After a series of high-profile SEC audits and fines, the issue of fees and expenses has polarized GPs and LPs. But look beneath the surface and a surprising fact emerges: **both sides want the same thing**. In this white paper, we look at three best practices to help investment firms and their LPs get back on the same page.

Winning Back Trust

In midtown Manhattan, a portfolio manager is enjoying her first coffee of the day and scanning the morning's financial news headlines. "SEC official warns GPs to pay close attention to waterfall calculations" catches her eye—another story about a firm improperly allocating carried interest (incentive fees). Didn't she just see a big allocation to a GP in her last statement? Hmm, maybe she should give her GP a call… Across town, her General Partner is reading the same article and bracing himself for the call he knows will come.

The greater the misalignment of interest between parties, the more important effective governance is to their relationship. But when we look beyond the headlines and examine the problem on a deeper level, it's clear that the allocation of fees and expenses doesn't need to be a zero-sum game. In fact, when we strip away the sensationalism, we can see that in most situations, GP and LP interests line up perfectly. In this paper, we'll look at how the needs of GPs and LPs align, explore what can cause them to diverge, and introduce three best practices that can help to achieve alignment and create a meeting of the minds.

"Things get into the press that seem very unlikely in relation to the issues of real importance. We need to change the conversation to what really matters: alignment."

A GP'S VIEW

Recognizing Alignment – 3 Key Goals

Putting the occasional examples of mismanagement and misconduct aside, GPs and LPs are fundamentally aligned around three key goals. To see long-term financial and professional success, both sides need to be united in their commitment to minimizing fund costs, maximizing fund returns, and establishing a long-term, mutually beneficial relationship.

MINIMIZE FUND COSTS

While it may seem advantageous for GPs to charge fees and expenses back to the fund wherever possible, in fact they have every reason to keep charges to a minimum. When the GP charges fees and expenses against the fund, they know that for each dollar called, they'll need to give the money back plus a preferred return and a competitive return on equity. Every fund expense results in capital that isn't invested but on which they still need to provide a hefty return. For the GP, when using equity to pay for expenses, it's the equivalent of an expensive loan. In other words, if the GP is taking a long-term view of the firm's profitability, minimizing fees and expenses maximizes their gains. For LPs, minimizing up-front fees and expenses enables them to maximize their investment dollars. It also reduces the number of questions they need to field from their plan members, boards, and constituents.

MAXIMIZE FUND RETURNS Post-2008

LPs have become hyper aware of the impact of fees and expenses on their returns. However, top-line returns will always matter more than cost savings. As a result, LPs and GPs are united in their desire to invest the right resources to maximize the return on their investments. No LP would begrudge the cost of something that could significantly improve the value of the fund. In fact, the LP is paying a premium for the insight and resources the GP brings to the investment strategy: second-guessing the GP's decisions by querying every expenditure prevents the GP from bringing the full benefit of their expertise to bear on the fund. Conversely, when GPs shy away from putting a specific resource in place because they're unsure of how to allocate the expense or fearful of being seen as “overpriced,” they are doing their investors a disservice. If you, as a GP, believe a CRM or an investor portal makes sense from a business perspective, get those tools in place. Or, if you believe a portfolio company will benefit from a particular resource, bring it in. Creating value for your investors is your primary responsibility. Determining the allocation, while important, is definitely secondary.

Top Concerns for LPs

- MANAGEMENT FEE OFFSETS
- FEES CHARGED TO PORTFOLIO COMPANIES
- OPERATING PARTNERS
- AFFILIATED SERVICE PROVIDERS
- ALLOCATIONS FOR SHARED SERVICES
- CO-INVEST EXPENSES
- BROKEN DEAL EXPENSES
- VARIOUS REGULATORY EXPENSES

BUILD LONG-TERM RELATIONSHIPS

Private equity has a very long lifespan compared with other asset classes, and just as short-term thinking and fastbuck strategies don't apply here, neither do short-term relationships. GPs and LPs can be locked in together for a period of 10 to 15 years, so building a level of mutual trust and commitment is essential.

No GP wants to do anything to jeopardize investor trust because their long-term success depends on the continued loyalty and patronage of their LPs. Always looking ahead to the next fund— and the fund after that—GPs need to know that their LPs will continue to invest and grow with them. As for the LPs, they need to give their GPs the freedom to make decisions that enhance long term fund value. If the relationship becomes adversarial or loses that fundamental layer of trust, it undermines the integrity of the decisions made on both sides, as well as the fund's true potential for growth.

Where It Falls Apart

While GPs and LPs usually share the same objectives, there are situations in which they fall out of step. The most common of these is when the firm is not planning on raising a new fund. At that point, the current fund's performance might not be as important to all partners, and internal conflict about fee and expense allocation can start to heat up.

Another situation in which interests may diverge emerges when management fees change suddenly due to foreseeable or unforeseeable circumstances. The predominant foreseeable cause is when the formula changes at the end of the investment period for a fund. This is a very predictable event, and most firms budget well in advance for the change in fees, but some may have been relying on a new fund starting up to fill in the gap. With uncertainty in the fundraising, timing is not predictable. For a small business (which is what most management firms are), providing the same level of services when revenues are suddenly cut in half can place significant stress on the organization. Unfortunately, this kind of pressure can lead to poor internal decision making. Open dialogue with counsel, LPACs, and investors is crucial during these challenging times.

FOSTERING COLLABORATION 3 BEST PRACTICES

Clearly, GP and LP goals are aligned on the essentials. But what can GPs do to remind LPs of this fact? Shifting from a defensive position to a collaborative one and breaking down the atmosphere of mistrust is critical if GPs are to make the best decisions for the fund and their investors. Based on our experiences working with more than 100 GPs, administering hundreds of funds, and reporting to over 4,000 LPs across virtually every fund strategy, we have identified three best practices that can help to clear the air and reinforce the alignment between both sides.

1. TRANSPARENT REPORTING

“Transparency” is often mentioned in the discussion around fees and expenses. The standardization that ILPA brings to the table can provide greater transparency and eliminate or cut down on the investor-specific requests that are supplemental to the fund’s reporting process. While it may seem painful to adopt, it’s ultimately better than having many different investor request templates to fill out.

Many GPs are reluctant to commit to the ILPA fee template because they perceive it to take an overly detailed - and administratively taxing—approach to reporting. According to a survey we conducted in partnership with PEI, Pepper Hamilton, and Withum, only 17% of GPs are using the ILPA fee reporting template. However, a further 38% are using a modified version. Note that this guidance is relatively new. More sophisticated LPs are starting to push for the use of the templates; therefore, we expect this to shift in the near term. Some of the clear benefits we see in the ILPA templates are in the area of management fees. While management fees may appear to be a simple calculation when reviewing a Limited Partnership Agreement, they typically can’t be recalculated without knowing the impact of offsets, waivers, and rebates, which are included in the template. The incentive allocation, which is often buried in unrealized gains and distributions for the purpose of investor reporting and disclosed in the financial statements at the fund level, is arguably the most difficult amount to verify and track. The new fee template provides a clear roll forward of accrued incentive allocation at the beginning of the period with detailed adjustments for incentive allocation paid during the period and the change in accrued incentive allocation for the period to arrive at the ending balance. In addition to making an effort to untangle the most contentious reporting areas, every GP should be on the lookout for the low-hanging fruit—areas where a simple disclosure can make a powerful gesture toward openness and transparency. For example, most funds incur an expense for the annual meeting of the Limited Partners. These meetings are becoming more important as investors, prospective investors, and portfolio company executives are invited, and they all play a crucial role in communication and marketing for the firm. Yet fewer than 8 percent of GPs disclosed the budget to the LPAC, and only 11 percent disclosed the budget to all LPs. Because so few of your peers disclose this expense, it gives your firm an opportunity to stand out, even though it’s a relatively minor cost.

42% of GPs rely on the management team to make allocation decisions about fees and expenses that aren’t covered by the PPM, LPA, or policy documents..

2. ALLOCATION FRAMEWORK

Governing documents and industry templates can help you bring clarity to the allocation of fees and expenses, but they won't cover all of the fees and expenses you encounter. For this part of the process, you need to develop a framework to guide the myriad of allocation decisions that are made about fund and management expenses. This framework also can demonstrate your firm's approach to fiduciary duty, since under the Investment Advisers Act of 1940, registered investment advisors (RIAs) have a fiduciary duty to act in the investors' best interests. Even if you are not an RIA today, investors would like you to run the firm with that same fiduciary approach.

Because the private equity industry evolves rapidly and the investment periods can stretch into a decade or more, GPs are faced with the need to make decisions about fees and expenses that didn't even exist when they first developed the agreements and policy documents to govern allocations. As a result, your PPM and LPA can't cover every eventuality, and you'll need to establish a process for ad hoc allocation decisions.

For example, no one was thinking about cybersecurity eight years ago, whereas today it's part of the cost of doing 2 business. While we can't anticipate the future, we can create decision frameworks that help us make consistent, rational, defensible allocations.

Ultimately, it comes down to identifying the primary beneficiary. For example:

A GP invests in a CRM. The firm uses it to keep their data organized and follow up more efficiently to find deals. Since it is the firm's responsibility to find deals, they are the primary beneficiaries. This should be a management company expense

A GP invests in an LP portal. The investors use it to securely access and manage their documents and data. Since they are the primary beneficiaries, this should be a fund expense.

In addition to creating a practical framework to guide decisions about fees and expenses, GPs need to be more diligent about bringing their investors into the decision-making process. According to our survey, nearly half of GPs (42 percent) rely solely on the management team to make allocation decisions, which can open them up to Monday-morning quarterbacking and regulatory vulnerability. By getting the LPAC's buy-in on the policies developed and any new interpretation of those policies, GPs can preempt the secondguessing and scrutiny.

FOR MORE ON THIS TOPIC, PLEASE SEE "THE PROACTIVE APPROACH," PEF'S ARTICLE ON DEVELOPING AN ALLOCATION POLICY.

3. PROACTIVE COMMUNICATION

Even GPs who are making strides in reporting transparently and developing an allocation framework may be missing one final ingredient in developing a collaborative approach to fees and expenses. That ingredient is communication.

Many GPs don't recognize the importance of communicating a compelling rationale for the expenses allocated to the fund. But if they communicate the positive impact these expenditures will have on the long-term value of the fund, LPs will appreciate the communication and will then have the information they need to monitor their investment and gauge the positive result. Nobody likes to hand over money without receiving some kind of benefit in return, and for fund expenses, the return may not manifest for years. But when the impact is communicated up front, it can allay concerns and strengthen LP confidence.

For example, the cost of an operating partner is frequently questioned by LPs, largely because the SEC has chosen to cast a negative light on this area of fund expenditures. But a seasoned executive with a proven track record and an understanding of a specific business niche is a rare and valuable asset that can turn a portfolio company around and dramatically increase fund value. GPs recognize 3 that in order to attract the right talent, they may need to keep executives on retainer and require the portfolio company to pay them too.

In an environment where negative press has characterized this type of expenditure as wasteful or unnecessary, GPs need to educate LPs with a clear cost-benefit analysis. If you're bringing on an operating partner, make sure the LP knows who they are, what kind of track record they have in the industry, how much they're being paid by both the portfolio company and the fund, what plan of action the executive will set in motion, and what kind of an impact this will have on the investment. This type of proactive communication can be invaluable in keeping LPs on board and in sync with your strategy.

THE FUND ADMINISTRATION CONNECTION

Fund administration is an interesting example of how changes in an industry necessitate new business practices. While "finance" is at the center of the title of private equity CFOs, running waterfalls and closing the books are no longer the bulk of their responsibilities.

There's a new normal in private equity fund administration. Today, CFOs find themselves managing IT, cybersecurity, marketing, taxes, accounting, payroll—the list of functions within their sphere of control goes on. And these responsibilities don't take into account the dual hats many CFOs wear as chief compliance officers or chief operating officers of their firms. As firms scale up, CFOs need to conduct themselves in ways that are more akin to a CFO of a large operating company because of the greater breadth and depth of responsibilities. They have to balance the management of the varied functions along with increased scrutiny on fund operations from both regulators and investors.

And CFOs are now facing a squeeze. With increased regulatory and technology requirements at the investment firm, the cost of running a management company has gone up. At the same time, investors are pressuring for a reduction in management fees. Now more than ever before, CFOs need to demonstrate greater diligence and explore options to increase operating efficiencies. New outsourcing options are available, including expanded services offered by third-party fund administration firms and other professional service organizations, such as compliance and valuation firms.

A third-party fund administrator can play a pivotal role in communicating alignment between GP and LP interests by demonstrating a focus on streamlining operations, providing a second pair of eyes on compliance with governing documents, and, if needed, aiding in staff transitions. Sometimes both sides also find it helpful to have an involved third party weigh in on best or common practices, since your fund administration team is with you on a day-to-day basis.

Increased pressure and strain on internal resources, coupled with a growing range of outsourcing options, has been increasing the number of asset managers and funds turning to third party administrators. According to a comprehensive 2013 PwC survey, 30 percent of all private equity and real estate firms were already outsourcing at least one back-office function to a third party administrator, and a further 25 percent of firms were planning to shift to an outsourced administrator for at least one back-office function over the next 12 to 24 months.

When considering the use of an outsourced fund administration firm, the geography of the expense should not drive the business decision. Even if the expense is borne by the fund, the GP still has to provide a competitive return on that dollar. As with operating companies, firm managers need to decide the best way to successfully operate their firm and provide services to their investors. The key is to have a process in place to justify and monitor quality and price for both in-house and outsourced resources.

A third-party fund administrator offers fund and investor accounting services along with essential reporting and investor services functions. Some benefits of outsourcing fund administration include:

- Increased investor confidence with regard to reporting and investor capital accounts
- Increased ability of the fund manager to focus on investment management activities
- Reduced operational expenses, including resource allocation and technical infrastructure costs
- Improved efficiency through the use of specialized systems and tools for accounting and reporting
- Work is performed by industry specialists with deep knowledge and expertise in fund administration

FOR A REAL-WORLD EXAMPLE OF THE WAYS IN WHICH A THIRD-PARTY FUND ADMINISTRATOR CAN ENHANCE GP-LP COMMUNICATION AND TRUST, SEE PEF'S CASE STUDY FOR RESILIENCE CAPITAL, A MIDDLE MARKET PRIVATE EQUITY FIRM.

REBUILDING INVESTOR TRUST

The casual attitudes that characterized private equity pre-2008 are unlikely to return—and that's probably a good thing for the alternative asset class as a whole. But the current levels of skepticism and mistrust between GPs and LPs are the result of a pendulum that has swung too far in the other direction.

While high-profile SEC enforcement actions have created the perception that the GP-LP relationship is fraught with compromise, the reality is that their goals are fundamentally aligned. Both sides want to minimize costs, maximize returns, and foster mutually beneficial, long-term relationships.

The challenge for GPs is to change the perception and help LPs understand how various fund costs contribute to the value of their investment. While transparent reporting—an area where ILPA has contributed greatly—is the first step in establishing trust with LPs, it's not a silver bullet. GPs also need to demonstrate good faith in other ways.

For example, take extra care around hot-button areas such as management fees and incentives so that offsets, waivers, and rebates are calculated and communicated clearly. Make an effort to disclose relatively minor expenses, such as annual meetings, as a simple means of signaling a higher level of transparency. Ensure that you have a decision framework in place for determining allocations for new expense areas. And finally, have communication resources in place that not only keeps LPs in the loop about the expenses incurred, but also provides a clear rationale for expenses that are tied directly to the added value that resources have the potential to bring to the fund.

Adopting proactive strategies for allocating and reporting on fees and expenses is the key to establishing mutual trust and respect with your LPs and becoming a firm of choice for discerning investors. The impact not only affects your reputation, but also your ability to deliver value to them. By giving you the freedom to make management and resource choices based on strategy and not optics, adopting a best-practice approach to allocating and reporting on fees and expenses can enable you to act confidently and make decisions that maximize returns.