The evolution of Private Equity Fund Terms Beyond 2 and 20

Abstract:
With the remarkable increases in the assets under management of private equity firms, the standard compensation arrangement of a 2% management fee plus 20% carried interest has raised concerns of a misalignment of interests between limited partners (LPs) and general partners (GPs). Using a proprietary data set that includes detailed fund terms of 210 PE buyout funds with vintage years between 1989 and 2012, the authors summarize the findings of their recent study of the evolution of fund terms. The authors report that PE fund terms have been remarkable mainly for their resistance to change, and that the only important force for bringing about reductions in percentage management fees has been the recent increase in fund sizes. But the modest cuts in management fees that have accompanied the increase in fund sizes have done little to address what appears to be a conflict of interest between LPs and GPs over the optimal PE fund size. As one possible solution to this conflict, the authors analyze a recent innovation by Bain Capital that involves considerably smaller management fees (say, 1%) and larger carried interest (as high as 30%). According to the authors, such terms have a good chance
of becoming the new industry standard for two reasons: First, LPs have become increasingly "professionalized," which has led to greater focus on GP compensation and ways of realigning their interests with LPs'. Second, the “signaling” benefits for those GPs willing to distinguish themselves by offering terms like “1 and 30” could encourage more GPs to move in this direction. In the authors' words, "For all but the most reputable and established PE firms, those GPs that do not offer the new terms may well be seen as signaling little confidence in their ability to do what they're being paid to do: namely, produce above-market returns."

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