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Private equity fund economics in Canada: An overview of the essentials

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Private equity fund economics play an important role in attracting investors to a given fund. Indeed, investors want to know how expenses will be shared, what fees are applicable and how profits will be allocated. The summary below provides a brief overview of the most common fund arrangements with respect to such considerations. That being said, no two funds are the same and a fund's organizational documents can be tailored to take into account a wide array of particularities unique to a given fund.

CONTRIBUTIONS, DISTRIBUTIONS AND ALLOCATIONS

THE GENERAL PARTNER CONTRIBUTION

Investors expect that either the private equity fund sponsor[1] (the "**General Partner**") or one of its affiliates will have a vested interest in the success of the fund. In most cases, investors expect that the General Partner, its affiliates or key executives will make an investment representing anywhere between 1% to 5% of the total capital contributions made by investors. This contribution is significant to investors as it ensures that the interests of the fund's management team are aligned with their own and also reduces the incentive for the General Partner to incur excessive risk in an attempt to generate greater returns for itself. This is one reason why the Institutional Limited Partners Association recommends that the General Partner itself be required to make a financial contribution to the capital of the private equity fund[2].

DISTRIBUTION WATERFALLS AND PROFIT-TAKING

A fund's basic economic structure will most often be set out in the "distribution waterfall" — a mechanism which dictates how profits are to be allocated and in what priority such payouts will be made. All distributions made are net of any fund expenses, liabilities and cash reserves and are done on a pro rata share basis among the investors according to their respective capital contributions to a given investment. Each tier must be satisfied in full before proceeding to the next priority tier.

The following is an example of a basic distribution waterfall that a fund may have in place:

First Tier:
Return of Capital Contribution to Investors
The first distribution provides that investors are entitled to recuperate any capital contributed with respect to a given investment before any other distributions may be made.
Second Tier:
Preferred Return to Investors
The next distribution also flows to investors until they have received an amount equal to the preferred return on their capital contributions. The *preferred return*, often referred to as the "hurdle rate" with respect to the

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investment in the fund, provides investors with a determined rate of return (often between 5% and 9% on any capital contributed by an investor to a given investment) before the General Partner is entitled to receive any of the proceeds of the fund's investments.

Third Tier:

Catch-up Tier

Once investors have seen their capital contributions repaid and their preferred return paid out, the General Partner will benefit from a "catch-up" tier. At this stage, the General Partner will be entitled to share in the profits generated by the fund until it has received an amount equal to the carried interest split (discussed below) it would have otherwise been entitled to as part of the first and second tiers.

Fourth Tier:

Carried Interest Split

The fourth tier entitles both investors and the General Partner to receive fund profits. At this stage, the investors and the General Partner split the pool of any remaining distribution funds payable according to the carried interest split stipulated in the fund's operating agreement (an 80/20 carried interest split whereby investors receive 80% of the distribution payable and the General Partner receives 20% is commonplace, although this range may vary significantly depending on market conditions and industry standards).

CLAWBACK

A fund's operating agreement may also include a "clawback" provision relating to the General Partner's carried interest. Such a provision, which may include a built-in escrow procedure, serves as an adjustment mechanism which requires the General Partner to hold back a certain percentage of its carried interest profit participation to guard against overpayment in the event that any given investment does not prove to be profitable. For example, a clawback may be triggered when, upon calculating the fund's aggregate returns from any such given investment, the investors have been distributed an amount of the profits that is less than the hurdle rate. In such instances, the General Partner will have to return any excess profits to the fund for re-distribution to investors.

FUND FEES AND EXPENSES

MANAGEMENT FEES

In connection with the establishment of a private equity fund, the General Partner will often either create an affiliated entity or appoint a third-party investment adviser or management company to provide investment advice with respect to the management of the fund. Such arrangements can be crystallized in the form of an advertisement advisory agreement or management services agreement, which will describe exactly which duties and responsibilities are delegated to the appointed entity.

The General Partner, or any manager or investment adviser appointed to act on behalf of the fund, will generally receive a management fee based on the aggregate capital committed to the fund (typically about 2%). Occasionally, the management fee will contain two components: one that is based on the capital committed but not yet invested, and the other that is based on the capital that has been invested by the fund. However, it is not uncommon to see a "flat" fee applied to all aggregate committed capital. The management fee is used by the General Partner (or any appointed entity) to employ investment professionals, cover costs associated with the daily functioning of the fund and evaluate potential investment opportunities. Such fees and expenses are borne by the fund (and therefore its investors) and are most often payable on a quarterly or semi-annual basis.

In addition to the fund economics, sales tax considerations and applicable dealer registration requirements in any given jurisdiction are considerations that must be taken into account when implementing any particular fee structure[3].

ORGANIZATIONAL OR ESTABLISHMENT COSTS

Those fees associated with creating and setting up the fund are most often paid for by the fund, but are also usually capped at an amount indicated in the fund's operating agreement. Occasionally, an operating agreement may instead provide that the General Partner will cover establishment costs up to an agreed upon amount. Such expenses include professional fees such as legal and accounting

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services, as well as administrative and marketing costs incurred at fund formation. Establishment costs will vary greatly depending on the complexity of the fund being created, and on whether any associated feeder funds, alternative investment vehicles or associated entities are being created simultaneously.

OPERATING EXPENSES

The fund will also be responsible for those fees and expenses related to the proper functioning and operation of the fund. Such fees may include ongoing professional or consultancy fees, administrative costs, any applicable taxes or regulatory fees, as well as the management fees payable to the General Partner, investment adviser or management company and any expenses incurred by such persons in carrying on their activities on behalf of the fund.

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[1] As a general rule, the promoter of private equity and venture capital funds is the general partner. Private equity and venture capital funds are most frequently created in the form of a limited partnership with a predetermined term.

[2] See «Private Equity Principles», (version 2.0), Institutional Limited Partners Association (available at: http://ilpa.org/index.php?file=/wp-content/uploads/2011/01/ILPA-Private-Equity-Principles-version-2.pdf&ref=http://ilpa.org/principles-version-2-0/&t=1426810053).

[3] For more information on this subject, please see our article entitled “Registration Requirements of Venture Capital and Private Equity Fund Managers in Canada : A Favourable Regulatory Framework” published in the May 2014 *Lavery Capital* newsletter.

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