Privcap/ Report

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Carefully Calculating the **Waterfall**

Part of the Gen II Fund Services thought-leadership series, *Unlocking the Power of Private Equity Data*

Featured Experts:

Gordon Barnes
Andrea Auerbach
Cambridge Associates

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Carefully Calculating the Waterfall

Private equity fund economics are complicated – just ask the people whose job it is to calculate who gets paid how much and when. The distribution waterfall determines how profits are shared among GPs and LPs, and the formula behind this waterfall varies among funds and sometimes among investors within the same fund. This sometimes leads to errors, which, if left undetected, can cause enormous headaches late in the fund's life. Privcap recently spoke to several fund operations experts to learn top tips for accuracy in waterfall calculation. Below is an edited transcript of the conversation:

Privcap: How important is it to fully understand the distribution waterfall at the outset of a fund?

Michael Tesoro, Gen II Fund Services: Understanding the distribution mechanics is of the highest priority. LPAs are complicated documents that are the result of heavily negotiated business deals. The importance of preparation and planning and review among all parties – whether it's the lawyers, administrators or GPs, cannot be underestimated. It is vital in the setup and early stages of a fund's life that all constituents have complete understanding of the waterfall. The private equity market – both GPs and LPs – believe that best practice includes an independent party calculating, reviewing and confirming accuracy of the waterfall. Auditors can verify numbers at the end of the year, but they're not involved as much in the setup process. You can't make assumptions and say, "Funds I and II were this way, so Fund III must be the same way." There are always changes. Thoroughly reading the documents and understanding the economics is critical.

Yuliana Gekhel, Gen II Fund Services: You need to be very careful about reviewing LP side letters and specific agreements on reporting when you are setting up these waterfall calculations.

Gordon Barnes, Cambridge Associates: It's all about applying what is written. And it sounds very simple, but it's actually not. There are layers of complexity to that, even inside a fund.

Tesoro: I totally agree. You have a communication dynamic across all parties – it starts with the GP who's usually an investment person, so they're speaking the language of investment. Then it goes to a lawyer who drafts the waterfall up in legalese, then it goes to a finance person who understands partnership accounting. They're speaking slightly different languages. Then, that all potentially goes to a technologist who's going to program the waterfall into a model. So, making sure that it gets reconciled correctly and is understood and agreed upon by all parties is crucial.

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The Experts

Gordon Barnes
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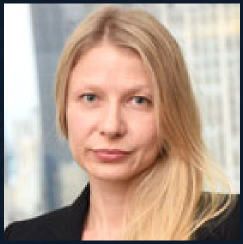
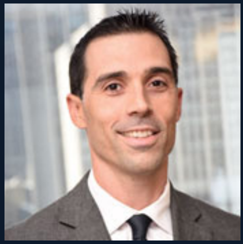


Yuliana Gekhel
Gen II Fund Services



Michael Tesoro
Gen II Fund Services

Privcap: What are some common mistakes that get made in the calculation of the waterfall?

Tesoro: At a high level, we have come across situations where in our view, a waterfall model was not interpreted correctly and therefore was calculated incorrectly. Also, as Yuliana mentioned, there could be side letters involved where certain investors may have their own unique economic arrangements. You also need to understand and confirm with the GP if there are key metrics to be aware of in the calculation, such as looking at an IRR method versus compounding. You need to verify exactly how everything works and confirm all constituents agree.

Privcap: How common is it for a specific LP to have a different form of waterfall calculation?

Gekhel: It is quite common. We've seen situations where some LPs negotiate their own deals, such as a European model for their specific investment compared to American for all other investors. In some cases, we have limited partners that negotiate different percentage carry instead of the typical 20%. In our experience, we have seen funds with multiple waterfalls, in some cases up to five or six different scenarios. It is important to realize that, when you calculate a waterfall, it's not performed at the fund but calculated in a limited partner by limited partner basis. So, that's one area where we have seen mistakes – a calculation on the fund as a whole and failure to take into account the economics that each limited partner negotiated.

Privcap: How painful is it to rectify a waterfall mistake?

"In some cases, a fund can have up to five or six different scenarios."

–Yuliana Gekhel, Gen II Fund Services

Gekhel: It all depends on what stage of the fund you are in. If your fund is still harvesting and liquidating investments, perhaps it's easier to correct it with a future capital distribution. But, at the end of the fund life, it's very difficult to rectify, because it would involve asking the general partner to return the money or, in some cases, pulling more money from your limited partners, which you definitely don't want to do. Ideally, you'd never want to be in that position. You want to do everything you can to avoid doing recalculations and making mistakes.

Privcap: Gordon, do you tend to recommend that GPs use a third-party administrator for this function?

Gordon Barnes, Cambridge Associates: We are able to get comfortable with GPs that do it internally, even with Excel. But it takes a little bit more due diligence to understand the checks and balances, given that it's very manual and there's some Excel risk involved. I think it's preferable to see that there's a third party involved like Gen II that's doing the calculation. And, generally, there's a couple reasons for that. You guys have economies of scale, so you can have better technology than an individual manager. You can invest more in security and have a bench of professional accounting people on staff, where maybe at the manager, there's only one CFO or two people.

"It takes a little bit more due diligence to understand the checks and balances, given that it's very manual and there's some Excel risk involved."

–Gordon Barnes, Cambridge Associates

Privcap: Without naming names, can you share an anecdote about a waterfall calculation error being uncovered?

Steven Alecia, Gen II Fund Services: Sometimes, when a client is transitioning to us, there is a situation where either another administrator was involved or the client had done it in-house. We'll ultimately recalculate everything and, if we identify something that we think may not have been done right, we'll bring it to the attention of the client and get their counsel involved. We once encountered a situation where we didn't think the preferred return was calculated correctly.

At the time, no dollars were involved – the reporting was just on an unrealized basis. So, ultimately, it was no harm/no foul in terms of distributions.

Barnes: I saw a situation where there was a slight change made to the language in the legal docs between Funds II and III, but that didn't make its way to the waterfall model and that actually impacted the waterfall calculation, which was identified at a later point. I think there was an assumption that Fund II and III had the same waterfall language.

Tesoro: It's important to understand, from a big-picture standpoint, that there's really nothing standard about these calculations – both waterfalls and carried-interest calculations – and that LP agreements are negotiated documents that can have complicated economics. The important thing is to focus on the early-stage review and preparation, preferably by an independent party, then that process will get you to apply correct approach and data into your calculations. And remember: the LPs will eventually review this calculation at some point, auditors will eventually review this calculation, and it's possible the SEC might wind up reviewing this calculation. That's how critical it is to set it up correctly. ■

Waterfalls Calculation Should be 'Nerve-Wracking'

An interview with Andrea Auerbach, Head of Global Private Investments at Cambridge Associates

Privcap: What is new by way of distribution waterfall configurations across private capital?

Andrea Auerbach, Cambridge Associates: There are two primary styles. One would be the European style, where the carry distribution is completely back ended until, typically, 100% of LP's called capital is returned plus a preferred return before the carry splits occur. Then, there's the American style which typically is a deal-by-deal approach. I would estimate the American and the European styles comprise 80% of the market with various tweaks and adjustments that may be specific to a certain fund. And then another 20% I would say are more experimental waterfalls that we're seeing introduced much more into the landscape.

Privcap: What are some elements you're seeing in these more experimental waterfalls?

Auerbach: Well, obviously, premium carry elements have been around for a while. And those have started to branch off into different forms of premium carry. So it might not be IRR based, it might be more multiple-based, or it might be both IRR- and multiple-based.

You also have GP carry distributions that can't be made until there's a certain amount of earned carry sitting on the fund's balance sheet. Think of it as a net worth test, if you will, in order for the GP to receive its distributions.

And then where things are definitely evolving are primarily from independent sponsors, who are constantly trying different levels of carry on a deal-by-deal basis. I'll give you an example - if I sell a company and earn a 10% return, I'll take a 10% carry. If I earn a 20% return overall, I'll take a 20% carry. And if I deliver a 30% return on an investment, I'll take a 30% carry. This type of laddered carry is starting to enter more fulsomely into the industry. And that definitely needs to be monitored.

Privcap: Interesting. And what are LP attitudes toward this smorgasbord of different carry options?

Auerbach: I do think LPs are more willing to think flexibly about carry, because returns are highly variable as you well know. And so it may not make sense to pay a 20% carry for access to a private credit return stream, right? I think the real concern that investors have today is that there isn't as much transparency into the carry waterfall, which is typically calculated, of course, by the GP. And the information is presented in the fund's financial statement that you receive as an LP. There isn't a lot of, "Let me walk you through this."

It's a nerve-wracking calculation. A lot of money is riding on a proper calculation being applied to results that govern the distributions to all the LPs and the GP. And I think GPs should be willing to walk investors through their waterfall properly. GPs need to be fully supported by their fund formation counsel and service providers to do that —sharing out how you're calculating the waterfall and inviting scrutiny is a very nerve-wracking exercise and I don't think it happens enough. ■

About the Experts

Gordon Barnes, CAIA
Head of Business Risk Management Group
Cambridge Associates

Gordon is the Head of the Business Risk Management Group where he oversees manager operational due diligence. Gordon has been with Cambridge Associates since 2006 and brings more than 20 years of investment due diligence experience to the firm.

Andrea Auerbach
Global Head of Private Investments
Cambridge Associates

Andrea is Head of Global Private Investments, where she leads a 50-person global team sourcing and underwriting private equity, growth equity, distressed, and venture capital funds, as well as direct, co-investment, and secondary investment opportunities. Her career with CA spans nearly two decades.

Steven Alecia
Chief Client Officer
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Steven is a founding member of Gen II Fund Services, LLC. He has spent over 23 years in the private equity administration industry. Steven oversees all of the client service team operations at Gen II.

Yuliana Gekhel
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Yuliana Gekhel is a Principal at Gen II Fund Services, LLC. Yuliana has over 19 years of experience in the private equity administration industry.

Michael Tesoro
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Michael Tesoro is a Principal of Gen II Fund Services, LLC. Michael has over 19 years of accounting, reporting, operations, and client service experience in the private equity industry. Michael has extensive knowledge of private equity, real estate and infrastructure fund accounting, general partner and carried interest accounting, complex fund structures & waterfalls, legal structuring, offshore administration, NCREIF reporting, and regulatory compliance including AML/KYC, Form PF, and AIFMD.