technology has revolutionized compliance and LP reporting in the wake of the financial crisis.

Now, private equity is slowly beginning to turn to automation for its most critical and complex calculation of all—the waterfall.

The waterfall calculation, which determines the priority in which investment proceeds are paid out to general and limited partners, is the lifeblood of the private equity model. It governs the crucial alignment between GPs and LPs and, as the generator of carried interest, it is also a vital source of incentivization for the investment teams themselves.

“The waterfall is the most important and complicated calculation that a private equity CFO faces, not least because it is highly visible to everybody,” says Daniel Parker, CFO at Synova Capital. “Every partner in the firm will be running their own background calculations and so will our underlying investors. You can’t afford to get it wrong.”

It is precisely because this calculation is so important—and so personal—to those running private equity firms, that auto-

mation has been slow to catch on. CFOs may fear ceding control of spreadsheets that have governed their waterfall models for years. Their investment teams may be suspicious of changes to the way they get paid. There may be distrust, in general, of the idea of a black box that simply spits out a number.

“This all still feels very new, and when something is new it is normal to get pushback,” says Joe Hayward, the tax and finance manager at ECI Partners, who is currently responsible for implementing a new automated monitoring, valuations and waterfall system at the firm.

“I think there can be concerns about not being able to delve into the underlying working in the same way you can with an Excel spreadsheet, which everyone understands, and which has been around for decades. It’s important to get buy in for a new system from the whole team.”

CFOs worry, too, that the implementation process and historical transfer of data will consume vital resources. They may also question whether software can really accommodate the many nuances and idiosyncrasies of their models.

“Partnerships are wonderful in that you have great flexibility to structure things exactly as you want to structure them. You can have excused investors, for example, or different fee structures for specific LPs,” points out Darren Jordan, CFO at Silverfleet Capital.

“But that flexibility can inherently create complexity, and the key area for that com-

“This all still feels very new, and when something is new it is normal to get pushback”

JOE HAYWARD
ECI Partners



plexity is the allocation of profits between investors and the carry partner of that vehicle – the waterfall. We have been around for more than 30 years and the models we have built with Excel have been shown to have great flexibility. They have integrity. Fundamentally, they work.”

The problem with spreadsheets

But while private equity’s passion for Excel remains undimmed, spreadsheets do have their limitations. And as the capital inflows into the asset class continue to swell, and the complexity governing the outflows – the waterfall – escalates ever further, those limitations are becoming increasingly apparent.

The most significant problem associated with Excel-based waterfall calculations is simply human error. Studies repeatedly show that 90 percent of spreadsheets contain at least one error, and further research demonstrates that attempts to correct those problems often introduce additional errors.

The reason that the error rate is so high is because there are just so many ways that errors can be made. Numbers can be mistyped; incorrect formulas or logic can be applied; there can be rounding mistakes; cells can be improperly formatted, or a formula may not be correctly expanded across a row or down a column.

“We see clients who simplify calculations to make the process easier to follow and more repeatable,” adds Scott Pearson, who heads the private equity services division at EWM Global. “But those simplifications can end up overstating the preferred return when compared to an automated system that is carrying out a far more detailed and complicated calculation. Those clients are simplifying something they know to be complex and by doing that they don’t necessarily get the correct answer.”

Indeed, the complexities of the waterfall calculation can quickly become compounded and errors can spiral across hundreds of linked spreadsheets and thousands of lines of data. Errors can cost private equity firms millions of dollars in time and money and dent their reputations, damage their relationships and impair their future fundraising.

Saving time

Maintaining these labyrinthine spreadsheets can also be extremely time consuming, with additional resources required for checking and re-checking the results. The implemen-

Automation at ECI Partners:

A work in progress

ECI Partners has historically calculated portfolio company valuations and modeled its waterfall using Excel.

“Excel has the advantage of familiarity,” says tax and financial manager Joe Hayward. “It also enables you to make adjustments depending on the intricacies of a particular investment. But it does have limitations in that it can be difficult to prevent errors creeping in. It can also create issues around auditing.”

ECI has recently, therefore, introduced a cloud-based automated system for monitoring P&L KPIs across its portfolio. It is now in the process of implementing a parallel valuation system that uses that information. “The two systems are meant to work in conjunction with one another. We are also testing the systems’ capability to accurately calculate waterfalls. We are not there yet but early testing suggests the system is flexible enough to meet our needs. We hope to be up and running by December.”

What makes the waterfall so complicated?

There are myriad different waterfall structures operated by different private equity firms, most notably the contrasting American deal-by-deal approach and Europe's whole-fund calculation.

Furthermore, individual firms will operate different structures across funds, and significant variation will even exist within funds themselves, depending on the specific negotiations with underlying investors.

Most waterfall models are some variation on:

- Return of invested capital
- Return of allocable expenses
- Preferred return
- GP catch-up
- Carried interest

However, the order of priority in which proceeds are allocated across these tiers can vary widely. And even where a firm does operate a standard model, with 20 percent carry and an 8 percent hurdle with 100 percent catch-up, those components can be calculated in many different ways. The preferred return can be calculated as an IRR, for example, or

simple interest, or monthly compound interest, or as a multiple of contributed capital.

Furthermore, sometimes waterfall calculations for a specific fund will be adjusted over time because of LPA amendments. The tax and regulatory treatment of proceeds in different jurisdictions also have to be taken into account, as do changes to those regimes. And when carry partners leave a firm, forfeited carry points must be reallocated.

As capital continues to pour into the asset class, LPs are becoming more sophisticated and the complexity around waterfalls is only increasing. Provisions such as deferred carry mandates, post carry fair value tests and interim claw back are now commonplace.

This lack of standardization makes automation challenging, certainly, but this level of complexity is also the reason why private equity firms are beginning to recognize the limitations of manual systems and some are embracing an automated approach.

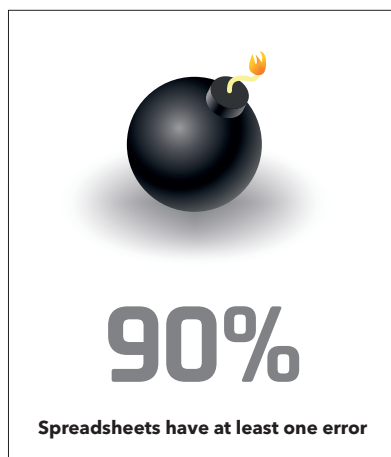
tation of automated systems does require upfront investment, both in terms of capital and time. But once operational, adding new funds should be relatively straightforward in a well-designed system.

Furthermore, responsibility for Excel-based waterfall calculations tends to rest in the hands of a small number of individuals, due to its importance and complexity, which creates an intrinsic keyman risk. Working with a software partner offers a route to strengthen business security and means there is always someone to step in to help train new recruits.

Excel also offers limited capacity for sharing, either internally or externally. And, as institutional investors become increasingly active in monitoring their investments – and indeed will often replicate the waterfall calculation themselves – Excel offers no easy way to let LPs dive into the calculation behind the waterfall without sharing the entire model. Automated systems, however, are built with collaboration in mind.

Perhaps most importantly, meanwhile, automated systems have the added bonus of allowing private equity firms to easily model and re-model the waterfall based on myriad variables, ultimately optimizing the outcome.

“You can tweak the compounding, or the



number of days you use in that compound, without having to copy that formula across hundreds of different rows,” says Riyaz Gadiwalla, head of product strategy at EWM Global. “Or you can play around with excluding a particular expense. Being able to optimize the most important calculation for a firm’s partners in an automated way is a pretty powerful tool.”

Finally, far from obfuscating the waterfall, the process of automation itself can help increase transparency and support clear decision making by pushing teams to reassess the way they approach the calculation rather

than automatically accepting the status quo. “Firms are forced to review policy and to review configurations and then make determinations for future funds,” explains EWM Global’s chief operating officer Rebecca Symonds.

Automated software should, in any case, provide detailed reporting on every variable that has gone into the system and CFOs should be able to retain visibility of the process, in much the same way that they would with Excel.

Keeping control

Indeed, while early automation focused on the provision of a full service platform, the emphasis now is on empowering CFOs to run their own waterfalls, supported by a system that is flexible enough to swiftly adapt to any internal or external forces that may come that firm’s way.

Automation of this revered calculation is still very much in its infancy, but more and more firms are preparing to take the plunge. “Waterfalls will probably be the last bastion of Excel,” says Haywood. “It’s still early days. But as automation is increasingly used for portfolio monitoring, and for pulling out the P&L inputs necessary for company valuations, it is likely that automation of the waterfall itself will be next.” ■

KEYNOTE INTERVIEW

Waterfall automation: Face your fears



Automation can minimize mistakes and optimize carry, while still leaving GPs in control of this vital calculation, say Riyaz Gadiwalla, Rebecca Symonds and Scott Pearson of EWM Global

Q Why is the ability to accurately administer waterfall calculations quite so critical?

Rebecca Symonds: There are two calculations that drive private equity firms. The first is fund performance – the IRR being generated for investors. The other is the way in which the firms are actually going to make money themselves. I liken it to how a lawyer or accountant, who gets paid by the hour, will meticulously track the time they spend on a client. Waterfall calculations are the lifeblood of the organization. They determine how the GP will make money based on the profits it is generating for investors. That's why it's so important.

Q To what extent is the private capital industry embracing waterfall automation today?

RS: We are – slowly – starting to see the industry embrace automation. Slowly, only because it is such an important calculation for these firms. Initially, we began to see traction for automation as a secondary cal-

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– a second set of eyes, if you will. Now we are starting to see much greater appetite for automation as the primary source. There has been a significant spike in interest over the last 12-18 months.

Q What makes waterfall calculations so complex?

Scott Pearson: They are complex because they are based on a series of individual negotiations with underlying investors. Certain investors may be charged a higher or lower fee or may be excluded from some investments, for example. There may be timing differentials. We see firms that may have multiple variations of already complex waterfalls across 80 to 100 different funds.

Q There are those who say the complexities mean waterfalls are too complicated to automate.

Riyaz Gadiwalla: The complexity really comes down to the way negotiations are structured. Firms do sometimes have concerns about whether an automated system is capable of dealing with that complexity, but we have a configurable platform that provides flexibility in both areas.

We also have an agile development process through which new functionality is released every eight weeks, which means we can adapt to any nuance that comes our way, either in terms of an individual firm's requirements or new regulation.

Q Finance teams also sometimes have concerns around retaining control of what, as you say, is a vital calculation. They fear the black box effect. Is that fair?

RG: I think what we offer is the opposite of a black box. Automation makes companies review their information.

As part of the implementation process, they are forced to reassess LPAs and the way waterfalls have traditionally been calculated.

Sometimes complacency has crept in and things are being done in a certain way, simply because that is the way they have always been done.

SP: I could see firms being concerned about a black box, if the system was simply producing a final carry figure, with no back up as to how that number had been reached. But any automated system worth its salt is going to provide complete transparency around all the variables that go into the calculations, freeing up the GP to spend more time on the things that they were actually hired to do.

Q So, how much time and resource does development take?

SP: There is always that initial set up that has to take place, but we are finding that after that initial migration of historical funds, the ongoing maintenance of introducing new funds to the system is really very straightforward. The complexity lies in each clients' calculation, but that complexity is replicable – albeit with slight variations.

Adding new funds takes a matter of minutes, whereas people will need to go through every single cell in an Excel sheet to ensure the logic in the formula is being applied correctly. There is always an up-front cost with any investment into your business. There's cost associated with moving into a new building, for example. But once that's completed, you would never look back and say, "I wish we were still in that smaller space."

RS: Making that investment is important from a business security standpoint as well. If your key players who hold all the knowledge around the calculations suddenly leave, you can end up in a real mess. It is worth investing that time and energy to get everything set up in the right way within the organization. You also have the reassurance of having a partner company who can step in and help train new people so that knowledge stays fresh.

Q But does Excel not suffice, at least for smaller firms with relatively few live funds?

RG: Excel is obviously a great application. We couldn't get along without it. And for a small firm, that has a couple of funds, five or six investors and a handful of portfolio companies, yes, Excel can work just fine.

“Automation makes companies review their information ... Sometimes complacency has crept in and things are being done in a certain way, simply because that is the way they have always been done”

RIYAZ GADIWALLA

“Until recently, private equity firms have been reticent to embrace technology for their own internal processes. We like to say digital transformation begins at home”

REBECCA SYMONDS

But is that firm really optimizing the waterfall calculation from a modelling perspective? An automated system allows you to tweak the compounding methodology, or to exclude a particular expense from a distribution and see how that affects the preferred return. That can be challenging in Excel and even small firms will want to optimize the most important calculation for the partners.

Q How should firms contemplating a transition to automation approach the move?

SP: Firms should look carefully at a provider's expertise and their experience with different types of waterfall methodologies. Most of these systems are also not just pure software that the client loads onto their own systems.

They are SaaS models, so it is important to look at things like information security, multi-factor authentication and role-based access. Having a provider that is flexible enough to adapt and to develop new capabilities quickly as a firm grows and expands beyond its original requirements is critical too.

At one time, clients wanted a full-service platform where we ran the calculation, audited the calculation and provided them with the results. That has now shifted and firms are increasingly demanding that they are empowered to run their own waterfalls so that they retain control.

Q How do you expect waterfall automation to develop?

RS: We find it ironic that private equity firms' MO is to buy portfolio companies, make them more efficient, typically through digital transformation, and then sell them at a profit – but, until recently, they have been reticent to embrace technology for their own internal processes. We like to say digital transformation begins at home.

I think the private capital industry is starting to do a better job and over the next few years we will see a very different industry emerge – an industry that has truly embraced the power of digital transformation and is capitalizing on the technology available. ■

Rebecca Symonds is EWM Global's chief operating officer; Riyaz Gadiwalla is head of product strategy; Scott Pearson is head of private equity services product.

Why CFOs need more convincing on automation

Chief financial officers are hesitant to automate their waterfalls, but those who have tried won't be going back, writes Ben Payton

Calculating the waterfall is perhaps one of the most important – and complicated – responsibilities of a private fund's CFO. So it's unsurprising that finance departments are cautious about moving away from internal Excel-based systems that they have spent years building up. Many are unconvinced that a third-party provider can capture the complexity in their calculations and deliver a cost-effective solution.

In April, we spoke with 15 CFOs con-

tacted by *Private Funds CFO* for our inaugural issue and found only three who used some kind of service provider or software for automating their waterfall calculations. Our latest annual survey of 124 CFOs, published in this month's *Insights 2020* supplement in partnership with Sanne, is even more striking. Just 6 percent report that they use a waterfall automator, although another 10 percent plan to adopt an automated system.

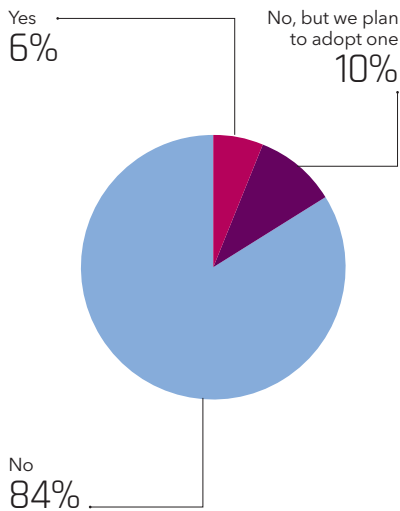
The reasons for their doubts vary. Almost 40 percent of our survey respondents

believe an automated system is simply unnecessary. "Waterfall is not that complex," said one respondent. "Have not found one that works well," said another.

Another CFO, who spoke with us anonymously in July, is equally adamant that Excel-based systems are adequate. "People make out that waterfalls are really complicated. They are, but essentially it's just a calculation. It shouldn't be as difficult as people make it, in my mind. Excel should be perfectly adequate."

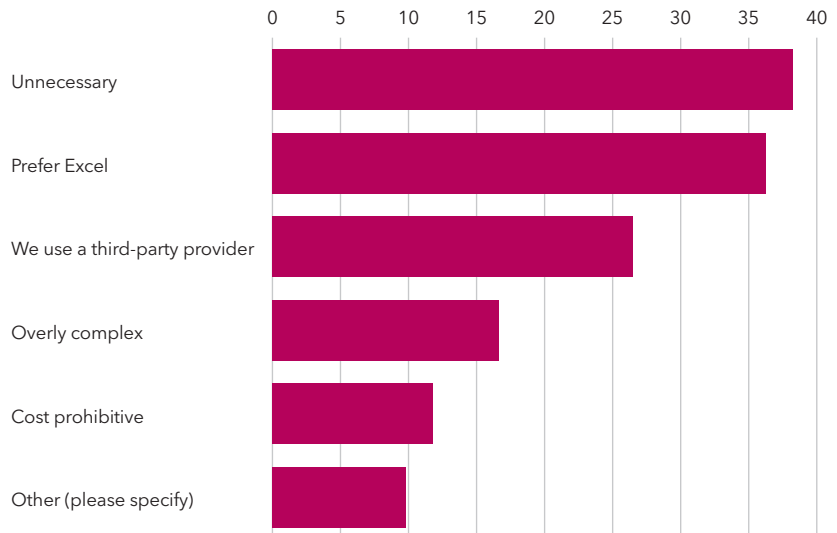
That's a common view. Of those sur-

Does your firm use a waterfall calculator?



Source: Private Funds CFO Insights Survey 2019

Reasons for not automating waterfalls (all that apply, selected, %)



veyed for this month's survey, more than 36 percent preferred Excel.

But not all CFOs would agree with this sentiment. Seventeen percent of those who took part stated that their calculations are too complex to automate. In fact, many appear to be intrigued by the possibility of automating their waterfalls, but doubt that a system can cope with the myriad bespoke arrangements contained across many different LPAs.

"I would love to find a solution," one CFO told us in April. "However, I have found that the waterfalls have gotten so complicated that I don't know how you would ever program all the steps in a system."

Meanwhile, 12 percent of our CFO respondents cited the prohibitive cost as deterring them from automating. One CFO has described using an accounting system that was an industry leader three years ago, and says they were interested in working with the same programmers to build a waterfall into the system.

They were put off by the cost: \$40,000. This group does, though, tend to be open to the merits of an automated system – at least in theory. "If it were inexpensive it would be something I would then consider," another CFO said.

The good news for technology providers is that while many CFOs are comfortable with Excel, many others have doubts about their current methods and would give waterfall automation a go – if providers can ensure their systems can capture complexity and deliver value for money.

So the door to waterfall automation is definitely opening. Even if only a relatively small band of trailblazers have already automated their waterfalls, another 10 percent of CFOs told us they have plans to take the plunge.

The other piece of good news is that those that have made the switch appear satisfied with the outcome. And those firms that have automated, or are in the process of doing so, felt the need to upgrade their systems in response to concerns over the accuracy and reliability of Excel-based approaches, with technology helping to avoid some of the data entry, formatting or formula errors that appear in Excel. ■



Automating the deal team allocation

We spoke with Seth Berger, chief financial officer at AEW Capital Management, about transitioning to an automated system for carry and co-invest plans

Q Have you decided to convert your carry and co-investment plans from Excel into a digital environment?

Yes, we decided to migrate our carry and co-invest plans to a central electronic platform earlier this year.

Q What were the key motivations for that decision? The error, 'key person' and auditability risks of Excel? The need for better transparency for members to understand the value of the firm's programs?

Our firm has been actively reviewing its various operations recently to enhance efficiency and effectiveness. The administration of our carry and co-invest plans has been highly manual and owned by one person for a number of years with little transparency to the employee participants.

Our motivations fell into 'all-of-the-above' that you mentioned in your examples. As our business has grown over the years with additional plans, the ability to maintain clean, consistent record-keeping has been outlived, so it made sense to look for a central solution that will also provide participants the opportunity to access plan information on a regular basis in a self-service way.

Q What challenges did you face in converting to the digital environment?

I would say that the most significant challenge in migrating was going through all the historical transactions maintained in different Excel-based files for active plans to report them to the new platform. By having to explain the data to third parties, it forced us to more carefully explain the way certain transactions were treated since the record-keeping may have historically been more informal when completed in-house.

Q Have there been any surprises, positive or negative, in the transition?

Well, I think the most significant surprise has been the amount of time it has taken to make our way through all of the data and make sure it is reported accurately in the new system platform. Our initial assessment was that we had all the transactional data available and could fairly easily send it over to the project team. We certainly were able to send all the data over in short order, but there ended up being lots more back-and-forth than we initially anticipated. At the end of the day, it all came together, so the process was well worth it in my opinion.

Q What would you advise your peers regarding the digitization process?

Following on my point above, be mindful of your time horizon. The timespan from beginning to end will always be greater than originally anticipated.



Carried interest: Taking your slice of the pie

*Dividing the rewards in a way that keeps everyone happy is no easy task, writes private equity recruiter **Gail McManus***

Carried interest, an essential part of the private equity compensation package, has been a source of debate since I started recruiting for the private equity industry more than 20 years ago. There are several thorny questions that fund managers must grapple with when considering carry.

Who should have it? How much should they have? Can carried interest be more of a golden handcuff than an incentive? And does it disincentivize succession?

Before the days of the multibillion fund, management fees barely covered the salary

and overhead costs of a young developing fund. The founding fathers of private equity were prepared to put their money where their mouths were and prove their worth with a share of the returns generated by the money they invested.

Skin in the game, alignment of interest – call it what you will – it was a creative reward scheme that pooled the returns from the good and not-so-good investments and ensured that the partners did their utmost to ensure that investors' money was looked after.

And to this day, it still works in the same way – the teams might be larger, the stakes and values may be higher and the scheme rules may be more complex, but the principle is still the same.

Allocating carry

So, who gets carry? Founding partners typically get stakes ranging from two-thirds to 75 percent of the carried interest pool, particularly in first-time funds where the risks are highest and the teams are leanest. Just a quick glance at our recent contributor sur-

Money at work in each fund typically equals:

3-5x

Cash compensation
for senior associates

7-10x

Cash compensation for
VPs or junior directors

12-15x

Cash compensation for
directors or junior partners

vey data bears this out, particularly in funds under \$1 billion. The individual partner allocations range from 15-22 percent, depending on the fund size – so the three or four partners in a nascent fund will consume the vast bulk of the carry. And while the percentage decreases in the multibillion funds – the potential reward increases just as a result of the multiplying factor of fund size. At founding and senior levels, the potential of carried interest dwarfs other forms of private equity compensation.

How about further down the hierarchy? It is unusual for carried interest to be allocated below senior associate level – although venture and smaller sized funds often do include all members of the investment team. Senior support functions usually enjoy inclusion in carry schemes: CFOs, heads of investor relations and HR directors are the most common recipients. Some funds give something to everyone in the team, recognizing the importance of everyone sharing in the upside of strong performance.

Over the many schemes and compensation packages that we have been involved in, we have noticed some interesting rules of thumb. By using the measure of money at work – ie fund size x carry pool percent x allocated percent – we have been able to compare carried interest allocations to cash compensation.

As a general rule, at the most junior levels of allocation – usually senior associate – carried interest money at work tends to be in the range of three to five times annual cash compensation. This multiplier increases to seven to 10 times at VP or junior director level and 12 to 15 times at director or junior partner level.

Carry or salary?

Allocating it is one thing – but how is it valued by team members? In our experience, the most junior levels would probably prefer cash – they aren't yet sure if they are committed to that fund, they have high cash needs as a result of their stage in life and pay-outs seem a long way off.

However, once personnel reach VP level, they start to expect carry. What's more, if they don't deem the amount to be fair, they can quickly become disgruntled. Given the large weight of carry reserved for partners (and particularly founding partners), resentment can sometimes build up among the cohort that feels it is delivering the bulk of the workload in a fund.

“Good people management in a fund should include encouraging ‘good leaver’ scenarios”

GAIL MCMANUS

The founding partner group naturally becomes diluted over time to some extent as more recruits become partners or directors in the fund. But distributing carry remains a major issue in managing succession effectively.

Founders may well feel that they are only just getting the rewards of their years of effort in funds three and four – as earlier funds were smaller and less meaningful in absolute terms. At the same time, the up-and-coming team feel they are doing all the work and lining the partners' pockets. Ensuring that carry remains a motivator and not a demotivator at this stage can be a challenge.

A golden handcuff?

What about staff that want to leave the business but are tied in by their carry? In my view, good people management in a fund would include encouraging 'good leaver' scenarios. This opens pathways to partnership for more junior members and allows long-standing employees the opportunity to leave unhampered by too many restrictions.

When we talk to partners who have managed to negotiate good leaver arrangements, they are generally looking for a different type of fund (or lifestyle) and rarely

want to replicate the scenario they are leaving behind. Just as the timing of bonus payouts can lead to resignations in more traditional finance roles, fundraising windows seem to be the trigger for most departure discussions. Team members must ask themselves whether they want to be included in the documentation for the next fund.

The future of carry

Not all private equity investors are third-party funds. For captive funds or limited partner direct investment funds to compete for talent, they have also had to develop ways of compensating for returns generated. We have seen various schemes designed to emulate carried interest, perhaps by pooling investments over periods of time – a two-year vintage would be quite a common way to do this.

Some of the larger sovereign wealth and pension funds have developed long-term incentive plans to emulate carry. These tend to produce a steadier reward that lacks the upside potential but avoids the downside. This greater degree of certainty was attractive in the years following the financial crisis – but we're now seeing investors in these organizations starting to hanker after the more traditional, spikier carry scheme.

Parent companies who provide the funding, or cornerstone investors in first-time funds also want their share of carry. Up to 25 percent of a carried interest pool might be set aside for parent or cornerstone investors.

So what is the future for carry? Management fees now provide significant cash compensation in larger funds, so its original aim of making up for lack of cash is no longer as valid. Its future taxation status as a capital gain is under threat in many jurisdictions. And it will always be maligned by team members who don't get the payout they expect.

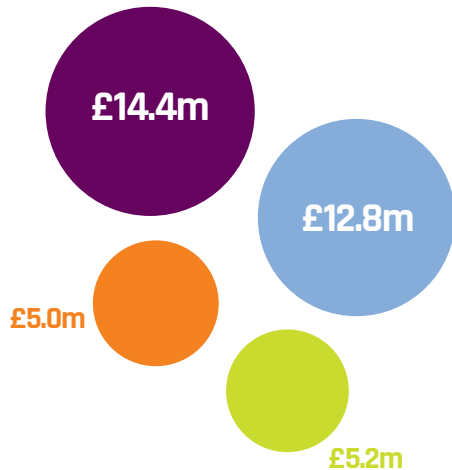
Nevertheless, its potential to align the interests of LPs and GPs remains as strong as ever. It's a fascinating and tantalizing way to incentivize. A pot of gold that always seems just slightly out of reach for most, but – for those who do eventually get their hands on it – a satisfying and meaningful reward for a job well done. In my view, it's here to stay. ■

Gail McManus is the managing director of Private Equity Recruitment, a recruitment company for private equity professionals. Prior to founding PER in the late 1990s, she worked in private equity with 3i.

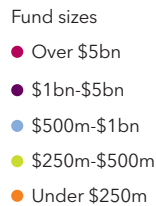
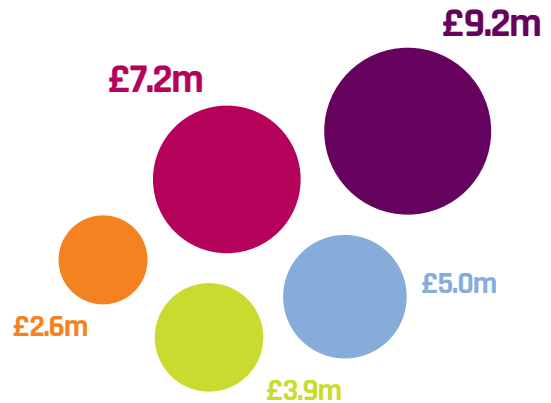
Analysis

Staff typically have a greater amount of 'money at work' in a larger fund ...

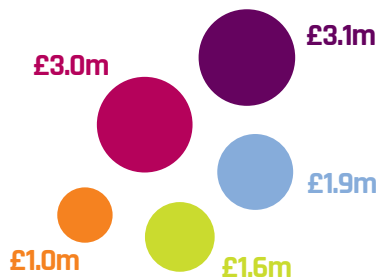
Senior partners/Managing directors



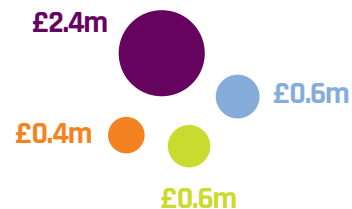
Partners/Directors



Principals/VPs/Investment directors



Senior associates



Figures show 'money at work', ie Most recent fund size (£) x Total carry pool (%) x Individual share (%), for individuals at the 50th percentile in each category
 No data for Senior partners/Managing directors or Senior associates in funds over \$5bn
 Source: PER, 2019 UK Investment Professionals Compensation Report

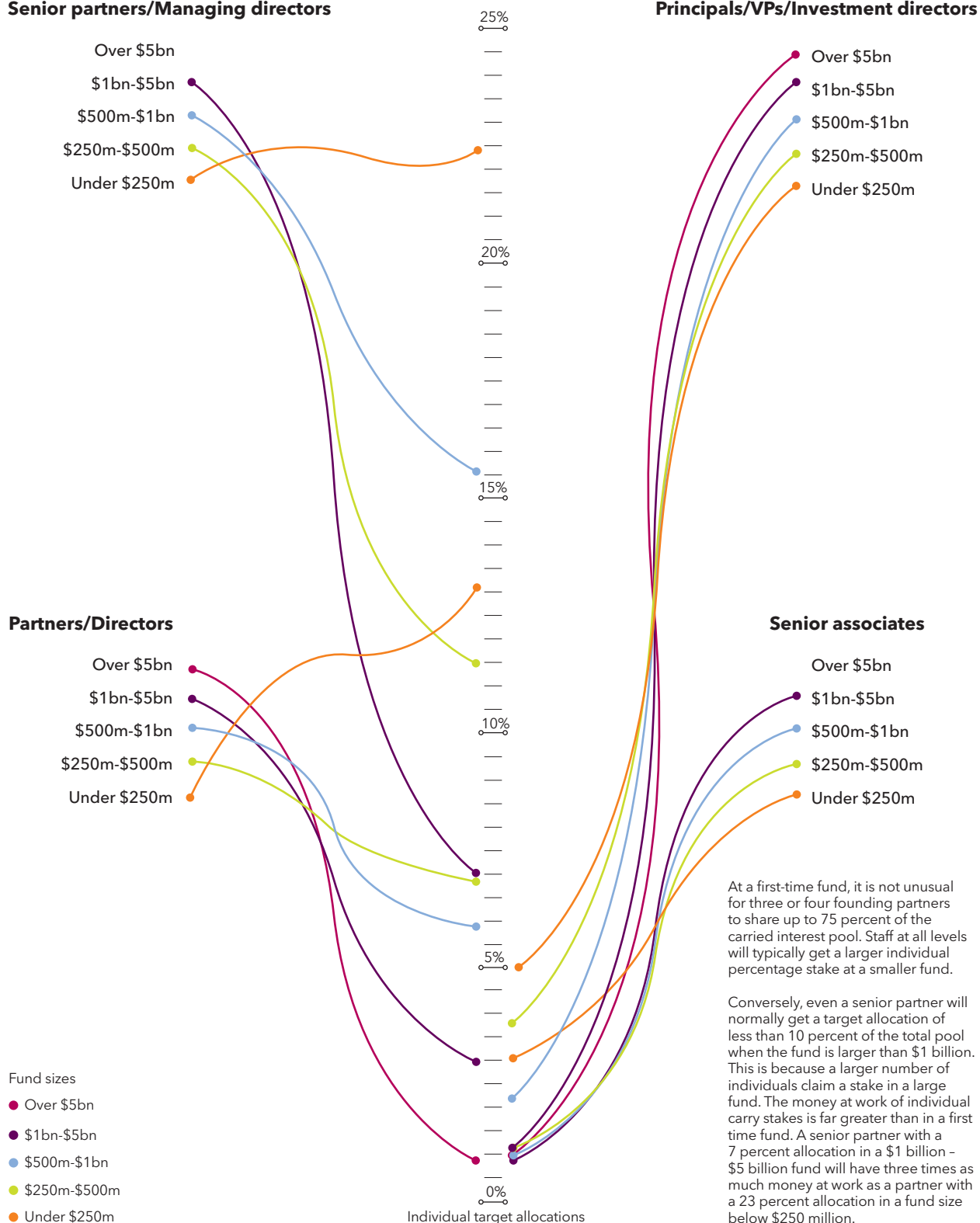
The pot of gold

Partners take the vast majority of carry at a first-time fund, but a larger fund will still offer the potential for greater cash rewards, according to the latest compensation report from Private Equity Recruitment

... although everyone gets a larger percentage share at a first-time fund

Senior partners/Managing directors

Principals/VPs/Investment directors



At a first-time fund, it is not unusual for three or four founding partners to share up to 75 percent of the carried interest pool. Staff at all levels will typically get a larger individual percentage stake at a smaller fund.

Conversely, even a senior partner will normally get a target allocation of less than 10 percent of the total pool when the fund is larger than \$1 billion. This is because a larger number of individuals claim a stake in a large fund. The money at work of individual carry stakes is far greater than in a first time fund. A senior partner with a 7 percent allocation in a \$1 billion - \$5 billion fund will have three times as much money at work as a partner with a 23 percent allocation in a fund size below \$250 million.

Co-investment considerations crucial for alignment



Guest comment by **Dominic Elias**

The right co-investment strategy helps keep team members motivated, writes the head of executive compensation at Investcorp

There is a reason that carry and co-investment by executives go together from an employer's and a limited partner's perspective. Co-investment, in which a private equity's firm's executives make a capital commitment alongside its investors, is the insurance plan that kicks in when carry fails. Given the binary outcomes associated with most carry plans, co-investment is the perfect foil to ensure that investment teams and LPs remain aligned.

For the alignment to bite, the amounts must be meaningful. Co-investment will rarely equate to the value in play in a carry program, but it doesn't need to. Once the carry plan is below the hurdle, its value becomes zero. The co-investment now only needs to be meaningful in relation to the other components of the investment team member's compensation to keep them motivated and focused.

No matter the personal financial situation of the investment team member, there is a percentage of annual compensation that will be painful for him or her to lose. For more senior team members, that may be 50-100 percent of total compensation (excluding carry). But for more junior team members it could be as low as 10-20 percent.

Cashflow will work in a similar way so that the more senior members of the team will have more cash readily available to meet co-investment needs. However, LPs today will require a significant amount of co-investment from at least the 'key persons' and often the broader team – up to 1-2 percent

“Leverage provides a kicker to the incentive provided by co-investment”

of the fund size in some cases. One way to achieve this is to ask the more junior team members to invest what they can and the senior people to pick up the slack. However, this invariably results in a very uneven distribution of co-investment across the team. After a few years of pay increases and promotions, that co-investment can be meaningless to the more junior team members.

Carrot-and-stick approach

For this reason, firms will do what they can to try to facilitate co-investment, often by reducing or (permanently or temporarily) removing bonus deferrals. Deferral with vesting can be a useful way to help retain employees and align them with the firm (if the deferral is directed into a vehicle linked to the firm's performance). Removing these deferrals eases the cashflow burden on the employee (at least temporarily) and hopefully helps them to meet the co-investment

requirement. However, this is at the expense of a retention device and aligning the employee with the firm.

A happy medium might be to direct an employee's deferral into their own fund and to apply vesting to the co-invested amounts that would otherwise have been deferred into shares or cash. However, the amounts would have to be taxed prior to being invested, and if there was a forfeiture it would be difficult to reclaim the tax. A loan structure may be a feasible replacement but the administrative burden and difficulty of communicating vesting status to employees makes deferred co-investment with vesting one of the least preferred alternatives.

Arguably the most powerful way to facilitate co-investment is to provide leverage. This is most commonly offered on a ratio of up to 3:1 of the out-of-pocket commitment (ie, the team member invests \$100 and the firm or third-party lender puts in another \$300). This has the effect of enabling the junior people to invest more so that the investment is spread more evenly across the team.

Leverage provides a kicker to the incentive provided by co-investment. If the fund or product return drops below the hurdle, it is 'disappointing'. If your out-of-pocket investment has declined in value it is more than disappointing. But if your out-of-pocket investment is now worthless and any further depreciation of the asset will result in a payment from you to the 'bank', it will definitely focus the mind. ■

EXPERT COMMENTARY

An anniversary date model can secure timely payments – and need not generate excessive complexity, writes Robert Hagmeier of EWM Global



Lifting the curtain on carried interest calculations

Amid the unprecedented growth in private markets and the increasingly competitive environment over the past decade, firms have become experts in finding ways to generate maximum value from their investment strategies. Rewarded based on the ability to identify and deliver optimal returns, carried interest remains the industry's gold standard employee incentive and shows no sign of losing favor anytime soon.

Given the amount of money derived from carried interest, it is not surprising that the mechanics of the calculation have come under scrutiny from LPs seeking transparency into the fees they pay. Today, most limited partnership agreements state the general methodologies behind the carry calculation, leaving only limited room for interpretation from GP finance departments.

One area often left ambiguous is the compounding model used in determining

the preferred return hurdle. When it comes to this calculation, a significant portion of firms choose simplicity over optimization. In doing so, they run the risk of inflating preferred returns, delaying carry payments to deal team members, and even lowering total carry payouts. To explore how these inefficiencies arise, we'll compare two commonly used European waterfall models and measure the impact of their different preferred return interpretations on a hypothetical fund.

The easy option - fixed date compounding

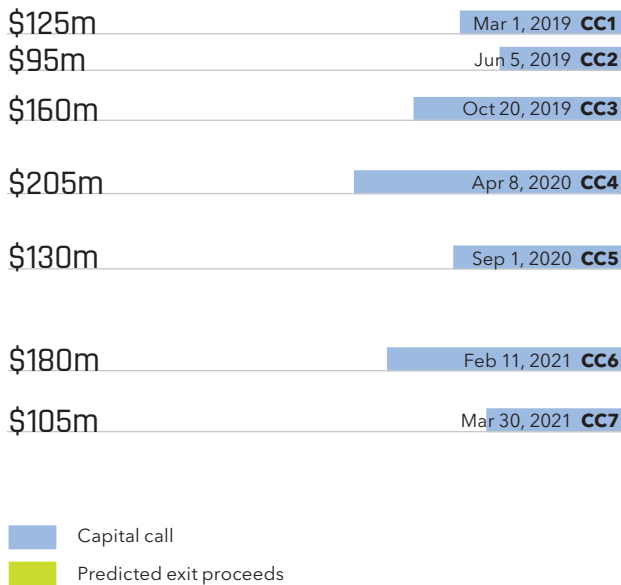
In an effort to simplify the preferred return calculation, many firms compound all their fund's outstanding capital on a fixed calendar date each year. Maintaining a fixed date waterfall model tends to reduce complexity compared to other approaches, but the simplicity comes at a cost.

A fixed date approach means that few (if any) of the capital calls accrue preferred return for a full 12-month period before the accrued amounts compound and begin accruing interest of their own. Not only does early compounding always result in a higher hurdle compared to more precise methods, it also results in a larger true hurdle than the rate stated in the LPA.

The fixed date model's impact on marginally profitable funds (ie, funds that liquidate with an IRR close to the hurdle rate) can be significant. Keeping the hurdle low in an underperforming fund may prove the difference between partners receiving a small amount of carry or none at all. Fixed date compounding is particularly damaging in these scenarios. Funds with substantial returns also feel the impact of sub-optimal compounding, albeit to a lesser extent than their low-IRR counterparts. Funds capable of repaying the preferred return and satis-

Analysis

A model fund



Waterfall parameters

\$1bn

in capital calls

8%

preferred return hurdle

100%

GP catch-up

80% **20%**

LP

GP carry split

Fund results

\$2.2bn

in exits

\$1.2bn

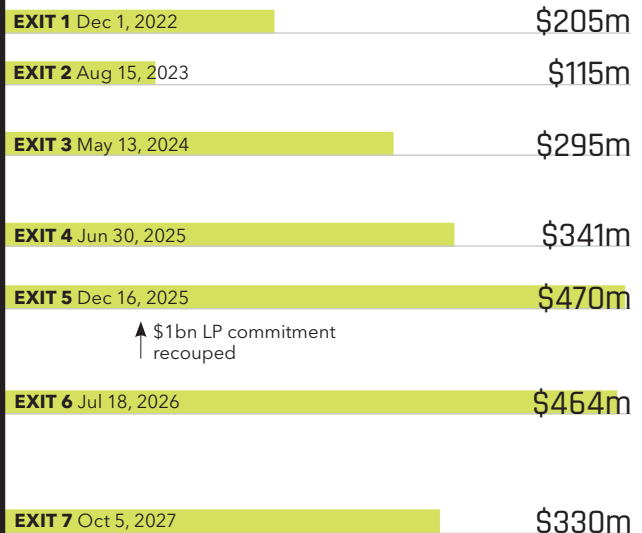
gross profit

16.34%

Fund IRR

\$244m

Carried interest paid



fyng the GP catch-up will be brought into equilibrium (eg, 80 percent LP, 20 percent GP) and will not see an impact to their final carried interest numbers, but the partners in those funds may still feel the impact in the form of time-value loss. A larger hurdle requires larger realizations before being paid down, which means partners are often paid on their carry later in the fund's life.

A worthwhile alternative?

Anniversary date compounding

Firms looking to keep their hurdle low may opt for an anniversary date model. This cal-

culates separate preferred return accruals for each capital call and compounds them on their respective anniversary dates. This model introduces two main complexities:

- (1) It can be difficult to maintain separate preferred return accruals for each capital call
- (2) Handling exits resulting in the partial pay down of a commitment may become more difficult. Partially returned capital calls require the financial controller to retroactively split the commitment into a returned portion, which no longer accrues preferred return after

the exit date, and an unpaid portion that continues to accumulate.

Despite the inherent complexities, an anniversary date waterfall tracks accrued preferred return on outstanding capital more accurately than a fixed date model and will always result in a lower hurdle value. Depending on the size and timing of cash-flows, carry payments to partners may also be available earlier in the fund's life.

Model analysis

Our model fund achieves a 16.34 percent IRR and realizes gross profits of \$1.22 billion, more

than enough to repay the preferred return and the GP catch-up for both waterfall models.

The full \$1 billion in investor commitments are recouped on the fifth exit on December 16, 2025, which leaves \$426 million available to pay down the accrued preferred return and GP catch-up. It is at this point that the two models begin diverging. The preferred returns and the GP catch-up requirements vary greatly between the fixed date and anniversary date waterfalls.

The fixed date waterfall accrues a preferred return more than \$44 million larger (11.7 percent) than the anniversary model. A greater portion of the proceeds are then required to satisfy the fixed date hurdle under this model, leaving less than \$3 million left over from the fifth exit to put towards the GP catch-up – compared to \$47 million using the anniversary date model.

The remaining portions of the GP catch-up is paid off under both models on the sixth exit in July 2026. Having repaid half of the catch-up during the previous exit, the anniversary date model only requires a further \$48 million before reaching the carry phase of the waterfall.

But using the fixed date waterfall, the sixth exit results in more than \$102 million in outstanding GP catch-up.

Once both models surpass the GP catch-up and begin splitting proceeds 80/20 in favor of the fund’s LPs, their total performance fees reach a state of equilibrium. They are then differentiated only by timing disparities in their cashflows. The \$44 million difference in payout values after the fifth exit is not resolved for seven months, creating a time value loss on the fixed date proceeds. Discounting the \$178 million in carry cashflows from the fifth and sixth exits at a 5 percent annual rate, the two models have different net present values.

Complexity is no longer a barrier to optimization

The fixed date model’s time value loss of nearly \$1.3 million is large enough to merit consideration from finance departments when establishing waterfall terms for future funds. Even when applying a conservative discount rate equal to that of the current three-month US Treasury rate (2.21 percent at the time of writing), the time value loss is still approximately \$570,000.

While it is true that any added GP value comes at the expense of the fund’s LPs, the difference in limited partner IRRs between

Preferred return and GP catch-up totals after exit 5

	Fixed date compound	Anniversary date compound
Preferred return	\$423,168,981	\$378,810,049
GP catch-up	\$105,792,245	\$94,702,512

GP catch-up and carry payments

	Fixed date compound	Anniversary date compound
Catch-up paid as carry on Exit 5	\$2,831,019	\$47,189,951
Catch-up paid as carry on Exit 6	\$102,961,226	\$47,512,561
Carry paid on Exit 6	\$72,207,755	\$83,297,488
Total Carry Paid*	\$178,000,000	\$178,000,000

*Does not include Exit 7, which pays a further \$66 million in carry proceeds for both models.

Time value analysis

	Fixed date compound	Anniversary date compound
Net present value	\$172,988,512	\$174,257,597
Time value loss	\$1,269,085	-

NPV assumes a 5% annual discount rate

“The private equity industry’s search for value should extend to the way firms handle their employee benefits, and the opportunity to generate additional value through optimized waterfalls is an attractive means of doing so”

fixed date and anniversary compound models for this fund was only 0.035 percent, arising due to the fixed date model’s tendency to inflate the preferred return above the LPAs stated rate.

Anniversary date waterfall models more closely align the preferred return calculation with the percentages outlined in the LPA. There is therefore a strong argument for abandoning fixed date waterfalls.

Not only is the reduction in investor IRR negligible, complexity is no longer a limiting factor given the availability of waterfall calculation technology.

At a fraction of the cost of an inefficient (or inaccurate) waterfall spreadsheet, digital third-party solutions are now sufficiently advanced to handle the complexities of most waterfalls.

The private equity industry’s search for value should extend to the way firms handle their employee benefits, and the opportunity to generate additional value through optimized waterfalls is an attractive means of doing so.

With millions of dollars in lost time value potentially at stake, finance departments should take a closer look at their waterfalls so that they can decide whether the simplicity of the fixed date approach is worth the cost. ■

Robert Hagmeier is regional director, business development for UK and Europe at EWM Global.

How to allocate carry to good and bad leavers



Guest comment by **Christopher Good**

What steps should a general partnership take when doling out carried interest to its partners who are leaving? There are various issues to consider

While the split of the fund proceeds between investor and manager is important to set incentives, most investors are concerned about how the carried interest is then divided (and kept) among the team. This is a sensible concern, since if the wider team is not properly incentivized then the team is likely to be dysfunctional and may lose key people over the course of the fund. To counter this, investors will want to know that carried interest is shared out among the ‘right’ deal executives, and that the manager will not let executives who leave keep too much of the carried interest pot; the pot needs to be available to incentivize the remaining deal team.

Given that carried interest tends to arise later in the life of a fund, this gives rise to ‘vesting arrangements’ and discussions over leaver provisions. The leaver provisions, which are typically found in the constitutional documents for the vehicle that receives the carried interest out of the fund, normally divide executives who leave the manager into two groups:

- **Bad leaver**, if they are leaving under a cloud, because they have been fired for gross misconduct, fraud or negligence (or similar acts).
- **Good leaver**, if they are leaving for other reasons (for example, redundancy or retirement).

If an executive leaves and is initially labeled a good leaver but then commits a trans-

“If an executive leaves and is initially labeled a good leaver but then commits a transgression (such as breaching the terms of his/her settlement agreement, breaching confidentiality...) then his/her status can switch from ‘good’ to ‘bad’”

gression (such as breaching the terms of his/her settlement agreement, breaching confidentiality, or more common, joining a competitor within a fixed time frame such as 12 months) then his/her status can switch from ‘good’ to ‘bad’. Some managers, recognizing the nuances of departures, also have an interim category (for example, intermediate leaver) and give themselves discretion to upgrade a bad leaver to intermediate status.

The status of the leaver is then applied to a set of vesting rules. These apply a timing discount to the share of the carried interest the leaver holds in the fund. Normally, the vesting rules are written so as to incentivize the executive to stay for the duration of the fund’s investment period – the carried interest will not ‘fully vest’ until that point in time. For example, where a fund has a five-year vesting period, the manager might agree a vesting schedule with an executive, which runs off how many years they have worked on the fund in question. The vesting percentage is then applied to the executive’s share of the carried interest when they leave, in order to get their ‘vested’ amount. This is the percentage they keep in the carried interest vehicle going forward and does not impact any previous payments they have had out of carried interest (which are said to ‘vest’ completely on payment). The mechanism is therefore forward-looking rather than retroactive, given carried interest typically arises late in the fund’s term.

For example, using this vesting schedule, if an executive holds 50 percent of the carried



Out the door: two separate vesting schedules apply to good leavers and bad leavers

interest (that is, 10 percent of the overall 20 percent fund carried interest) and leaves after two full years, but before three, and is a ‘good leaver’, 40 percent of his/her carried interest has vested. The manager will reduce his/her carried interest percentage so that he/she keeps 50 percent multiplied by 40 percent, which equals 20 percent. The excess 30 percent is then freed up to re-allocate among the remaining team. The example uses a ‘cliff-edge’ vesting, so that if an executive leaves after two years and 363 days, they still only get the vesting percentage that applied after two full years. An alternative to this approach is to use a graduated, straight-line vesting mechanism, so that the percentage of vesting increases for each day over the period. A typical way to draft this would be as a formula, like the following: (Number of days between first closing and date of executive’s leaving date divided by 1,826) times 100.

The denominator of 1,826 reflects a five-year period of four years of 365 days plus one leap year of 366 days. So, if the executive leaves halfway between years two and three and is a good leaver, their vested percentage would be $(912.5/1,826) \times 100 = 50$ percent. Accordingly, the executive’s vested carried interest would be 50 percent rather than 40 percent and they would keep 25 percent (with the excess 25 percent being freed up for re-allocation).

The consequences for being a bad leaver (or being downgraded from a good to a bad leaver) are uniformly bad. Irrespective of when the executive leaves, his/her carried interest vesting goes to zero. Managers may adopt a whole set of different principles for dealing with intermediate leavers, but typically give themselves discretion to apply a vesting which is more than zero, but less than the amount the executive would have received if they were a genuine good leaver.

While headline discussions may focus on the actual carried interest percentage and preferred return number, there are a number of variations on how carried interest schemes are arranged and how carried interest is allocated among the team. These need to be considered. These provisions can be the most complicated in the limited partnership agreements. It is, therefore, always advisable for the commercial teams to discuss these at an early stage with the lawyers who will draft the provisions, and the back-office team or administrators who will operate the scheme, before finalizing the commercial deal with investors. ■

Example application of a vesting schedule

Number of years passed between the fund’s closing date and the executive’s leaving date	Bad leaver vesting percentage	Good leaver vesting percentage
0 (leaves when the fund closes)	0	0
1	0	20
2	0	40
3	0	60
4	0	80
5	0	100

Source: Christopher Good



This is an extract from The Definitive Guide To Carried Interest, published by PEI. For more details go to www.privateequityinternational.com

Christopher Good is a partner in the investment management group at Macfarlanes, where he advises on private fund formation and related transactions. Good is also a member of the Association of Partnership Practitioners and participates in Invest Europe’s working group on legal and regulatory affairs.



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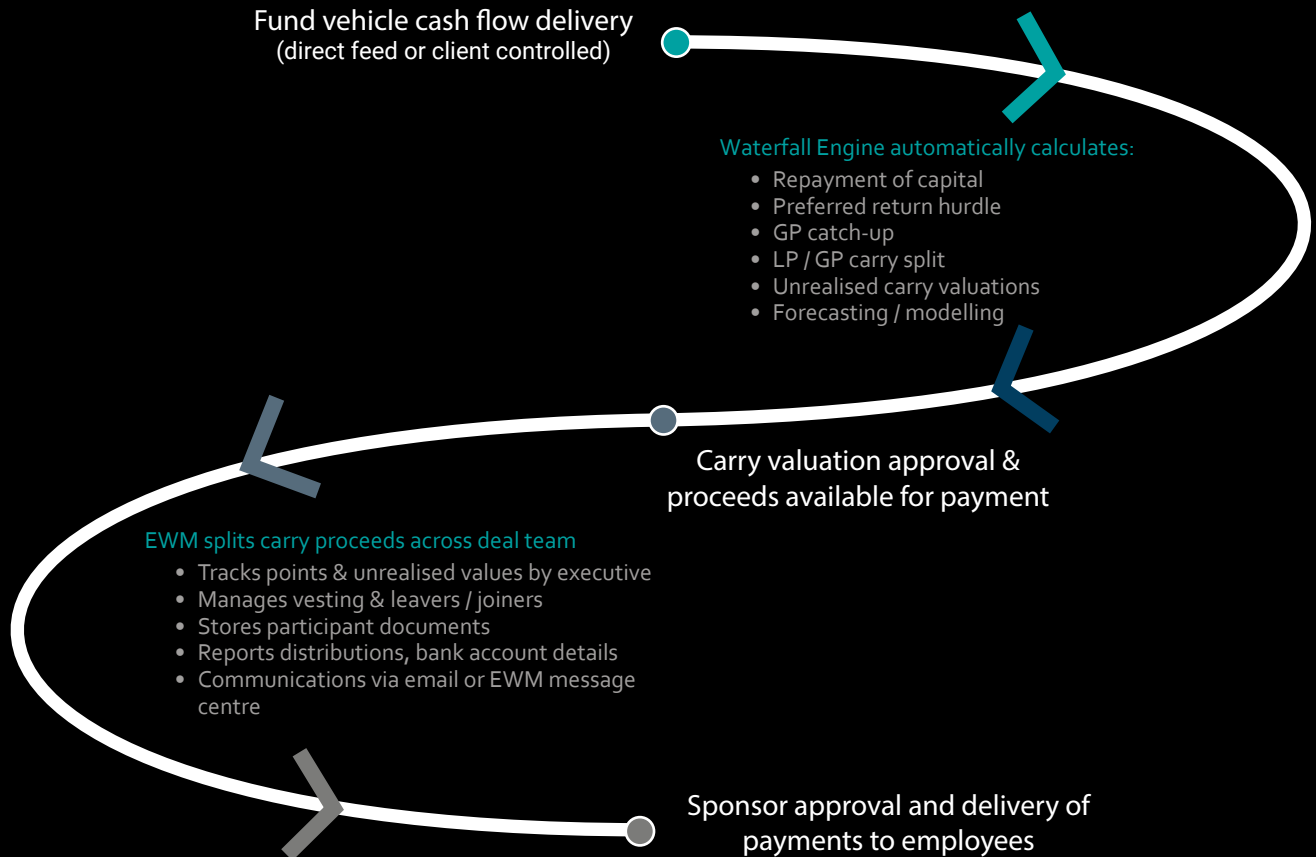
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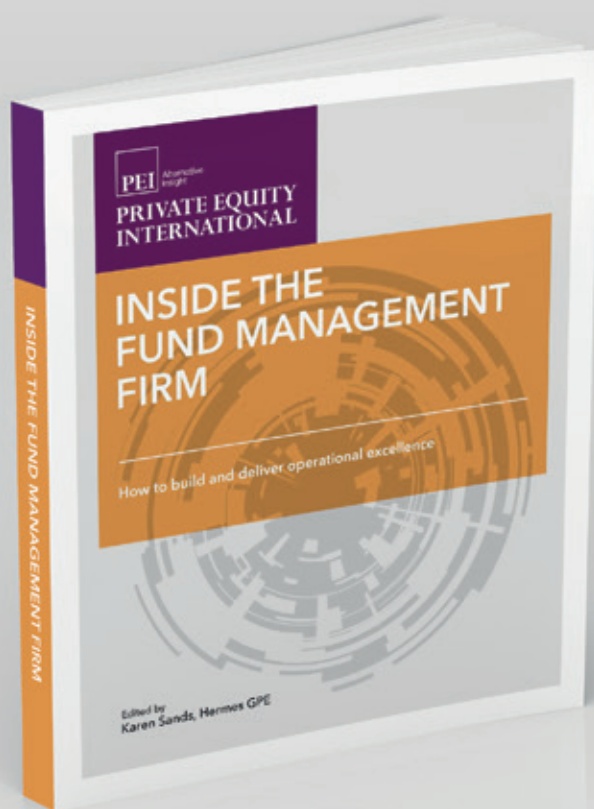
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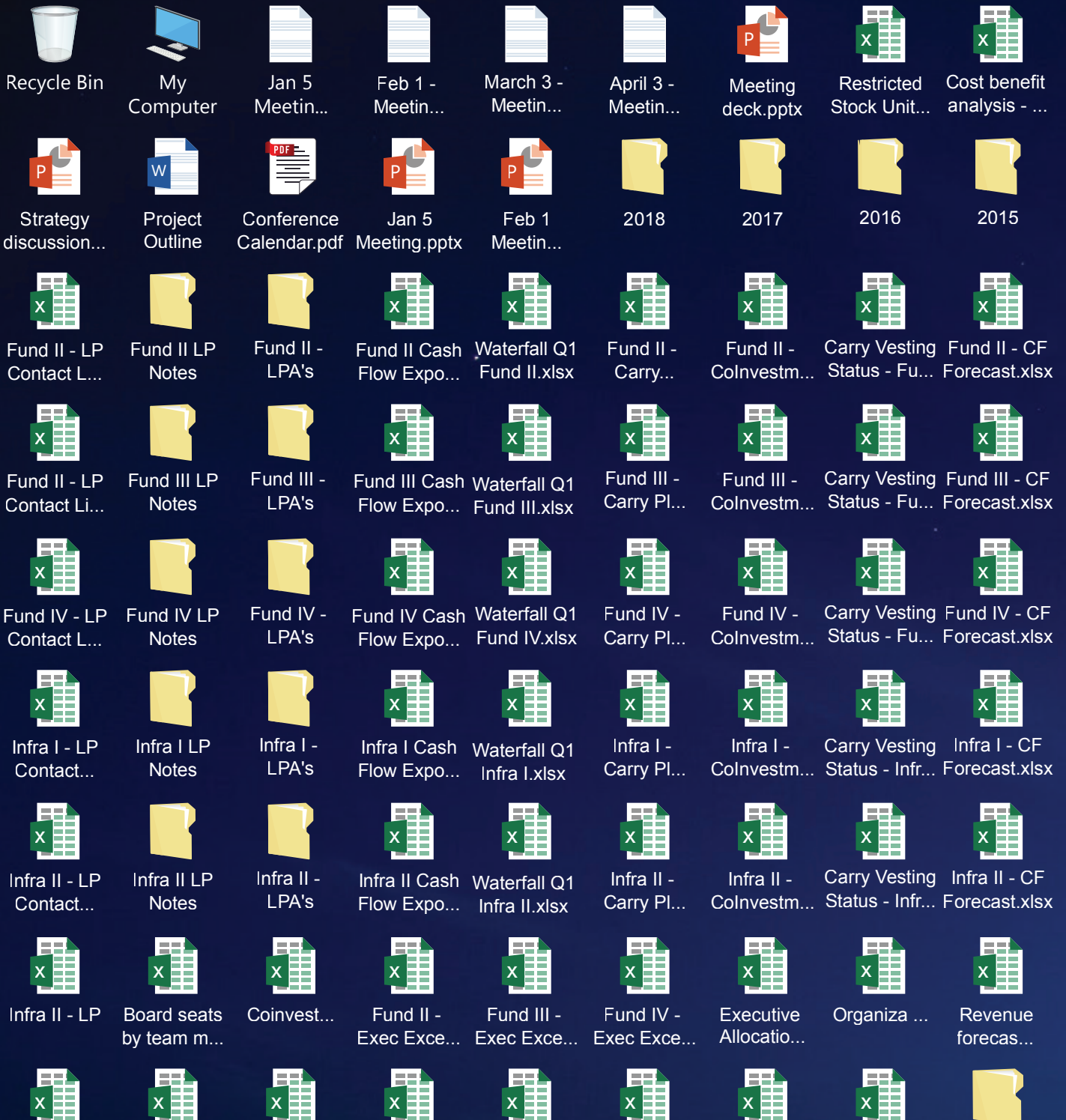
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