

Key Considerations for Starting a Private Equity Fund: What You Need to Know - Part 3

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This is Part 3 of Key Considerations for Starting a Private Equity Fund that was published on [May 13](#) and [May 20, 2021](#).

Starting your own private equity fund requires many steps to succeed and prevail in the alternative investment space. A few of these steps have many financial considerations to keep in mind. While today there are many successful and large private equity firms, many of the firms in this space are small-to-midsize shops with the number of employees ranging from just a few to several hundred. The following summarizes financial implications that managers should keep in mind when launching a private equity fund.

Fund Expenses, Fees and Distribution Waterfall

One of the most important areas to address when forming your private equity fund is to set the fees that will be charged to your investors. Well-thought-out and sound private equity fund offering documents contain terms that look to protect the fund manager and that are amenable to potential investors. Accordingly, the following will focus on private equity fund industry best practices regarding fund expenses,

fee terms, and distribution waterfalls.

- **Fund Expenses** - Expenses such as legal, fund administration, tax preparation, and audit fees are generally the costs to set up and run a private equity fund. The fund generally bears expenses directly related to forming and operating the fund. Overhead expenses are typically the responsibility of the fund manager. Your fund documents should clearly state which expenses will be borne by the fund and its investors and which by the fund manager. Quite often an expense cap is placed on the amount of expenses that can be charged to the fund, with the excess to be paid by the fund manager.
- **Management & Incentive Fees** - Private equity fund managers generally charge their investors an annual management fee as well as an incentive fee (also known as a performance fee or carried interest). Management fees typically range from 1.25% to 2.00% and are generally charged on committed capital, regardless of whether the capital has been called or invested. Incentive fees generally range from 15% to as high as 30% and represent an allocation of appreciation of assets or net profits by the fund. However, for the fund manager to begin receiving carried interest, the fund must first achieve a stated hurdle rate (also known as the preferred return).
- **Distribution Waterfall** - This distribution waterfall defines the economic relationship between the fund manager (general partner) and the investors (limited partners). There are four primary components to a distribution waterfall:
 - 1. Return of Capital** - All distributions go to the fund investors until they have received back their full committed capital contributed to the fund.
 - 2. Preferred Return** - Fund investors will continue to receive all distributions until the fund has achieved its preferred return (or hurdle rate). These percentages can range from 6% to 12% of the investor's contributed capital, are compounded annually, and are generally defined in the fund's offering documents.
 - 3. Catch-up Provision** - Once the fund has returned all capital to its investors as well as the preferred return, the fund manager (general partner) is then able to start collecting carried interest. This is generally calculated by going back to the first dollar of net profits of the fund, and allows the fund manager to retain most of the fund's future profits

until it has received its stated share (assume 80% if the carried interest rate was 20%).**4. Remaining Distributions** – After the fund manager has received its carried interest for fund returns beyond the preferred return, all remaining distributions are then allocated between the limited partners and the fund manager at the rate specified in the fund offering documents. For example, if the carried interest percentage is 20%, the remaining distributions would be allocated 80% to the limited partners and 20% to the fund manager.

While the above four components are standard across most private equity funds, some variations are worth mentioning here. The most common variations are the European Waterfall and the American Waterfall.

- The ***European Waterfall*** is where the carried interest is calculated at the fund level across all portfolio company deals. In this scenario, the fund manager does not begin to take any carried interest until the fund has returned all limited partner contributions across all portfolio company deals as well as delivered the preferred return.
- The ***American Waterfall*** is calculated on a deal-by-deal basis whereby the fund manager is compensated for each successful deal. This allows the fund manager to begin taking carried interest earlier in the life of the fund but can also result in the fund manager receiving carried interest on a fund that is underperforming its preferred return (or hurdle rate), as long as there are individual portfolio company deals that have outperformed the preferred return. For funds that use the American waterfall, a clawback provision is needed and should be included in the fund offering documents. Such a provision allows investors to recoup the carried interest at the end of the fund's life if the fund underperformed in total and the fund manager collected more than its share of the overall fund's net profits.

Raising Capital

Raising money for a new private equity fund manager can be a formidable task if the fund manager is unprepared. Engaging an experienced attorney and other relevant

service providers should assist and help to reduce fears related to this endeavor. Items such as the offering memorandum, subscription agreement, fee terms, marketing materials, and due diligence questionnaires should be prepared in advance of meeting with potential investors.

Potential investors will also want to see a “meaningful” contribution from the fund manager (or fund management group) to better align their interests. Based on our experience and industry standards, fund managers have generally provided at least 1% to 3% of the fund’s total capital commitments.

At some point, while raising capital for your fund, you will most likely be asked by one or more potential investors to enter into a side letter. A side letter is an agreement between the fund and an investor to vary the terms of the limited partnership agreement concerning that particular investor. Some of the most common side letter requests from investors are for a partial or complete waiver of the fund’s fees (management fee, carried interest, or both), to reduce the lock-up requirements (which would give them the right to withdraw capital at an earlier date than other investors) and “most favored nation” clauses (which would, in essence, give that investor the right to obtain any benefit granted to other investors via a side letter). Tread lightly and carefully when assessing each side letter request from potential investors and seek legal assistance in drafting and negotiating such agreements.

Audits and Taxes

You will need to engage an accounting firm to perform an annual audit of your fund and to prepare the fund’s tax returns (including Schedule K-1s that you will need to provide to your fund’s investors). It is prudent to meet with a firm like Anchin, which is experienced with start-up private equity funds, before you finalize your legal documents so that you can discuss and better understand the tax issues involved with your particular fund strategy, fund investors and investments. These include reviewing fund and related-entity structures; identifying requisite Federal and state tax filings; considering potential issues related to foreign investors, foreign investments, retirement plans, beneficial tax elections, your plan for manager and employee compensation, and the overall tax impact of running your fund. Preferably, you should look to hire a firm to partner with that not only covers the basics for your

accounting needs but is also capable of helping as you grow your fund. The firm should be actively working with you to minimize tax exposure and to consult and advise on your operations. Look for a firm with a strong reputation for working with emerging managers, as larger accounting firms may not be initially focused on your start-up needs. A coordinated and experienced audit and tax team focused on your business and personal needs are what you will need as you launch your new fund.

It can be a challenging goal to start a private equity fund. It requires partnering with experienced accountants and other professionals, a tremendous effort to refine your business strategy, as well as considering financial implications such as expenses, raising capital and taxes.

For more information about what is involved in launching and operating a private equity fund, please contact a member of Anchin's [Emerging Manager Platform](#) or your Anchin Relationship Partner.