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Private Equity Fundraising: Key Trends and Market Survey

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Contents

03 | Introduction
08 | Section 1: Economic Terms
18 | Section 2: Governance and Other Terms

Introduction

Dear Clients and Friends,

Navigating the private equity fundraising market continues to be an uphill battle. With a sluggish exit environment reducing distributions to investors (LPs), private equity managers (GPs) are competing over limited investor dollars. The fundraising market is more favorable towards LPs than it has been in many years, and the outlook is uncertain. Notwithstanding the many challenges, there is sustained and growing demand for private equity by LPs and, with an improving deal environment, a rebound in fundraising is likely in late 2024.

Several noteworthy trends are taking place in today's private equity marketplace:

- **Slow but improving fundraising market.** Private equity funds raised $747.75 billion globally in 2023, an approximately 7% increase from 2022.[1] The topline numbers do not convey the difficulties being experienced by many GPs. The pace of funds closing slowed in Q1 2024 with 163 private equity funds reaching a final closing, down 35% from 249 funds that closed in Q4 2023, the lowest quarterly number since Q3 2013.[2] The average time to close a private equity fund stretched to 21 months in 2023, up from 17 months in 2022.[3] The 10 largest private equity funds accounted for 27% of aggregate capital raised in 2023 (compared to 23% in 2022 and 17% in 2021).[4] LPs are behaving cautiously, and the investor dollars are being directed at fewer, larger GPs.

  Because GPs are holding onto companies for longer periods rather than selling in an unattractive market, distributions to LPs as a percentage of NAV fell to 11.2% in 2023, the lowest level since 2009.[5] Many LPs are short on cash and cannot recommit to new funds until they receive distributions from existing ones. According to a recent *Private Equity International* survey, only 56% of GPs say their current fund is larger than their predecessor fund (compared to 75% in 2022).[6] For many GPs, fundraisings are long and drawn-out processes. The classic fundraising model is not suited to scaling in a challenging market, and there are simply too many funds seeking too much capital relative to what LPs have the ability or willingness to deploy. Since Q1 2019, the number of private equity funds fundraising has almost tripled, while aggregate capital targeted has increased only 24%.[7] As is the case in any difficult fundraising market, the environment is hard on GPs with consolidated investor bases, undifferentiated strategies, and average returns. The market is a sea change for these GPs, but it is a temporary dip for those GPs who have built strong and resilient businesses and can ride it out.

There is sustained and growing demand for private equity by LPs and, with an improving deal environment, a rebound in fundraising is likely in late 2024.

- **Heightened pressure on fund terms.** With a record number of private equity funds currently fundraising and LPs facing slowed distributions and overallocations, GPs are competing over limited investor dollars and coming to terms with the most LP-favorable environment in many years. The market is not resulting in wholesale changes but rather negotiations at the edges of key terms. GPs are being pushed to revisit terms in areas including: (a) key person composition and governance (including succession planning), (b) management fee discounts, (c) expense allocations, and (d) potential conflicts of interest. The pressure from certain LPs on the "gross negligence" standard for indemnification continues, but GPs have been able to resist this demand. Given the liquidity needs of LPs, GPs are pressing for more flexibility to address the need for funding at all stages of a portfolio company's life cycle, including (i) providing flexibility to facilitate secondary transactions, (ii) expanding the ability to recycle proceeds and make follow-on investments, and (iii) providing flexibility to use credit facilities (including NAV facilities) to assist with cash management, investments, and distributions.

GPs need to come to terms with an LP-favorable environment and explore terms that respond to market realities.

5 noteworthy trends from our survey of fund terms and market information:

1. **Longer offering periods.** Offering periods are longer, with 27% of funds providing contractual offering periods longer than 12 months in 2023, compared to 11% of funds in 2022.

2. **More fee discounts.** More GPs are offering “early bird” discounts on management fees, with 38% of GPs offering “early bird” discounts on management fees in 2023, compared to 18% of GPs in 2022. The average minimum LP commitment in order to receive size-based discounts on management fees dropped to $166.75 million in 2023, down from $237.5 million in 2022. In addition, platform-wide fee discounts are increasingly being requested in fund offerings.

3. **More flexibility to recycle.** Fewer private equity funds are specifying a time period in which investments must be disposed of to qualify for recycling, with 53% of funds limiting recycling based upon a specified time period in which investments have been disposed, compared to 73% over the past two years. Instead, more private equity funds are limiting the cumulative amount of capital that may be invested (including as a result of recycling), with 60% of funds limiting the cumulative amount that may be invested, compared to 49% over the past two years.

4. **Larger organizational expense caps.** Organizational expense caps are trending upward, with 47% of funds capping organizational expenses borne by the fund at 0.11% or more of aggregate commitments in 2023, compared to 39% of funds over the past two years. The average organizational expense cap increased to 0.12%, up from 0.10% in 2021.

5. **Smaller GP commitments.** Capital commitments by GPs and their affiliates are trending downward, with 15% of GPs committing 6% or more of aggregate capital commitments to their funds in 2023, compared to 22% of GPs over the past two years. The average GP commitment declined to 3.84% in 2023, down from 5.24% in 2021.

- **SEC aggressively targeting private funds.** The current SEC continues to aggressively target GPs through rulemaking, examinations, and enforcement activity that is expected to continue at least through the rest of this election year.

  - **Private Fund Adviser Rules.** In August 2023, the SEC adopted a package of new rules that seek to fundamentally reshape the regulation of private fund management (Private Fund Adviser Rules). The rules purport to enhance investor protection by promoting "efficiency, competition, and capital formation," but in a more fundamental way reflect a desire by the SEC to realign what it perceives as an imbalance in power between GPs and LPs. Several trade groups representing the private fund industry filed a legal challenge to the Private Fund Adviser Rules in the U.S. Court of Appeals for the Fifth Circuit, which is expected to issue a decision by the end of May 2024. Many are optimistic that most, if not all, of the rules will be vacated, but the outcome of the challenge remains to be seen. Given the legal uncertainty and the operational complexity of implementation, many GPs have been reluctant to devote expansive resources toward coming into compliance with the rules, despite fast-approaching compliance dates (September 2024 and May 2025). If the legal challenge is unsuccessful, the rules will have a significant effect on the private equity industry and result in consequential changes to fundraising and investor reporting practices. The expansiveness of the Private Fund Adviser Rules, ambiguities as to their interpretation, and costs and burdens of implementation all contribute to an already high level of anxiety for GPs on the regulatory front.

  - **SEC rulemaking agenda.** In addition to the Private Fund Adviser Rules, the SEC's public rulemaking agenda contains an unprecedented number of items that will potentially impact private equity sponsors and their clients, investors, and portfolio companies. The SEC docket indicates continued work by the commission toward the adoption of proposals relating to, among other things, (a) the use of "predictive data analytics," (b) a "safeguarding rule" which would replace the SEC's existing custody rule, (c) outsourcing of services, (d) ESG practices and disclosures, (e) cybersecurity, and (f) privacy and protection of consumer financial information. All of this is in addition to a slate of adopted rules, proposed rules, and potential rule proposals relating to capital markets regulation, which can only be expected to increase barriers for portfolio companies seeking capital and liquidity through public and even private markets. Collectively, the SEC's actions and agenda reflect a shift from a principles-based approach to a more prescriptive, rules- and prohibitions-based approach toward private fund regulation – a construct that makes it easier for the SEC to bring enforcement actions, even for "broken windows"-type violations. Although the SEC is targeting the private equity industry through rules, the current administration has also made clear that it does not see a need to adopt new rules to shape conduct. This is evidenced by the stringent interpretation and enforcement of the SEC's "new" marketing rule for private fund advisers and an intense focus on recordkeeping as part of the Division of Enforcement's off-channel communications investigations and settlements.

The regulatory headwinds facing GPs are expected to remain strong in 2024.

- **Ongoing momentum in GP-led secondaries market.** Amid the overall weakness in private equity exit volume in 2023, GPs continued to access the secondaries market through fund-to-fund transfers of portfolio companies and the formation of continuation vehicles. Indeed, GP-led secondaries more than doubled as a percentage of overall sponsor-backed exits from 2020 to 2023, from 5% to 12%.[8] While annual secondary volume increased to $112 billion in 2023, up 4% from $108 billion in 2022, GP-led volume remained in line with 2022 levels at $52 billion (representing approximately 46% of total secondary volume).[9] Asset sale transactions (e.g., continuation vehicles) represented 88% of total GP-led secondary market volume, and structured equity and fund finance transactions represented 12% of total GP-led secondary market volume.[10] Of the total continuation vehicle activity, multi-asset continuation vehicles represented 59% of volume, and single-asset continuation vehicles represented 41% of volume – with middle market buyout assets featuring prominently in each.[11] In addition, GP-led market activity accelerated in H2 2023, increasing 88% relative to H1 2023 and achieving the highest half-year level since H2 2021.[12]

The momentum gained in the GP-led secondaries market during the second half of 2023 will continue throughout 2024.

- **Increased use of NAV loans.** The market for net asset value (NAV) loans is growing as other sources of capital become more expensive. Indeed, the market for NAV-based financings is estimated to be between $80 billion and $100 billion today and is projected to grow to $700 billion by 2030.[13] Instead of using the capital commitments of the LPs as collateral, as is the case for subscription lines, NAV facilities are generally secured by assets (i.e., the consolidated equity value of the fund's portfolio). NAV facilities may be used to: (a) enhance a fund's investible capital, (b) accelerate distributions to LPs, (c) address liquidity constraints of LPs, (d) reduce leverage, often in conjunction with a refinancing, and (e) protect portfolio company positions where asset-level financing is not available. Significantly, there is a trend among GPs to exclude NAV facilities from a fund's borrowing cap set forth in the fund agreement, with GPs taking the view that such facilities are tantamount to leverage recaps at the portfolio company level, and thus non-recourse to the fund.

GPs will increasingly access NAV facilities throughout 2024.

- **Consolidation among managers.** A growing number of GPs are giving strategic M&A a fresh look. Larger firms may consider these transactions as an opportunity to access new asset classes, clients, or opportunities, grow AUM, or mitigate risks. Meanwhile, smaller firms may consider partnering with a larger platform the longer that fundraising remains challenging. Sixty percent of the alternative asset manager acquisitions completed between 2012–2023 were motivated by asset class expansion, with credit, real assets, and private equity the most common targets.[14] Publicly traded firms account for 84% of the strategic acquisitions and investments completed since 2012 – likely due to their ability to leverage their balance sheets and liquid currency in executing transactions, as well as pressure from public shareholders to grow fee-generating AUM.[15] One in six asset managers globally are expected to be gone by 2027 (twice the historical rate of turnover).[16]

Strategic M&A involving private equity managers is expected to accelerate in 2024 and beyond.

- **Increased focus on succession planning.** GPs remain tightly controlled by a few partners. The aging of founders, the ambitions of "next generation" professionals, and the maturation of the industry are forcing sensitive discussions about succession across the marketplace. These discussions are resulting in a transition from founders to a broad set of team members in key person triggers. In some cases, these generational changes also lead to monetization opportunities for founders in the form of minority acquisitions of managers.

2024 can be expected to see significant changes to key person triggers and continuing acquisitions of interests in GPs.

- **Growing interest in tapping the mass affluent.** Wealthy individuals have traditionally been under-represented as LPs in private equity funds, but the mass affluent now comprise one of the fastest-growing sources of capital in private equity funds. Historical obstacles to investments in private equity funds by wealthy individuals include high commitment minimums, regulatory impediments, administrative complexities, "high" fees (relative to public markets), and a general lack of liquidity. However, GPs are exploring new avenues of entry by the mass affluent, including bank platform feeders, private wealth manager feeders and perpetual products. Tech-enabled fundraising platforms that are often fully digital and automated and that consolidate a high volume of small-ticket investors are also proving themselves valuable to GPs in overcoming the complex administrative and compliance processes of raising capital from individuals. Moreover, some GPs view the mass affluent as a source of strategic growth for their firms and are dedicating internal resources to build the necessary in-house infrastructure and technology to onboard and service wealthy individual investors.

The mass affluent will increasingly access the private equity market in 2024 and provide more opportunities for AUM growth by GPs.

- **Rising anti-ESG sentiment.** A subset of LPs is increasingly demanding firmer commitments and more detailed reporting on environmental, social, and governance (ESG) matters, while another subset is pushing to have ESG and sustainability excluded from investment considerations and, in some cases, refusing to invest in private equity funds that prohibit investments in industries such as oil and gas or munitions. The dichotomy creates a difficult balancing act for GPs, forcing some to choose which subset of LPs to prioritize.

ESG-related issues will continue to be a factor in negotiations with LPs in 2024 and beyond.

There are many more trends at work in the marketplace that I have not addressed herein. The views discussed above reflect recent experiences as well as the results of the attached confidential survey of selected terms of over 50 recently raised private equity funds, 70% of which were raised by the top 100 private equity firms measured by private equity AUM. While many market surveys include a diverse range of strategies, vintages, geographies, and sizes, the attached analyzes the top echelons of the current (and mostly U.S.) private equity market. The survey considers only the most established and well-known private equity funds (whose identities are and will remain confidential). The private equity funds selected for analysis had a minimum target fundraising size of $2.5 billion.

Unlike many private equity surveys, I relied not on the voluntary submissions of the relevant firms but, to the extent available, on the information and terms set forth in fund agreements. Where no agreement was available, I relied on the information in the offering materials. Consequently, the survey may be an over-simplification of the key terms. Any related commentary is based solely on my experiences in the current market. I am enormously grateful to Karen Hughes and my many colleagues for their assistance in developing the survey.

I hope that you find the survey informative and a contribution to our collective understanding of the private equity marketplace. I look forward to seeing you soon.

Very truly yours,

Marco V. Masotti
Partner
Global Co-Head, Investment Funds Group

[1] Preqin (April 2024).
[2] Preqin (April 2024).
[3] Preqin (April 2024).
[4] Preqin (April 2024).
[5] Raymond James Financial Inc. (February 2024).
[6] Private Equity International's Private Fund Leaders Survey 2023.
[7] Preqin (April 2024).
[8] Jefferies Global Secondary Market Review (January 2024).
[9] Jefferies Global Secondary Market Review (January 2024).
[10] Jefferies Global Secondary Market Review (January 2024).
[11] Jefferies Global Secondary Market Review (January 2024).
[12] Jefferies Global Secondary Market Review (January 2024).
[13] 17Capital (March 2023).
[14] Bain & Company; Is Strategic M&A Finally Catching on in Private Capital? (May 2023).
[15] Bain & Company; Is Strategic M&A Finally Catching on in Private Capital? (May 2023).
[16] PwC 2023 Global Asset and Wealth Management Survey.

SECTION 1

Economic Terms

The economic terms of a private equity fund are designed to ensure that the GP maximizes its own economics by maximizing returns for the LPs, aligning interests and providing the GP with a strong economic incentive to ensure that the private equity fund is successful.

Management Fee Rate

Most private equity funds charge an annual management fee that is intended to cover the ongoing operating expenses of the manager, such as rent, base compensation for employees and other overhead. Due to concerns that excessive management fees could result in a misalignment of interests between GPs and LPs, and the impact of increasing fund sizes on the total amount of management fees paid, management fee rates are on the frontline of an evolving debate between GPs and LPs.

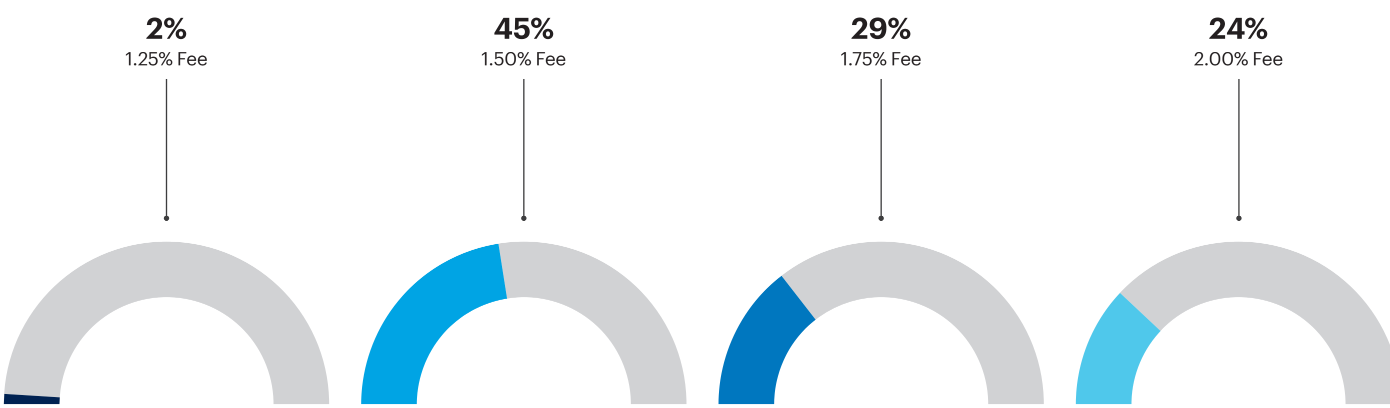
Pre-Step Down Rate

The management fee percentage and the base upon which it is calculated vary both among funds and from one period in the fund's life to another. During the commitment period, the management fee is typically calculated as a percentage of commitments. As illustrated in *Figure 1*, the headline rate for most funds is now in the range of 1.5% to 1.75% per annum. (*Figure 1* does not take into account blended fee rates based on reaching certain total commitment thresholds or other discounts.) In addition, some funds provide multiple classes of LP interests, whereby an LP elects which class to participate in, e.g., Class A: 2.00% management fee and 20% carried interest or Class B: 1.00% management fee and 30% carried interest.

Post-Step Down Rate

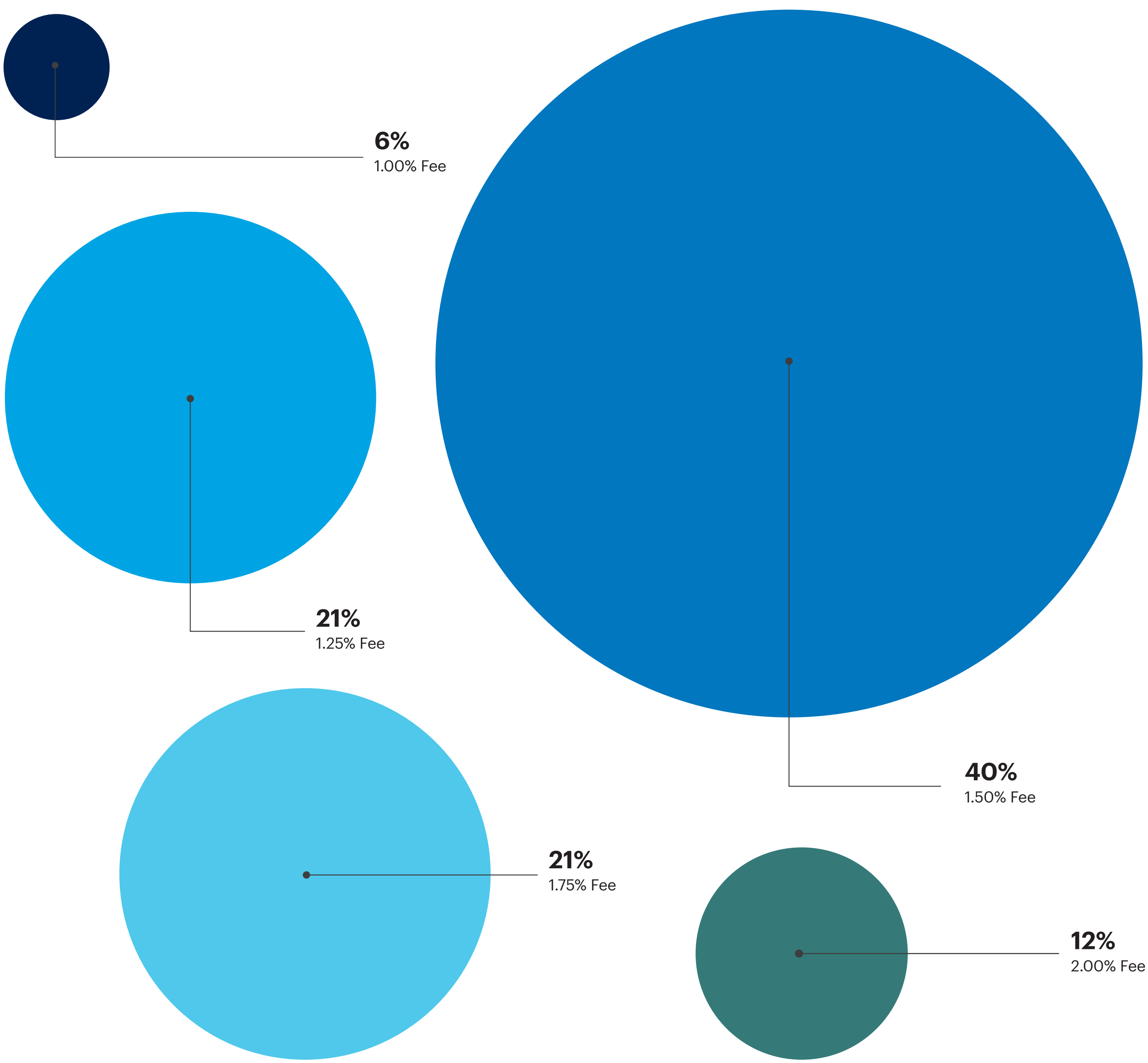
Private equity funds typically provide for the management fee to be calculated as a percentage of invested capital (and often reduced by write-downs or write-offs) after the commitment period has ended or when the firm starts to accrue a management fee with respect to a successor fund.

PRE-STEP DOWN RATE
Figure 1



As illustrated in *Figure 2*, while many private equity funds surveyed had a decreased management fee rate after the end of the commitment period, the amount of this decrease varied. Some private equity funds are also agreeing to a sliding scale reduction over time in order to alleviate LP concerns about "zombie" or dormant funds that continue to accrue management fees. (Please note that *Figure 2* reflects the initial post-step down rate of each fund and does not take into account sliding scale reductions over time.)

POST-STEP DOWN RATE
Figure 2



“EARLY BIRD” DISCOUNTS

Figure 3

“Early Bird” Discounts

Some private equity funds provide a discount on management fees to LPs that come in at the first closing (or early in the offering). These discounts often apply only to management fees paid during the commitment period, but sometimes apply to both the pre- and post-step down management fee rate.

As illustrated in *Figure 3*, a minority of private equity funds surveyed are offering “early bird” discounts on management fees.

Size-Based Discounts

Some private equity funds provide a discount on management fees to an LP based upon the size of the capital commitment of the LP.

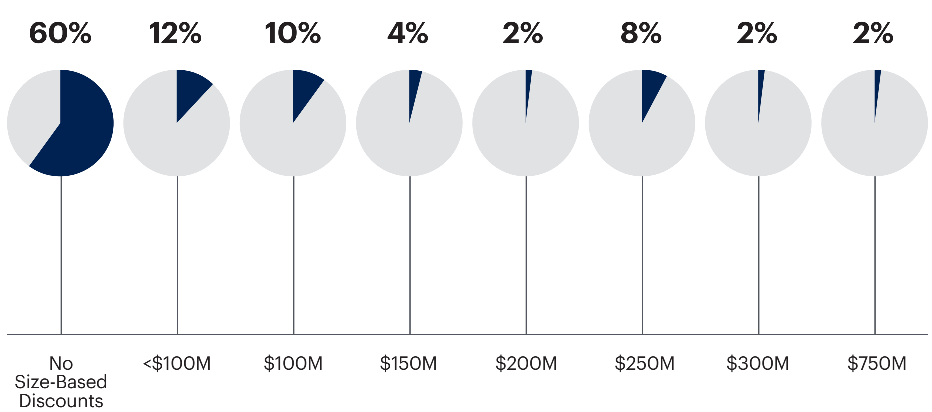
As illustrated in *Figure 4*, 40% of the private equity funds surveyed are offering tiered management fee structures based upon the size of the capital commitment of the LP – with most discounts starting at significant commitment levels (generally not lower than $100 million). In reality, the percentage of private equity funds providing size-based discounts with respect to management fees is probably higher, as breaks in economic terms are frequently reflected in side letters rather than in the express terms of the fund documents (which we relied upon for this survey).

Transaction Fee Offset

Transaction fees are special fees and other revenues that the manager receives in connection with investments in portfolio companies (including monitoring fees, director’s fees or fees received in connection with the acquisition of a portfolio company). In recent years, LPs have pushed the manager to apply 100% of the allocated share of these fees (as

MINIMUM COMMITMENT TO RECEIVE SIZE-BASED DISCOUNTS

Figure 4



TRANSACTION FEE OFFSET
Figure 5

opposed to the 50%–80% often seen in the past) to offset the management fees paid by the private equity fund. In addition, it has become more common for the management fee to be offset by only the portion of transaction fees that are allocable to (i) the investment by the fund (and not the portion allocable to co-investors) and (ii) the management-fee-bearing partners (and not the portion allocable to the GP or any affiliate thereof).

As illustrated in *Figure 5*, 98% of the private equity funds surveyed have a 100% transaction fee offset.

Management Fee Waiver Program

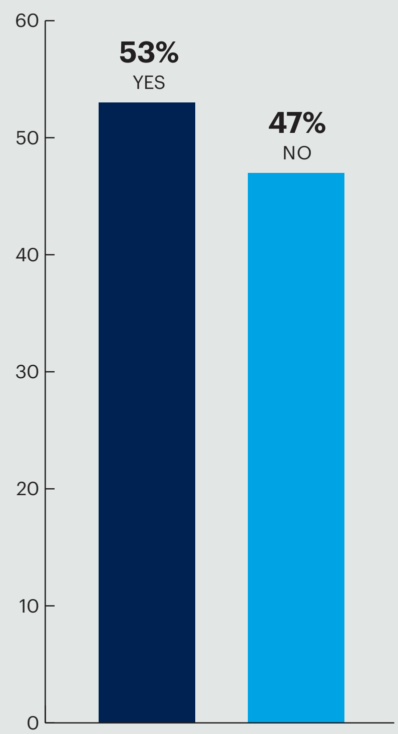
Some private equity funds have implemented "management profits interest" programs. Generally, at the election of the manager, a portion of the amounts contributed by LPs is employed by the fund as part of an incentive program for the benefit of the investment professionals. Under this structure, these contributions are invested in fund investments in an amount equal to the amount that the manager would have received if it had invested an amount equal to such contributions. The management fees otherwise payable to the manager are then reduced by the amounts invested. This permits the manager to be allocated a share of capital gains from the underlying investments.

As illustrated in *Figure 6*, 53% of the private equity funds surveyed provide a management fee waiver program. (Please note that some of the surveyed funds may provide for a management fee waiver program but not use the flexibility provided in the fund documents.)

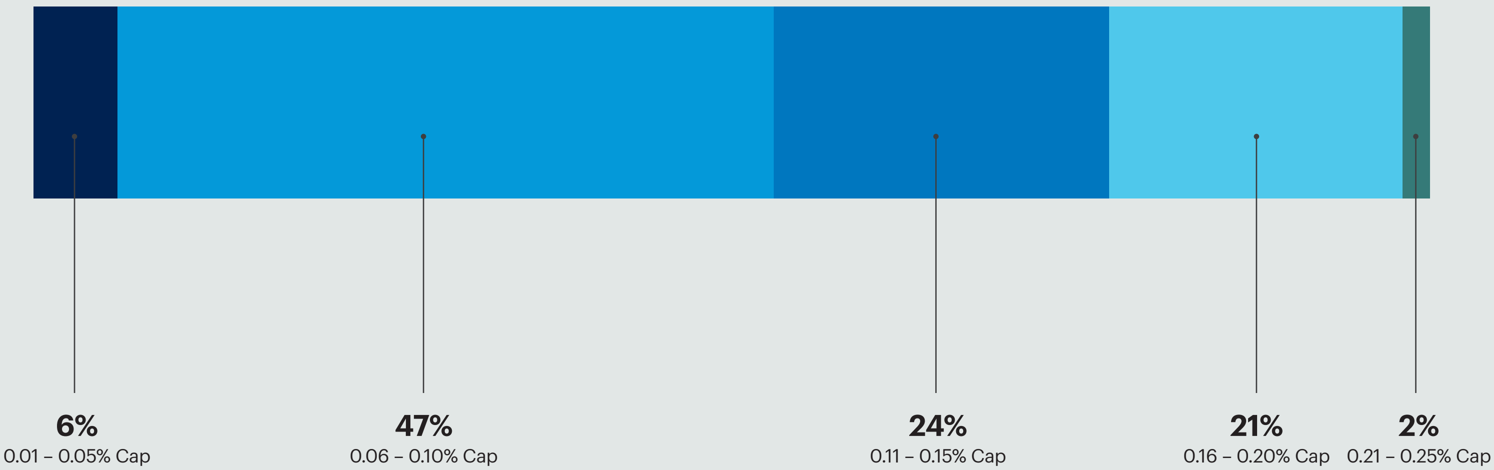
Cap on Organizational Expenses

During the formation of a private equity fund, the GP will incur organizational expenses related to raising and forming the fund, which can include travel, legal and accounting expenses. These organizational expenses are typically capped at either a percentage of the aggregate size of the fund or a specified dollar amount. Organizational expenses in excess of this cap typically offset the management fees borne by the LPs.

MANAGEMENT FEE WAIVER PROGRAM
Figure 6



CAP ON ORGANIZATIONAL EXPENSES
Figure 7



(measured as a percentage of target fund size)

As illustrated in *Figure 7*, approximately 53% of the private equity funds surveyed cap organizational expenses borne by the fund at .10% or less of the aggregate commitments of the fund.

Chargeback of In-House Expenses

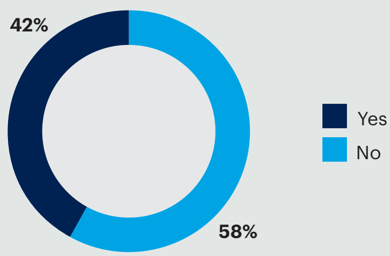
Some private equity fund managers allocate to the fund a portion of their in-house legal and/or accounting expenses that are related to the operations of the fund.

As illustrated in *Figure 8*, 42% of the private equity funds surveyed allocate a portion of their in-house legal and/or accounting expenses to the funds that they advise. (Please note that some of the surveyed funds may allow the chargeback to the fund of certain in-house expenses but not use the flexibility provided in the fund documents.)

Operating Partners

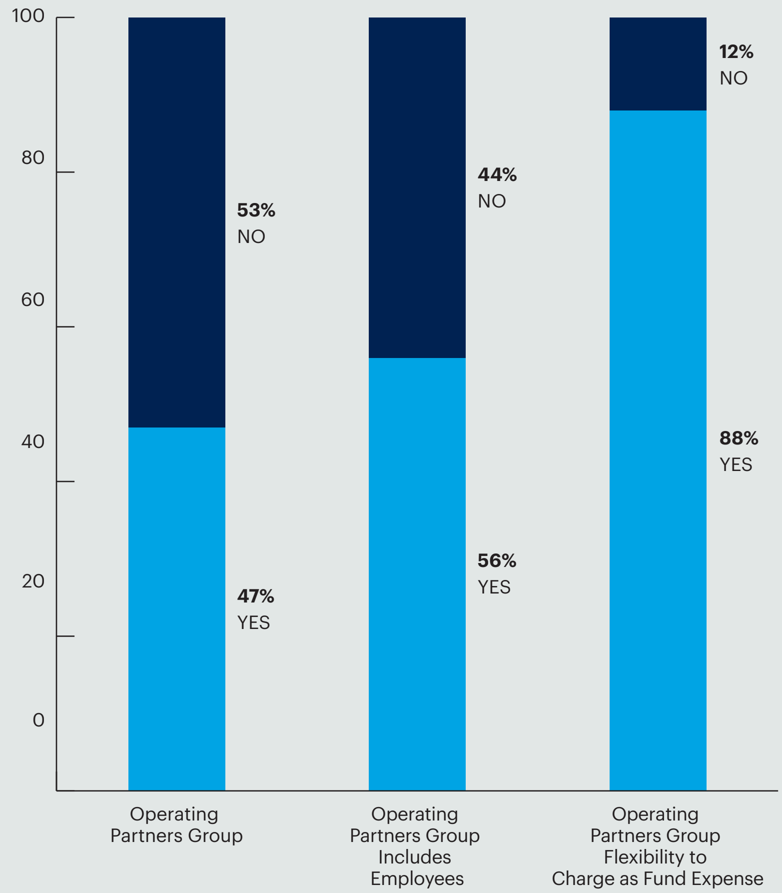
Some private equity firms establish a dedicated group of professionals (which may include employees of the firm or an affiliated entity) to provide operational expertise and related services to the fund's portfolio companies. Typically, compensation and expenses of these operating professionals are borne by the portfolio companies and/or the fund.

IN-HOUSE EXPENSES CHARGED TO FUND
Figure 8



As illustrated in *Figure 9*, 47% of the private equity funds surveyed have a dedicated group of operating partners. Among these funds, approximately 56% include certain employees of the firm in the group as illustrated in *Figure 10*, and 88% provide the flexibility to charge the fund for expenses relating to such operating partners as illustrated in *Figure 11* (although some may not in practice).

OPERATING PARTNERS GROUP
Figures 9, 10, 11



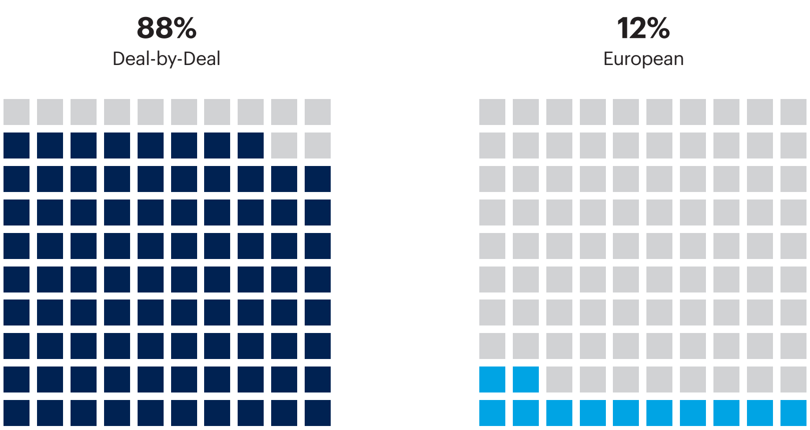
Distribution Waterfall

European or "All-Capital-Back." In a European waterfall, proceeds attributable to an investment are distributed to the LPs until they have recovered all capital contributed to the fund to date (i.e., for all investments, management fees and expenses) before the payment of the preferred return and carried interest.

Deal-by-Deal. In a deal-by-deal waterfall, proceeds attributable to an investment are distributed to the LPs until they recover their capital invested in that investment and any capital invested in other deals that have been disposed of at a loss or significantly written down, as well as an allocable portion of management fees and expenses, before the payment of the preferred return and carried interest. Where a deal-by-deal distribution methodology is used, the *ILPA Private Equity Principles* propose, and LPs are increasingly asking, to alter the model by returning all expenses paid to date (as opposed to an allocable portion), known as a "modified deal-by-deal" waterfall, and to use carry escrow accounts and effective clawback mechanisms — each, as discussed more fully below.

As illustrated in *Figure 12*, the deal-by-deal distribution methodology remains the norm for the private equity funds surveyed.

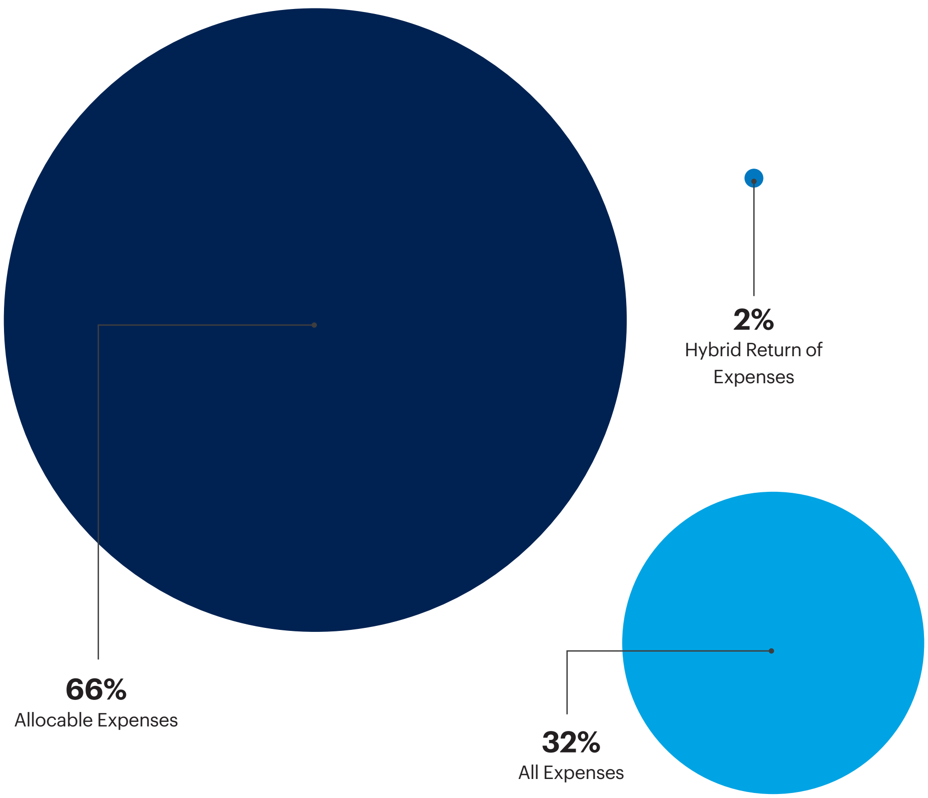
DISTRIBUTION WATERFALL
Figure 12



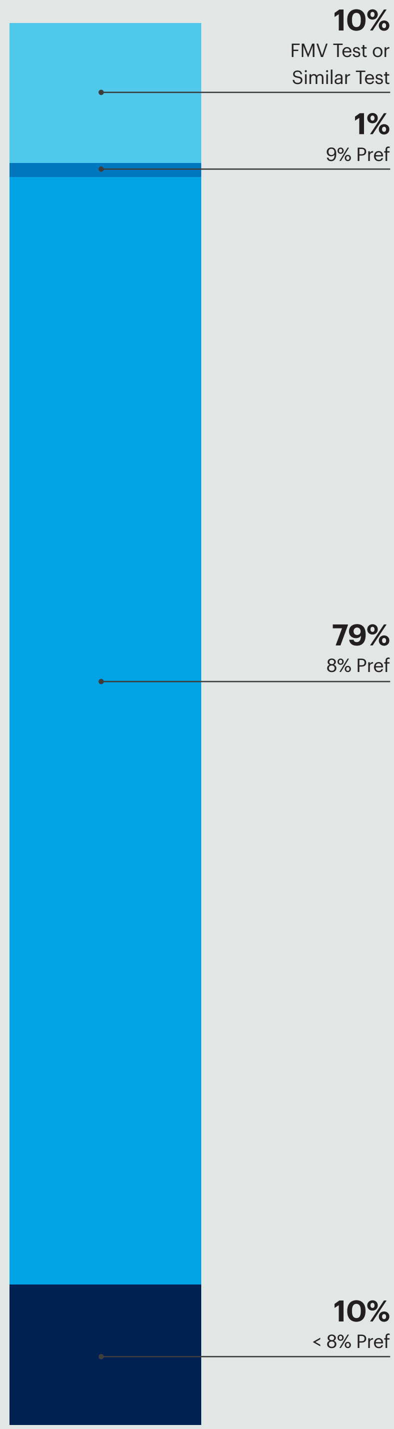
Treatment of Expenses – Deal-by-Deal

In a deal-by-deal waterfall, the "return of capital" step requires the fund to return to LPs both capital invested in disposed of investments and management fees and expenses allocable to those investments by a prescribed formula, before moving on to the preferred return and, eventually, the carried interest. However, "modified deal-by-deal" waterfalls require that the fund return all management fees and expenses paid prior to the distribution before moving on to the preferred return and carried interest.

TREATMENT OF EXPENSES – DEAL-BY-DEAL
Figure 13



PREFERRED RETURN
Figure 14



As illustrated by *Figure 13*, 66% of the private equity funds surveyed continue with the traditional model and return only allocable expenses (rather than all expenses) prior to the preferred return and carried interest.

Preferred Return

In many cases, private equity funds provide for a preferred return (or "hurdle rate") on contributed capital, requiring the LPs to receive a pre-determined rate of return before the GP begins to receive carried interest. Preferred returns have historically been 8% and are intended to align the interests of the GP and LPs by preventing the GP from taking its carried interest if the private equity fund has not outperformed a specified minimum return.

As illustrated in *Figure 14*, 8% remains the most common preferred return, although an increasing number of private equity funds surveyed have a lower preferred return. Ten percent of the private equity funds surveyed utilize an FMV test or similar test in lieu of a preferred return.

GP Catch-Up

Most private equity funds permit the GP to "catch-up" on the preferred return distributions made to LPs so that the GP ultimately receives 20% of all profits of the fund. As a result, if the carried interest is ultimately 20%, then the GP will receive a special distribution of more than 20% of the profits until it has "caught up" and received 20% of the total profits distributed. Depending on the rate of catch-up, the GP will achieve its goal of receiving 20% of fund profits at different breakpoints.

As illustrated in *Figure 15*, the level of the GP catch-up varies, with 100% and 80% GP catch-up remaining the most common.

Carried Interest

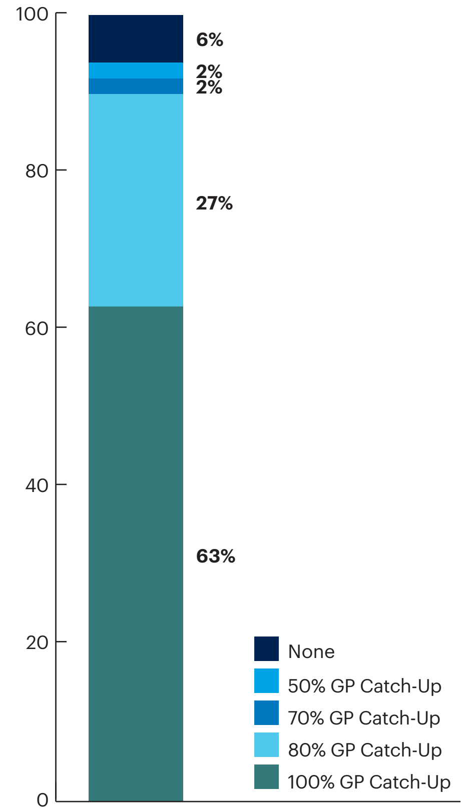
The GP of a private equity fund receives a disproportionate share of the fund's profits, referred to as the GP's "carried interest," "override" or "promote." The carried interest is calculated as a percentage of realized profits. The classic carried interest split is 80/20 – with 20% of profits going to the GP. Occasionally, a GP with a strong track record may receive a carried interest percentage as high as 25% to 30%. Some GPs offer a class of interest with a lower management fee and a higher carried interest. In addition, some funds calculate the carried interest based upon a multiple of returns, e.g., 20% carried interest until a 2.5x return, 25% from a 2.5 to 3x multiple return, and 30% if a 3x return.

As illustrated in *Figure 16*, the carried interest percentage for most private equity funds surveyed remains 20%.

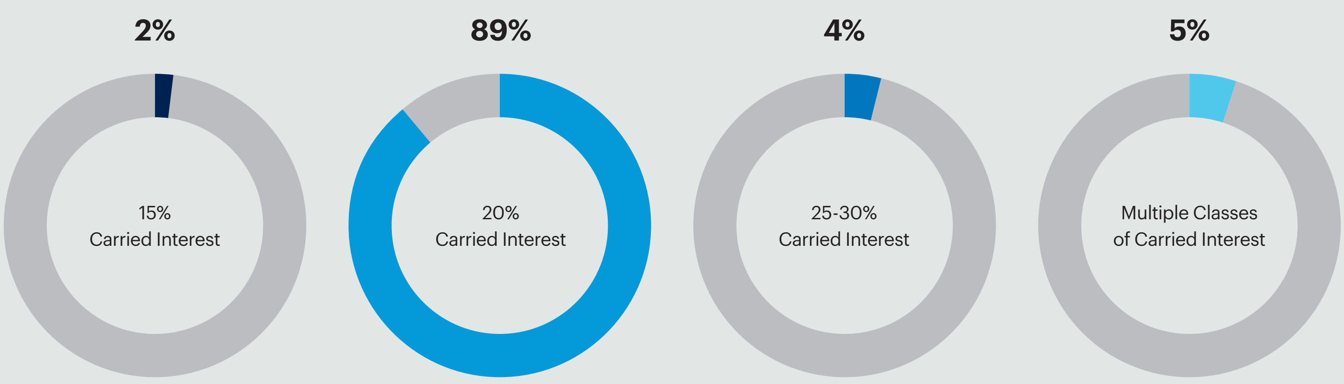
GP Clawback

In a deal-by-deal waterfall, if profitable investments are sold first (and the GP receives carried interest on those investments), and later investments are sold at a loss, or, in an all-capital-back waterfall, if the GP receives a carried interest distribution before all capital contributions are made and later investments are sold at a loss, the cumulative profits of the fund may be reduced (or eliminated) such that the amount of carried interest actually paid to the GP may exceed the agreed upon portion of the profits. Accordingly, private equity funds typically provide for a GP "clawback" (or "giveback") as a mechanism to recapture overpayments to the GP if it has received more than its contractual carried interest at the end of the life of the fund (and, occasionally, more frequently over the life of the fund). The GP typically agrees to return to the LPs amounts previously distributed to it as carried interest, to the extent that such amounts exceed the carried interest due on a cumulative basis.

GP CATCH-UP
Figure 15



CARRIED INTEREST
Figure 16



A GP clawback is generally capped at the after-tax amount of all carried interest received, although LPs sometimes request that amounts returned be pre-tax, or at least share in any tax benefits that the carry participants realize from paying the clawback.

GP Clawback Escrow

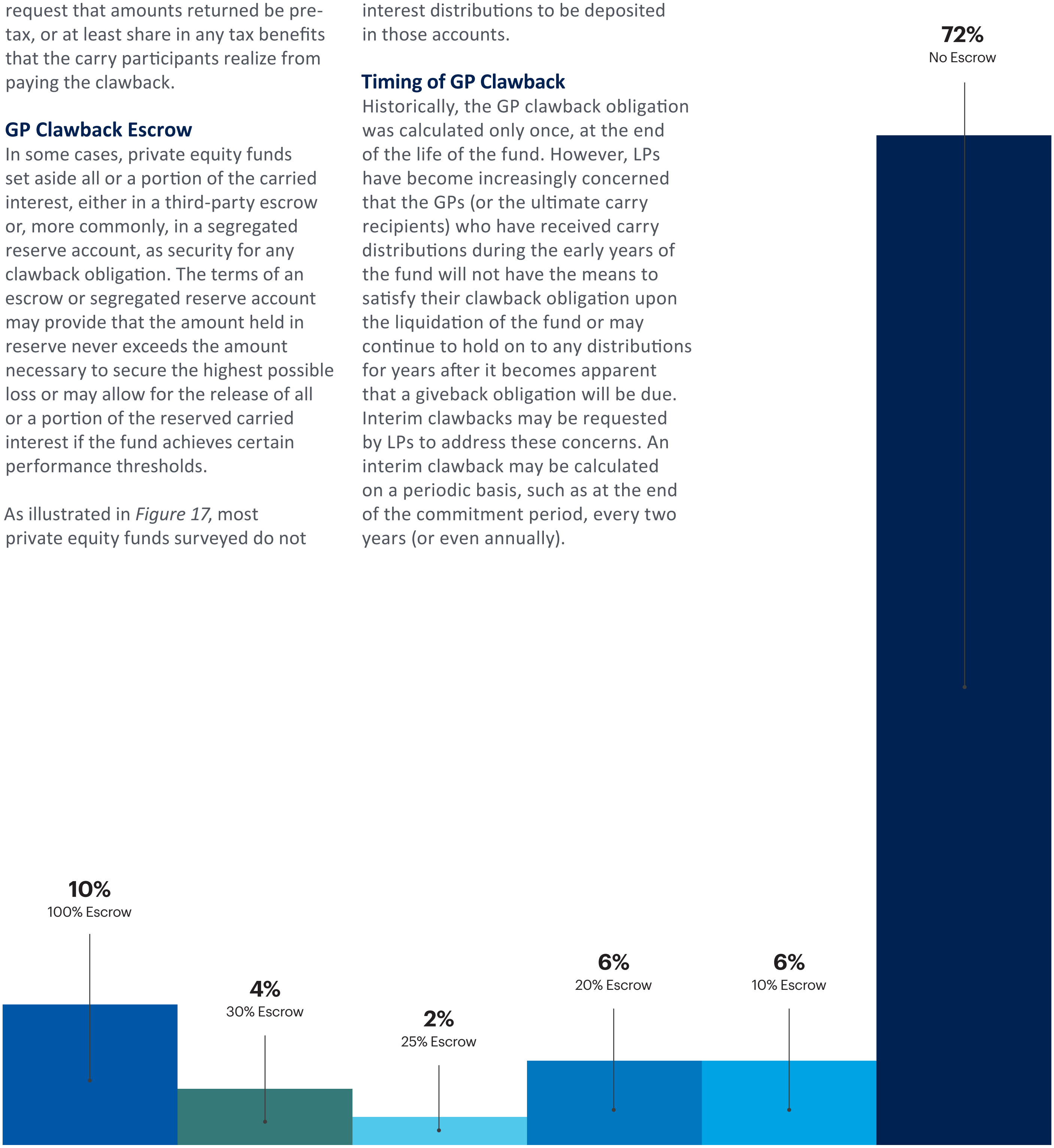
In some cases, private equity funds set aside all or a portion of the carried interest, either in a third-party escrow or, more commonly, in a segregated reserve account, as security for any clawback obligation. The terms of an escrow or segregated reserve account may provide that the amount held in reserve never exceeds the amount necessary to secure the highest possible loss or may allow for the release of all or a portion of the reserved carried interest if the fund achieves certain performance thresholds.

As illustrated in *Figure 17*, most private equity funds surveyed do not provide for segregated reserve accounts, and those that do most often require 10%-20% of carried interest distributions to be deposited in those accounts.

Timing of GP Clawback

Historically, the GP clawback obligation was calculated only once, at the end of the life of the fund. However, LPs have become increasingly concerned that the GPs (or the ultimate carry recipients) who have received carry distributions during the early years of the fund will not have the means to satisfy their clawback obligation upon the liquidation of the fund or may continue to hold on to any distributions for years after it becomes apparent that a giveback obligation will be due. Interim clawbacks may be requested by LPs to address these concerns. An interim clawback may be calculated on a periodic basis, such as at the end of the commitment period, every two years (or even annually).

GP CLAWBACK ESCROW
Figure 17



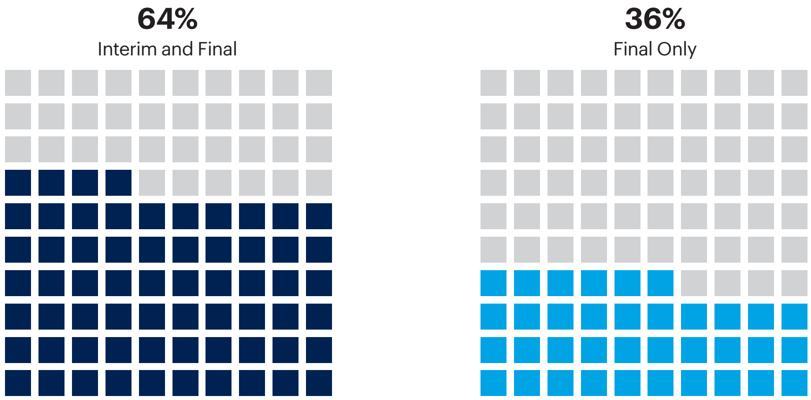
As illustrated in *Figure 18*, 64% of the private equity funds surveyed provide for interim GP clawbacks during the life of the fund.

GP Capital Commitment

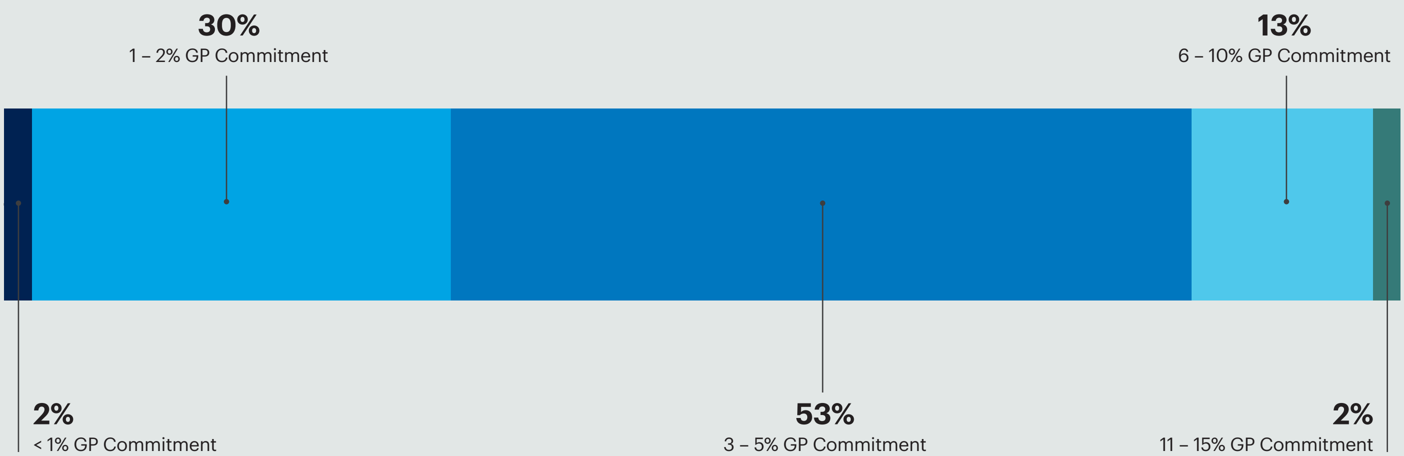
The GP and its affiliates will typically make a capital commitment to the private equity fund that is invested pro rata in all investments with the LPs. For historical tax reasons, the amount of the GP's commitment typically is at least 1% of the aggregate commitments to the fund. However, LPs expect to see a more meaningful commitment so that the GP and its affiliates are aligned in sharing the risks associated with the fund with the LPs. The actual dollar amount that the GP contributes to a private equity fund is based on a variety of factors, including the size and type of the fund and the prior experience of the GP.

As illustrated in *Figure 19*, 53% of the private equity funds surveyed provide for a capital commitment by the GP and its affiliates of 3%–5% of aggregate commitments to the fund.

TIMING OF GP CLAWBACK
Figure 18



GP CAPITAL COMMITMENT
Figure 19



(measured as a % of target fund size)

SECTION 2

Governance and Other Terms

The governance and other non-economic terms of a private equity fund are meant to achieve a balance between the duties and responsibilities of the GP, on the one hand, and adequate protections for the LPs, on the other hand, given the LPs' passive role in the fund.

OFFERING PERIOD
Figure 20

Offering Period

Most private equity funds admit additional LPs at one or more subsequent closings that take place within a set period of time following the initial closing (traditionally 12 months). This limitation is imposed, among other reasons, to ensure that the GP focuses as soon as possible on the main purpose of the fund, which is the making and managing of investments.

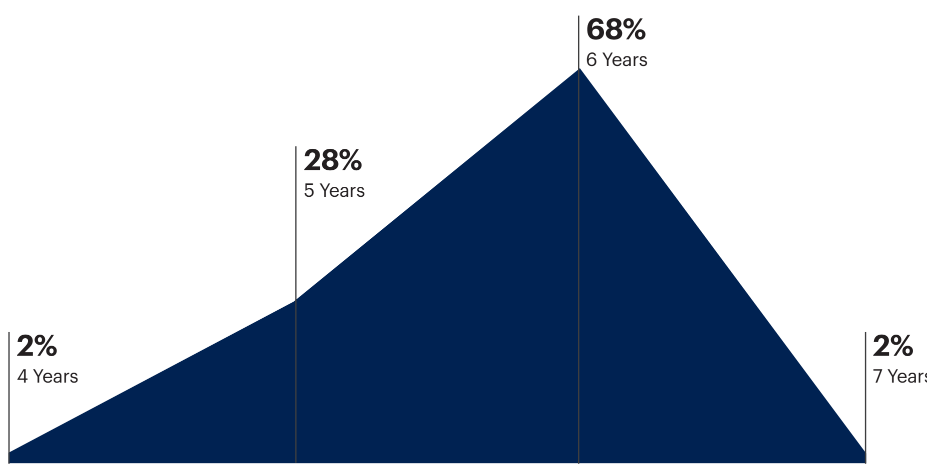
As illustrated in *Figure 20*, the offering period for 73% of the private equity funds surveyed is 12 months, though extensions of this time period may often be requested by the GP.

Commitment Period

The commitment period is the period during which capital may be called by a private equity fund to make "new" investments. The commitment period for a private equity fund is typically five to six years (shorter terms being more typical of new managers). The commencement date of the commitment period varies considerably among funds (e.g., initial closing date, final closing date, initial management fee draw down date or date of first investment).

As illustrated in *Figure 21*, the commitment period for 68% of the private equity funds surveyed is six years.

COMMITMENT PERIOD
Figure 21



Key Person Trigger

The investment team is a critical factor for many LPs when making a commitment to a private equity fund. Accordingly, any significant changes in that team typically allow LPs to reconsider their decision to continue investing. Although key person provisions contain various moving parts (including requirements around devotion of time and attention, processes to resolve a trigger, whether a trigger results in a suspension of the commitment period, etc.), considerations surrounding the composition of such "key persons" – whether founders, team members or some combination thereof – vary from firm to firm.

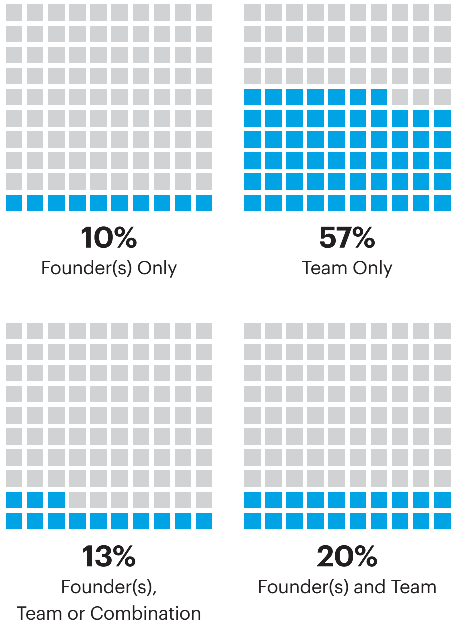
As illustrated in *Figure 22*, 57% of the private equity funds surveyed do not include founders as part of the key person triggers.

No-Fault Termination of Commitment Period ("No-Fault Divorce")

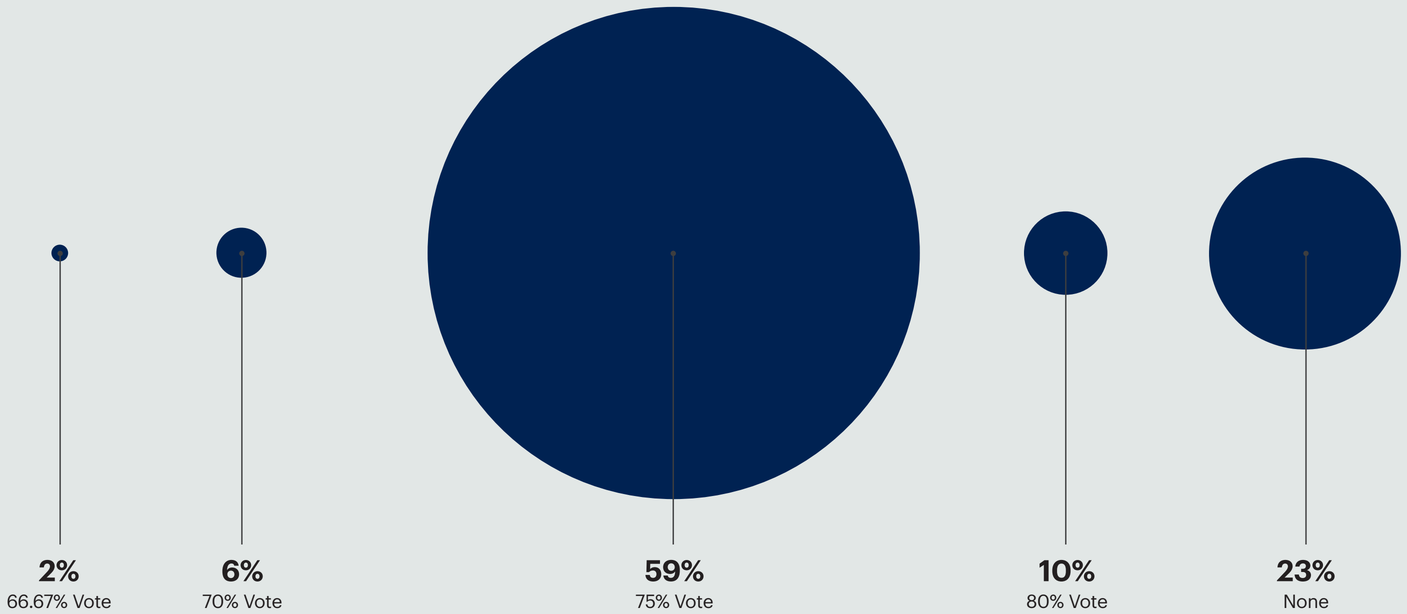
Although somewhat contrary to the notion of a "committed" vehicle, a "no-fault divorce" provision is essentially the right of a supermajority of the LPs to terminate the commitment period, and therefore stop contributing capital for new investments. In some cases, the right is exercisable after an initial period following the closing of the private equity fund (e.g., two years). Although rarely invoked, the existence of this type of provision provides a measure of leverage for LPs during circumstances where a private equity fund encounters problems such as investment losses or organizational instability.

As illustrated in *Figure 23*, most private equity funds provide for a "no-fault" termination of the commitment period upon a supermajority vote of the LPs (typically, 75% or more).

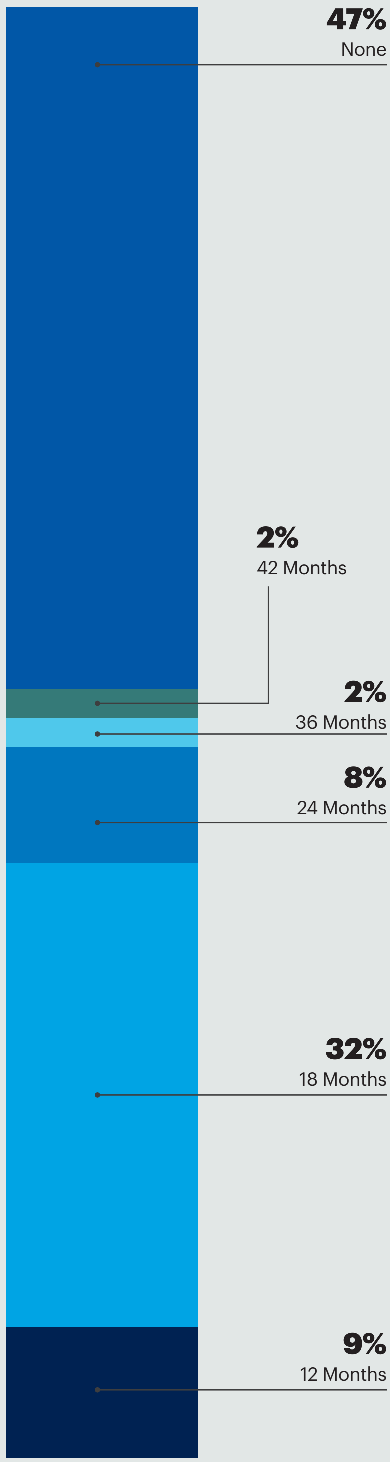
KEY PERSON COMPOSITION
Figure 22



NO-FAULT TERMINATION OF COMMITMENT PERIOD ("NO-FAULT DIVORCE")
Figure 23



RECYCLING – TIME PERIOD
Figure 24



Recycling

Private equity funds typically permit the GP to retain or recall for reinvestment the invested capital portion of any proceeds received by the fund from the disposition of an investment that is realized within a specified number of months after the investment was originally made. The time period for recycling of capital (including whether such recycling is only permitted during the commitment period) may vary based on the size or strategy of the particular fund.

All of the private equity funds surveyed permit recycling, and, as illustrated in *Figure 24*, approximately 32% permit recycling where capital is returned within 18 months of investment.

As illustrated in *Figure 25*, 38% of the private equity funds surveyed permit recycling during the commitment period of the fund and cap the amount subject to recycling at the capital portion of proceeds received.

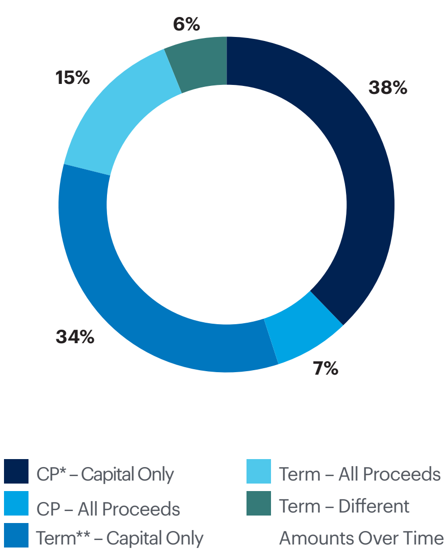
Some private equity funds limit the cumulative amount of capital that may be invested (including as a result of recycling) to a specified percentage of commitments.

As illustrated in *Figure 26*, this cap is typically 110%–130% of commitments.

Term

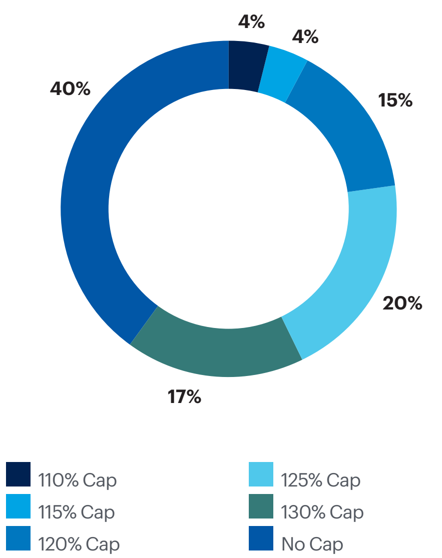
The term of a private equity fund is the period during which the fund is permitted to hold investments in order to maximize their value. After the end of the commitment period and prior to the end of the term of the fund, limited additional investments typically are permitted, such as follow-on investments in existing investments. After the term of a fund expires, the fund must begin an orderly liquidation of the fund.

RECYCLING – PARAMETERS
Figure 25



*CP – During Commitment Period
**Term – During Term

RECYCLING – OVERALL CAP ON INVESTMENTS
Figure 26



As illustrated in *Figure 27*, approximately 72% of the private equity funds surveyed have a term of 10 years.

GP Removal

A private equity fund may provide for the removal of the GP by a vote of the LPs. GP removal provisions are often limited to actions constituting "cause" on the part of the GP and/or the investment professionals; however, LPs are more frequently requesting that investors retain the right to remove the GP without cause (which is a right separate and apart from the "no-fault divorce" right described above).

For Cause

The threshold for actions meriting removal for "cause" is often high, such as fraud, gross negligence or material violations of securities laws, and generally requires the approval of a majority or supermajority of LPs.

As illustrated in *Figure 28,* most private equity funds provide for the removal of the GP for cause upon a majority or supermajority vote of the LPs.

Without Cause

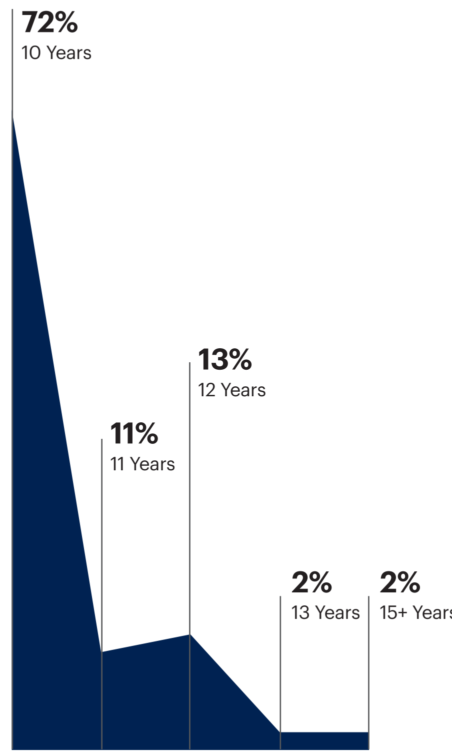
Less frequently, private equity funds may provide for removal of the GP without cause, typically upon the vote of a supermajority of LPs.

As illustrated in *Figure 29*, 60% of the private equity funds surveyed do not permit removal of the GP without cause and, where it is permitted, the requisite voting percentage is most often 75% or 80% of LPs.

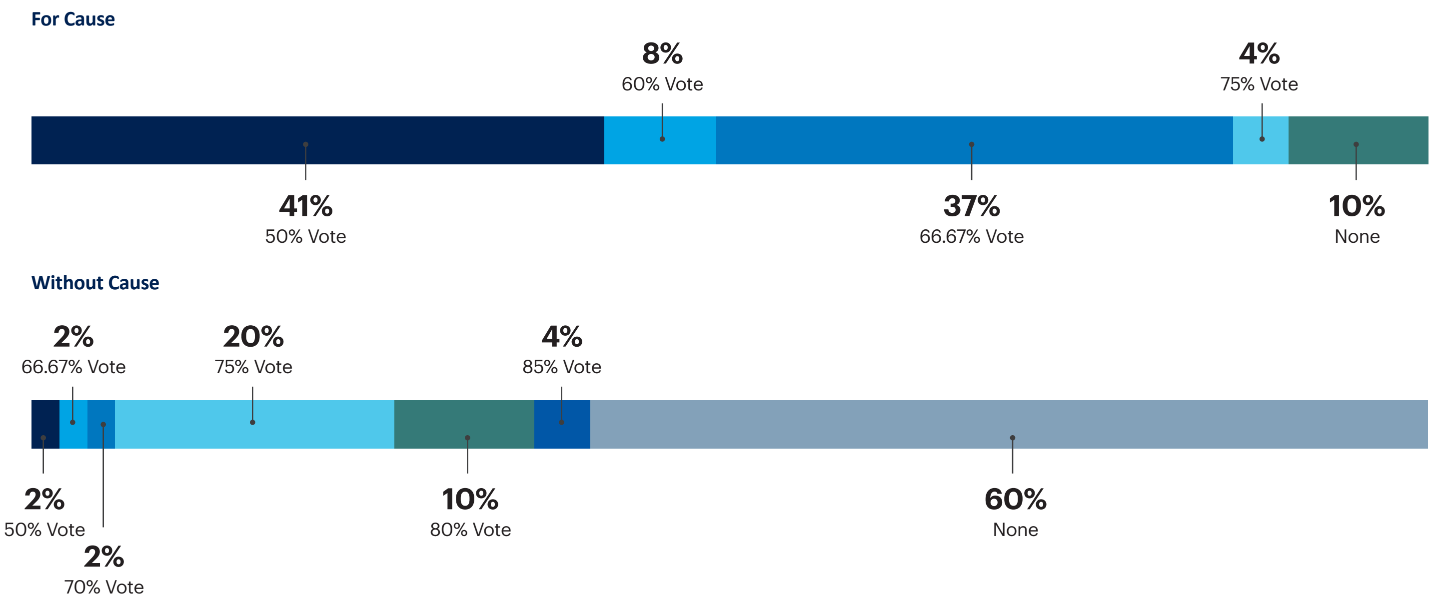
Carry Haircut Following For Cause Removal

The consequences of GP removal for cause range from requiring a replacement GP to purchase the carried interest at fair market value to requiring a discount (carry "haircut") on future carried interest otherwise distributable to the removed GP with respect to the fund investments existing at the time of removal.

TERM OF FUND
Figure 27

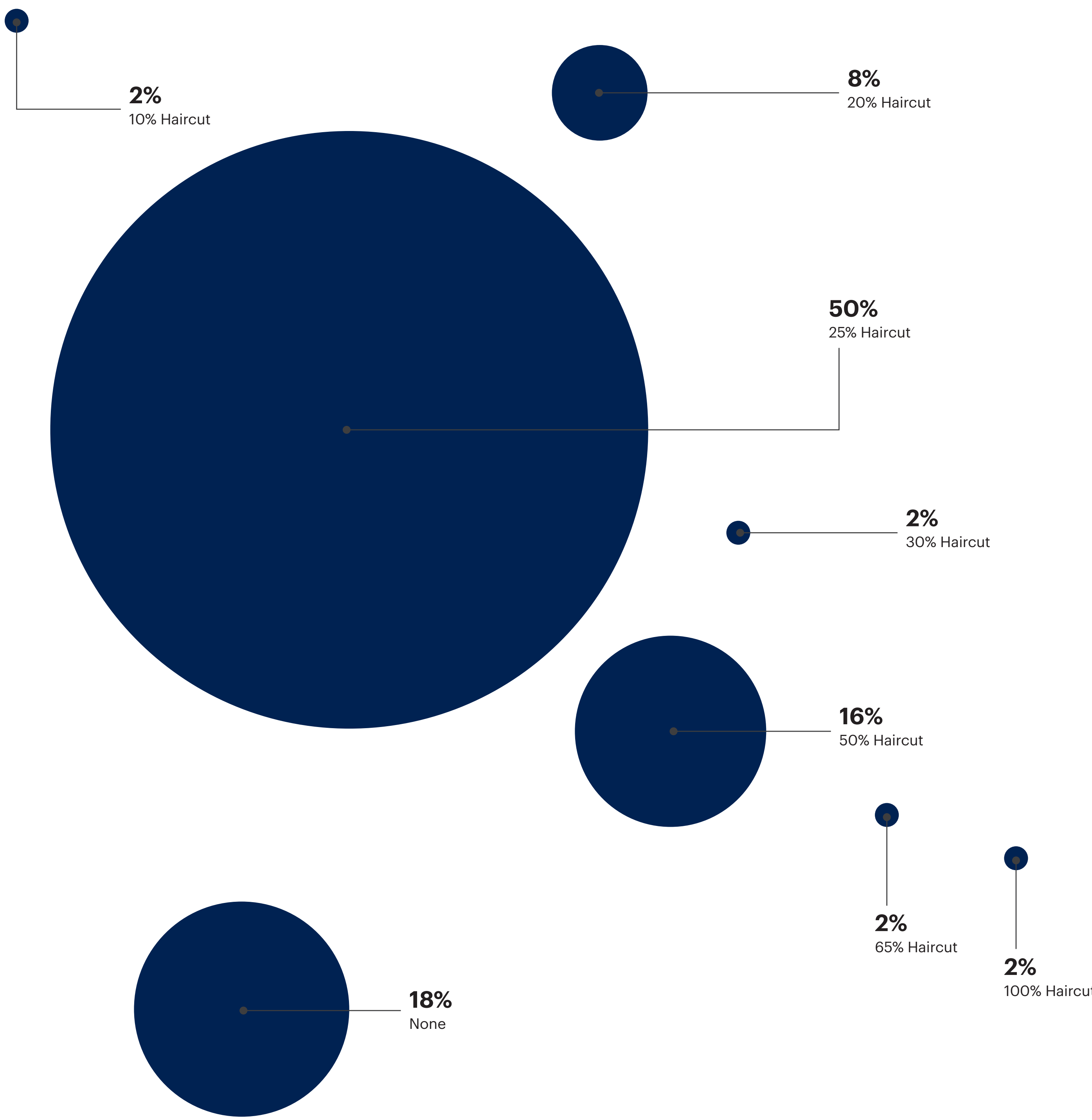


FOR CAUSE AND WITHOUT CAUSE
Figures 28 and 29



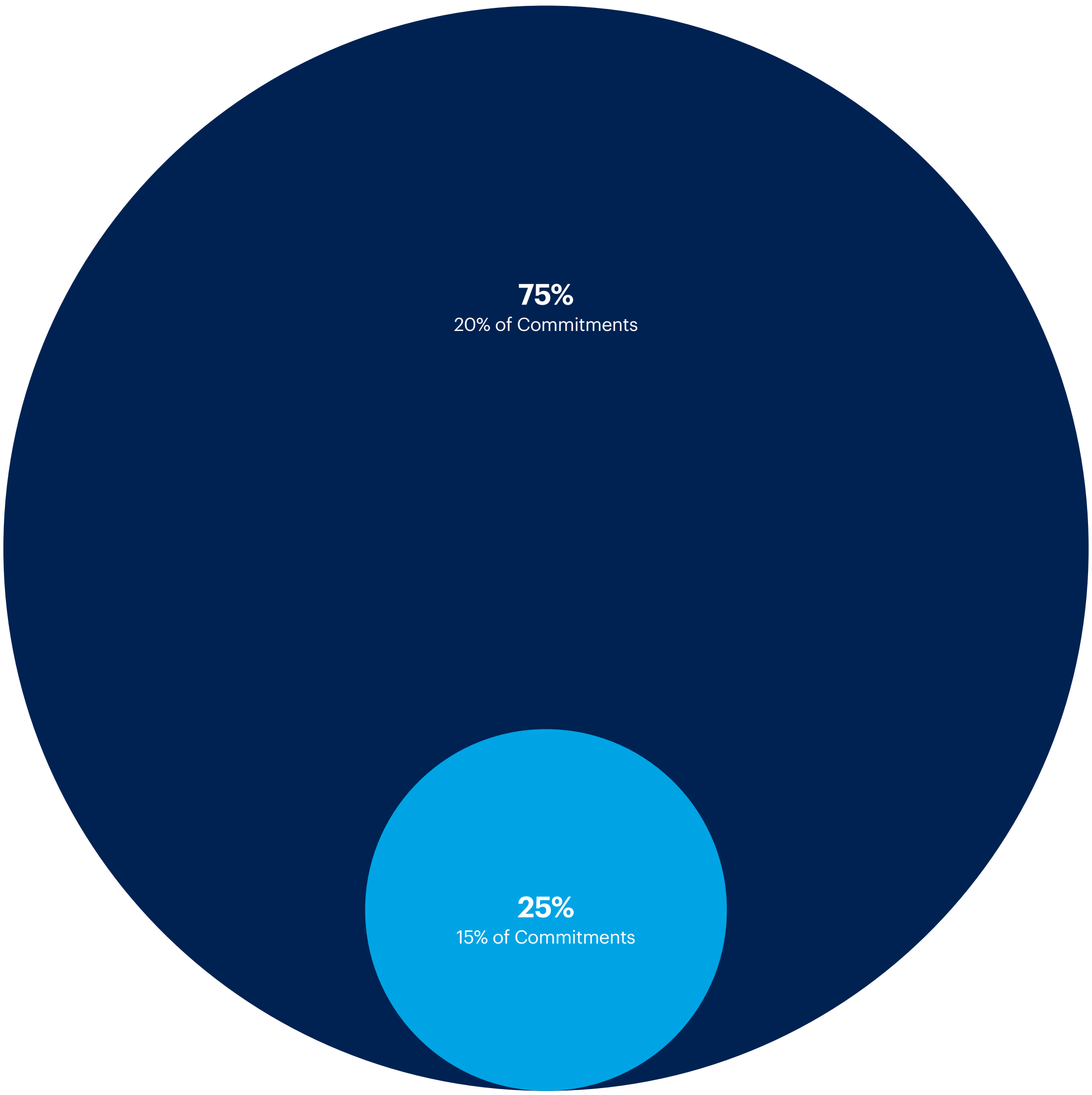
As illustrated in *Figure 30,* 50% of the private equity funds surveyed provide a carry haircut upon removal of the GP for cause of 25%.

CARRY HAIRCUT FOLLOWING FOR CAUSE GP REMOVAL
Figure 30



SINGLE INVESTMENT CONCENTRATION LIMIT

Figure 31



Single Investment Concentration Limit

Investment limitations are utilized to promote portfolio diversification and restrict activities that are outside the scope of the GP's intended investment strategy. In many private equity funds, some or all such limitations may be waived by the LPAC. The most common limitation caps the amount that the fund may invest in a single portfolio company.

As illustrated in *Figure 31*, every private equity fund surveyed has a single investment concentration limit, with the most common limitation being 20% of the fund's total commitments in a single investment.

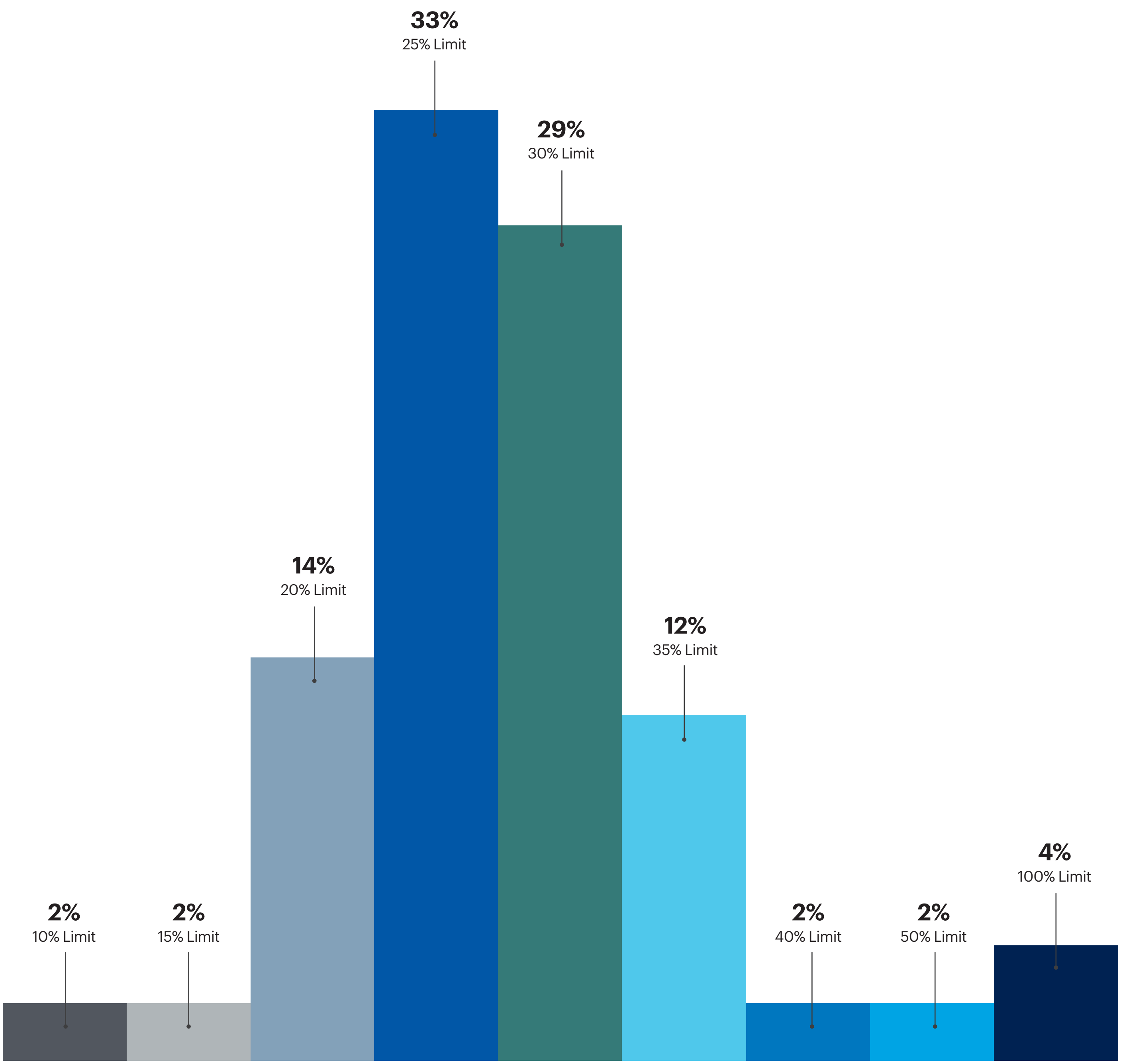
Fund Level Borrowings

Private equity funds have the ability to use leverage or borrow money for investments or guarantee their portfolio companies' debt. Subject to any tax undertakings, private equity funds often include a limitation on borrowings – and guarantees of portfolio company obligations – expressed as a percentage of the aggregate size of the fund.

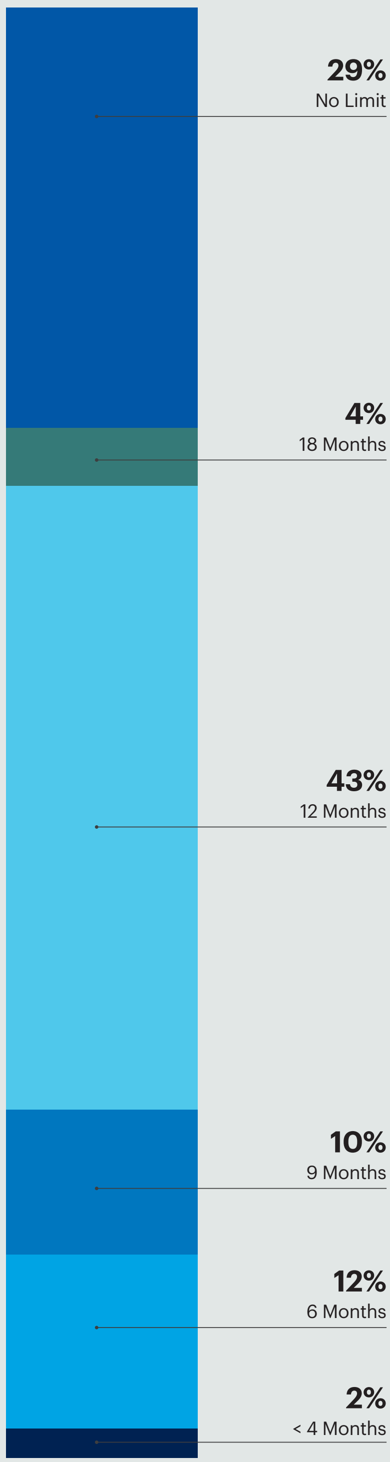
As illustrated in *Figure 32*, approximately 62% of the private equity funds surveyed limit borrowings and guarantees that are recourse to the fund to 25% to 30% of the fund's commitments.

FUND LEVEL BORROWINGS

Figure 32



DURATION OF BORROWINGS
Figure 33



Duration of Borrowings

Private equity funds typically provide specific limits on the time period during which borrowings that are recourse to the fund may remain outstanding.

As illustrated in *Figure 33*, 43% of the private equity funds surveyed limit the time period during which a borrowing may remain outstanding to 12 months.

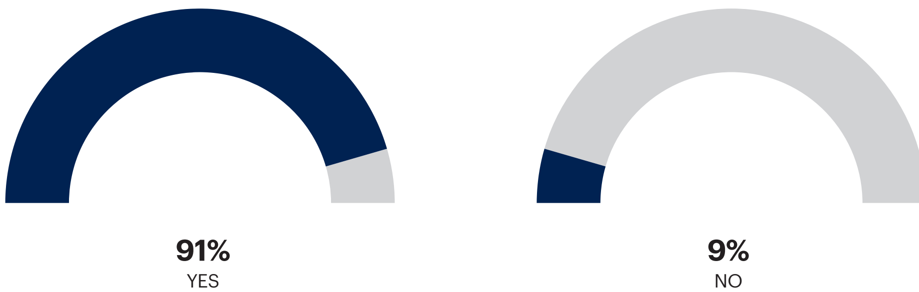
NAV Facilities

In addition to general fund level borrowing provisions, some private equity funds expressly permit the fund to enter into NAV loans, which are secured by assets (i.e., the consolidated equity value of the fund's portfolio).

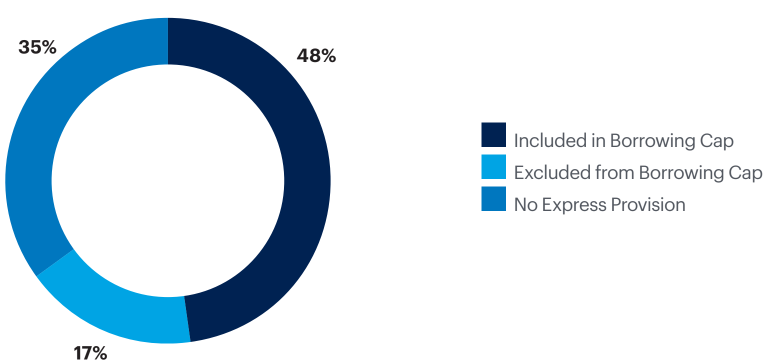
As illustrated in *Figure 34*, 91% of the private equity funds surveyed expressly permit the fund to enter into NAV facilities.

As illustrated in *Figure 35*, 17% of the private equity funds surveyed exclude NAV facilities from the fund's borrowing cap set forth in the fund agreement.

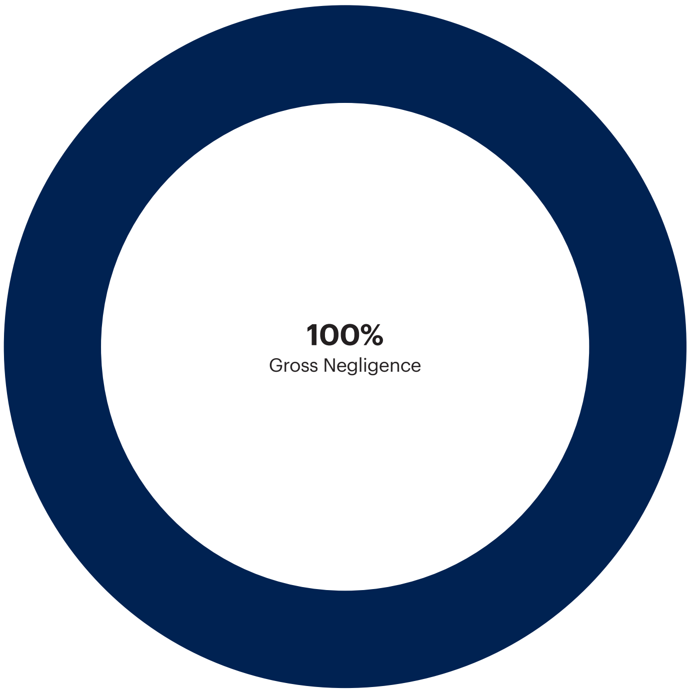
USE OF NAV FACILITIES
Figure 34



NAV FACILITIES – BORROWING CAP
Figure 35



INDEMNIFICATION – GROSS NEGLIGENCE
Figure 36



Indemnification – Gross Negligence

Private equity funds provide for indemnification of the GP and its affiliates with respect to liabilities arising out of the fund's activities, other than those resulting from some specified misconduct. By doing so, the GP and its affiliates are protected from liabilities or losses arising out of their activities on behalf of the fund.

As illustrated in *Figure 36*, 100% of the private equity funds surveyed contain a gross negligence standard carve-out from the indemnification provisions.

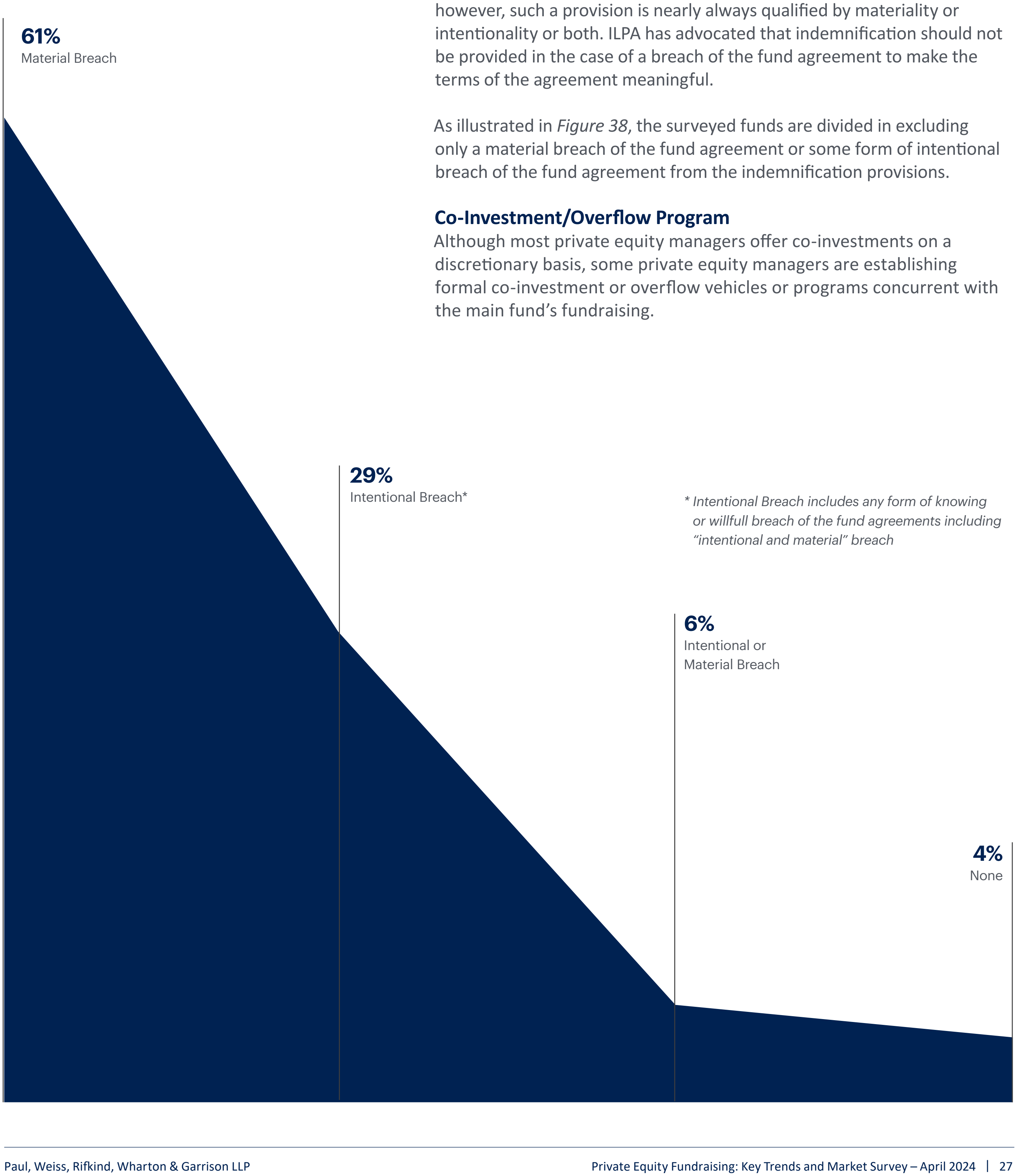
Indemnification – Breach of Fiduciary Duty

While a GP owes a fiduciary duty to its clients, whether the GP of a private equity fund may be indemnified for a breach of its fiduciary duty has been historically determined through the contractual provisions of the fund's limited partnership agreement.

As illustrated in *Figure 37*, 65% of the private equity funds surveyed do not include a separate carve-out for a breach of fiduciary duty from the indemnification provisions.

INDEMNIFICATION – BREACH OF FIDUCIARY DUTY
Figure 37

INDEMNIFICATION – BREACH OF AGREEMENTS
Figure 38



Indemnification – Breach of Agreements

Private equity funds often provide that indemnification will not be provided to the GP and its affiliates for a breach of the fund agreement; however, such a provision is nearly always qualified by materiality or intentionality or both. ILPA has advocated that indemnification should not be provided in the case of a breach of the fund agreement to make the terms of the agreement meaningful.

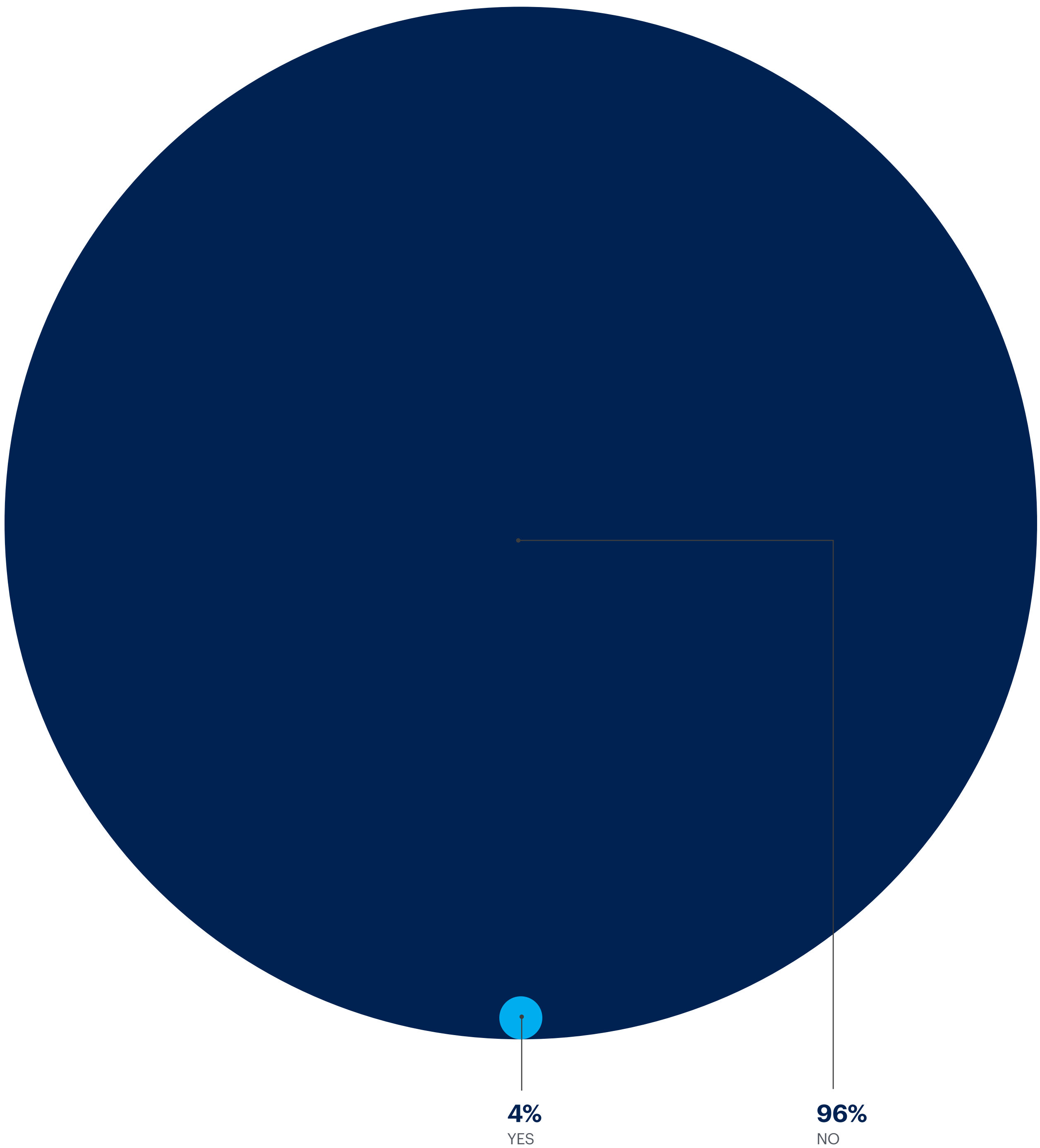
As illustrated in *Figure 38*, the surveyed funds are divided in excluding only a material breach of the fund agreement or some form of intentional breach of the fund agreement from the indemnification provisions.

Co-Investment/Overflow Program

Although most private equity managers offer co-investments on a discretionary basis, some private equity managers are establishing formal co-investment or overflow vehicles or programs concurrent with the main fund's fundraising.

As illustrated in *Figure 39*, 96% of the private equity funds surveyed do not have a dedicated co-investment vehicle or program as part of the fund offering.

CO-INVESTMENT / OVERFLOW PROGRAM
Figure 39



Investment Funds Group

Recognized as one of the premier private equity funds practices in the marketplace, the Paul, Weiss Investment Funds Group serves as industry-leading advisors to a diverse group of private equity firms, ranging from up-and-coming middle market firms to large public managers. Our extensive market knowledge is built on decades of experience working hand-in-hand with private equity managers, investors and other key market participants, making us uniquely positioned to offer cutting-edge yet practical advice. The full suite of the firm's resources are at our clients' fingertips, and we work closely across practice areas to provide seamless advice to private equity funds throughout their lifecycles.

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