Private Equity Cash Flow Distribution Examples

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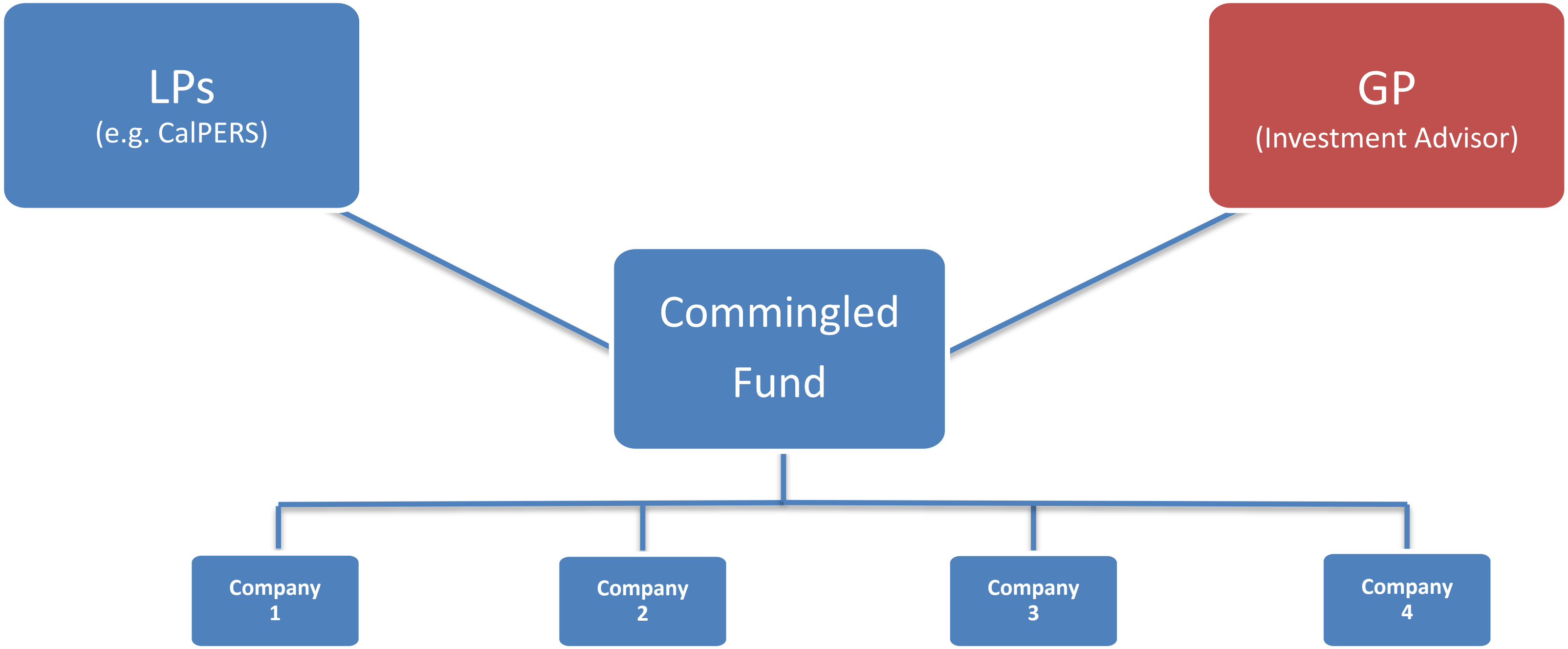
CalPERS | Investment Office
Private Equity

Presentation Objective

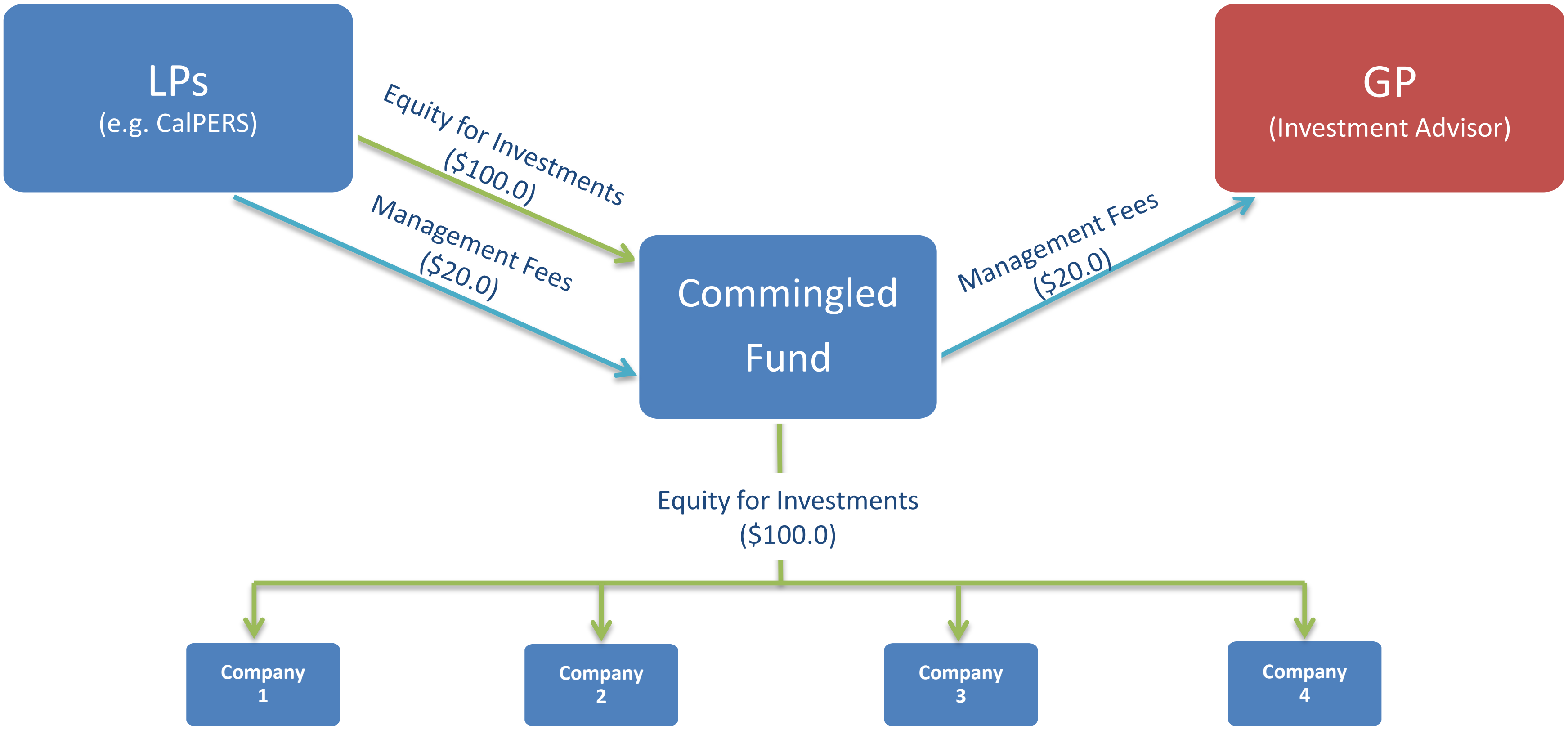
- This presentation is intended to provide a high level review of the economic structure of Private Equity ("PE") fund investments. The presentation will cover:
  – priority payment of cash flows, including the netting of fees and expenses, to Limited Partners ("LPs")
  – the timing of the General Partner ("GP") participation in the profit sharing ("carried interest") allocation

Note: For the purpose of simplification, this presentation does not illustrate attributes and concepts specific to Private Equity commingled funds such as: preferred return, sharing or offset of fees charged to portfolio companies, borrowing, clawbacks, or other terms (please refer to the Glossary of Terms).

Typical Private Equity Fund Structure

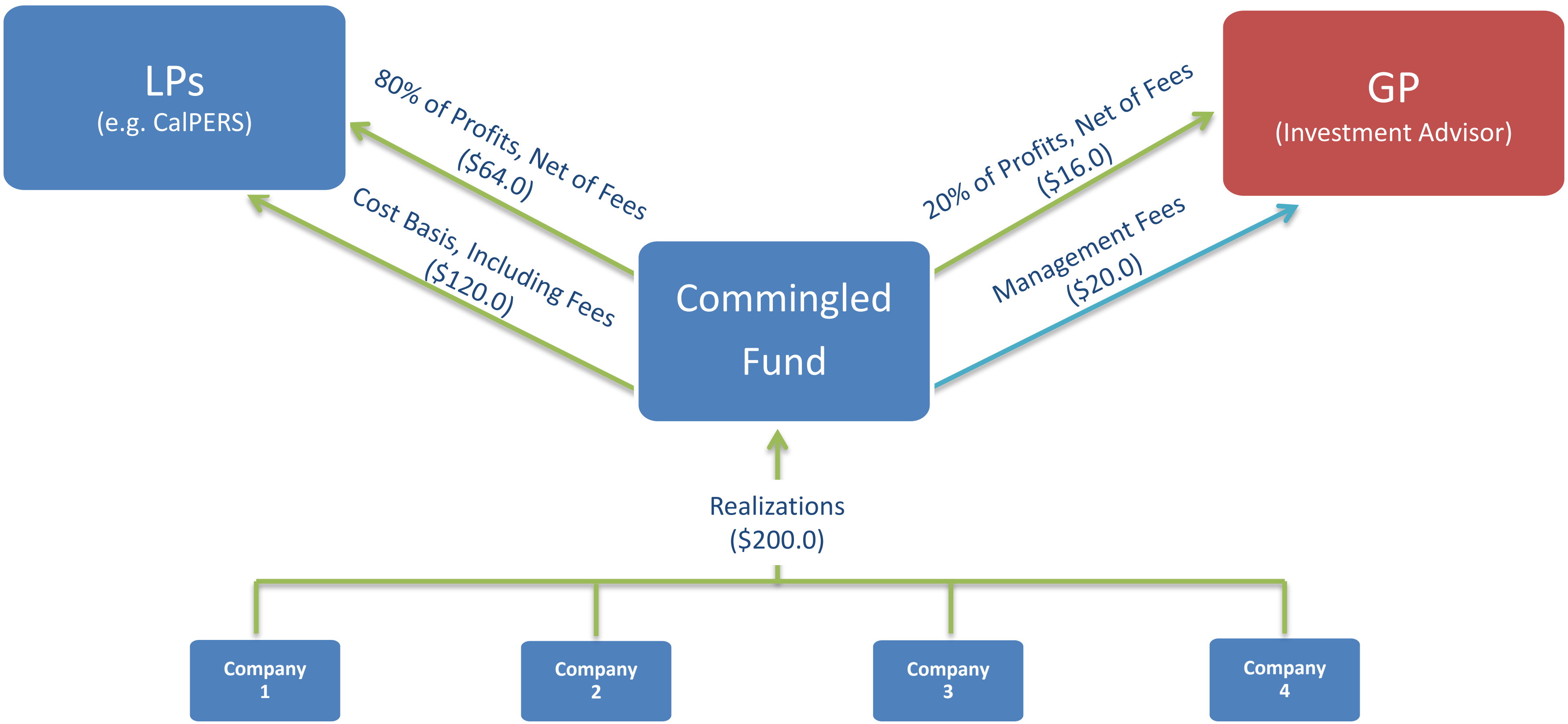


Typical Private Equity Contributions



- Assumes a $120MM commitment as an LP to a 10 year fund.
- Terms: Average management fee of ~2% per year for the life of the fund and 20% profit share with GP.
- Assumes no preferred return.

Typical Private Equity Distributions



- Assumes a $120MM commitment as an LP to a 10 year fund.
- Terms: Average management fee of ~2% per year for the life of the fund and 20% profit share with GP.
- Assumes no preferred return.

Private Equity Cash Flows

The Distribution Provision in a Limited Partnership Agreement (LPA), typically referred to as a “Distribution Waterfall,” refers to the priority of distributions returned to the LPs and the GP.

Distribution Waterfall Illustration – Positive Return

Investment in Fund = $100
Return on Fund = $200

Fund Management Fee: $20MM
LP Profit Share: 80%
GP Profit Share: 20%

I	INVESTMENT ($MM)	
	Investment Cost	$100.0
+	Management Fees	$20.0
	Total Investment Cost	*$120.0*

II	REALIZATION of INVESTMENT ($MM)	
	Investment Realization Proceeds	**$200.0**
	Return of Investment Cost to CalPERS	$100.0
+	** Management Fee Recapture	$20.0
	Total Investment Cost Returned	*$120.0*

III	NET INVESTMENT GAIN ($MM)	
	Investment Gain (Investment Proceeds - Investment Cost or $200-$100-$20)	**$80.0**
	20% of Profit Share to GP on Gain of $80	$16.0
	80% of Profit Share to CalPERS on Gain of $80	$64.0

IV	TOTAL CAPITAL RETURNED TO CalPERS ($MM)	
	Investment Cost	$100.0
+	** Management Fee Recapture	$20.0
+	80% of Profit Share to CalPERS on Gain of $80	$64.0
	Total Capital Returned to CalPERS	**$184.0**

V	TOTAL GP CASH FLOW ($MM)	
	Fund Investment Management Fee	$20.0
+	20% of Profit Share to GP on Gain of $80	$16.0
	Total Cash Flow to GP	**$36.0**

**** GP earns its 20% profit interest only after CalPERS total cost of the investment has been realized, including all fees. Management fees may be offset by portfolio company reimbursement to the GP for services provided.**

Distribution Waterfall Illustration – No Return

Investment in Fund = $100
Return on Fund = $120

Fund Management Fee: $20MM
LP Profit Share: 80%
GP Profit Share: 20%

I	INVESTMENT ($MM)	
	Investment Cost	$100.0
+	Management Fees	$20.0
	Total Investment Cost	*$120.0*

II	REALIZATION of INVESTMENT ($MM)	
	Investment Realization Proceeds	**$120.0**
	Return of Investment Cost to CalPERS	$100.0
+	** Management Fee Recapture	$20.0
	Total Investment Cost Returned	*$120.0*

III	NET INVESTMENT GAIN ($MM)	
	Investment Gain (Investment Proceeds - Investment Cost or $120-$100-$20)	**$0.0**
	20% of Profit Share to GP on Gain of $0	$0.0
	80% of Profit Share to CalPERS on Gain of $0	$0.0

IV	TOTAL CAPITAL RETURNED TO CalPERS ($MM)	
	Investment Cost	$100.0
+	** Management Fee Recapture	$20.0
+	80% of Profit Share to CalPERS on Gain of $0	$0.0
	Total Capital Returned to CalPERS	**$120.0**

V	TOTAL GP CASH FLOW ($MM)	
	Fund Investment Management Fee	$20.0
+	20% of Profit Share to GP on Gain of $0	$0.0
	Total Cash Flow to GP	**$20.0**

**** GP earns its 20% profit interest only after CalPERS total cost of the investment has been realized, including all fees. Management fees may be offset by portfolio company reimbursement to the GP for services provided.**

Distribution Waterfall Illustration – Portfolio of Multiple Funds

$12B Private Equity Commitment

I	TOTAL CAPITAL RETURNED TO LP ($B)	
	Investment Cost	$10.0
+	** Management Fee Recapture	$2.0
+	80% of Profit Share to LP on Gain of $8.0	$6.4
	Total Capital Returned to LP	**$18.4**

II	TOTAL GP CASH FLOW ($B)	
	Fund Investment Management Fee	$2.0
+	20% of Profit Share to GP on Gain of $8.0	$1.6
	Total Cash Flow to GP	**$3.6**

**** GP earns its 20% profit interest only after LP total cost of the investment has been realized, including all fees. Management fees may be offset by portfolio company reimbursement to the GP for services provided.**

In summary, this large LP constructed an $12B private equity portfolio that, overall, achieved a gain of $8B

- LP share of profit = $6.4B
- GP share of profit = $1.6B

Glossary of Terms

- Carried Interest ("Carry," or "Profit Share") – The GP's share of the profits of the fund's investments as articulated in the LPA.
- Clawback – GP carried interest received that is required to be returned to LPs due to failure of the Fund to achieve the hurdle rate.
- Commingled ("pooled") Fund – A common partnership structure, which consists of assets from various accounts that are blended together.
- Contribution ("Drawdown," or "Paid-in Capital") – Capital deployed by LPs, to fulfill capital call notices submitted by GPs, to fund new or follow-on investments, or otherwise pay for fees and expenses of the fund.
- Deal-by-deal ("American") Waterfall – GP receives carried interest after capital associated with each investment, including fees and expenses, is returned to LPs, regardless of performance of other investments.
- Distribution Waterfall – Refers to the priority of cash flows returned to investors in a PE fund as articulated in the LPA.
- European Waterfall – GP receives carried interest only after all capital, including fees and expenses, is returned to LPs.
- General Partner ("GP") – The investment manager responsible for managing the activities of a fund. The GP invests its own money in the fund alongside the LPs, and earns a return in the form of carried interest if the fund outperforms the hurdle rate.
- Limited Partner ("LP") –Investors who invest capital into a fund for the GP to manage according to the terms of the LPA.
- Limited Partnership Agreement ("LPA") – The contract that governs the terms of a fund. The terms define the obligations and responsibilities (and any potential recourse) for all parties.
- Management Fee – A periodic payment that is paid by LPs to the GP for investment and portfolio management services, typically investment advisory services as well as administrative services.
- Preferred Return ("Hurdle Rate") – The minimum return to investors (not guaranteed) before carried interest is permitted, as articulated in the LPA.

Appendix: Waterfall Types

Deal-by-Deal Waterfall

- GP takes carry on each investment
  - LP receives all capital contributions (including fees and expenses) associated with the investment being sold and the preferred return (on realized and written off investments) before any remaining profit is split between the LPs and the GP.
- Must achieve preferred return (“hurdle rate”) before the GP can distribute the carry
  - Preferred return, for example 8% compounded annually, and on all realized capital, (including permanent write-offs and write-downs) and costs.
- Majority of fees and expenses front-end loaded during the commitment period
  - Return of all fees and expenses generally back-end weighted.
- GP-friendly Distribution Waterfall creates clawback risk
  - Greater risk of clawback if GP values assets aggressively early in the fund life.
  - LPs attempt to mitigate this risk via a clawback provision; however, the clawback obligation is typically net of taxes.

European Waterfall

- Returns 100% of called capital (including all fees and expenses) plus a preferred return, for example 8% compounded annually, before the LPs and GP spilt any remaining profit.

- Majority of fees and expenses front-end loaded during the commitment period
  - Shorter duration to LP reimbursement of all fees and expenses relative to deal-by-deal waterfall.

- LP-Friendly Distribution Waterfall minimizes clawback risk
  - Because the GP cannot distribute any carry until the contributed capital has been returned, it is unlikely for the distributions to the GP to exceed 20% of total profits.