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Funds' expenses, commissions and profits: this is how they are divvied up.

Incentives for the team and distribution of profits are among the most debated issues during fund raising.

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The management fee and the performance fee are a key negotiation point in the fundraising stage of a private equity fund. This article describes the main ways to determine these fees and the corresponding methods for the distribution of proceeds, and addresses the subject areas most debated over by investors and manager during the fundraising of a closed-end Italian private equity fund.

Investment Commitments and Management Fee. In almost all cases of closed-end private equity funds, each investor makes certain investment commitments to the fund at the signing of the fund rules. Payments in respect of this commitment are made from time-to-time by the investor, according to the manager's requests, in order to finance the fund investments and to periodically cover the fund expenses. The management fee is part of the fund expenses and is periodically paid by the fund to the manager in order to cover its current expenses, including salaries and other operational expenses, as well as, in general, costs for preliminary evaluations of investment opportunities which do not translate into a closed deal (to the extent such costs are not charged to the fund). The management fee is calculated as a percentage, usually at an annual rate between 2% and 2.5%, of a base value that varies with time.

During the investment period (usually the first 4/5 years from the fund's first closing) this base value equals the aggregate amount of investment commitments of all the investors (the "committed capital"). The amount of the fee, calculated in this way, is justified by the manager's intense efforts in researching investment opportunities during the first phase of the fund.

At the end of the investment period, the lesser efforts required of the manager are reflected in the step down of the management fee, which is usually calculated as a percentage of the cost of the remaining portfolio investments, therefore excluding investments that have already been divested. In the majority of cases, however, in this second phase the manager's own costs are covered also by the management fees of a successor fund, the first closing of which is usually organized by the manager to coincide with the end of the investment period of the previous fund.

Even when the most standard terms are agreed, as described above, there are various issues concerning the management fee that may be negotiated between manager and investors. In particular, investors often request that the base value for calculating the management fee at the end of the investment period be reduced by any write-downs or write-offs in the value of portfolio investments. Managers often object to this request by arguing, in the case of write-downs, that it is exactly those investments in difficulty that generally require more attention and work from the manager, which as such justifies an appropriate compensation to the manager.

Certain payments made directly to the manager by portfolio companies (*e.g.*, for acquisition of the same companies, for subsequent consulting work, participation in meetings of the board of directors) also usually add to the current expenses of the fund. A substantial portion of these payments is nevertheless returned to the fund, in a percentage agreed from time to time between manager and investors.

Distribution of Profits and Performance Fee. As in the case of payments by investors, the distribution of fund profits occurs as investments are realized and to the extent the profits are not used to cover forthcoming fund costs. Fund profits are divided between investors and manager. The distribution mechanism ("the so-called "waterfall") takes into account the contributions in instalments by investors and is divided into three main phases.

First, profits are distributed among investors in proportion to their contributions, usually up to the total amount paid up until that moment, increased by a percentage (typically, 7-8% compounded annually, the "preferred return").

Once such level of reimbursement of investors has been reached, this triggers the right of the manager (and/or of the members of the management team) to receive a performance fee – the so-called "carried interest" - which is generally set at around 20% of fund profits. For this purpose, a distribution is generally made to the manager of an amount of up to 25% of the preferred return distributed to investors (the "catch-up").

After which, any further profits are split 80% among investors and 20% to the manager.

Private equity fund rules generally provide for an escrow account to hold part of the carried interest due to the manager. This is done out of the need to safeguard the investors: the carried interest must in fact be calculated taking into account the proceeds from divesting *all* of the fund's portfolio investments and, therefore, also those which may account for a loss to the fund. Escrow payments facilitate the return to investors of any excess carried interest payments made to the manager, at times when only part of the fund investments had been divested (for example, in situations when those payments were followed by divestments at a loss of other portfolio investments).

The carried interest is distributed amongst the management team on the basis of specific criteria agreed within the same team, generally in such a way as to reflect each team member's ownership of the manager, seniority, participation in fundraising and the extent of involvement in management of the fund. However, the investors also have a strong stake in arranging for appropriate incentives for the team (including for the more junior members who guarantee continuation of the initiative) and, on such incentives, more and more frequently ask to express their own point of view.

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(1st in a series of articles on fund raising)