Nothing Ventured, Nothing Gained

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Keyword

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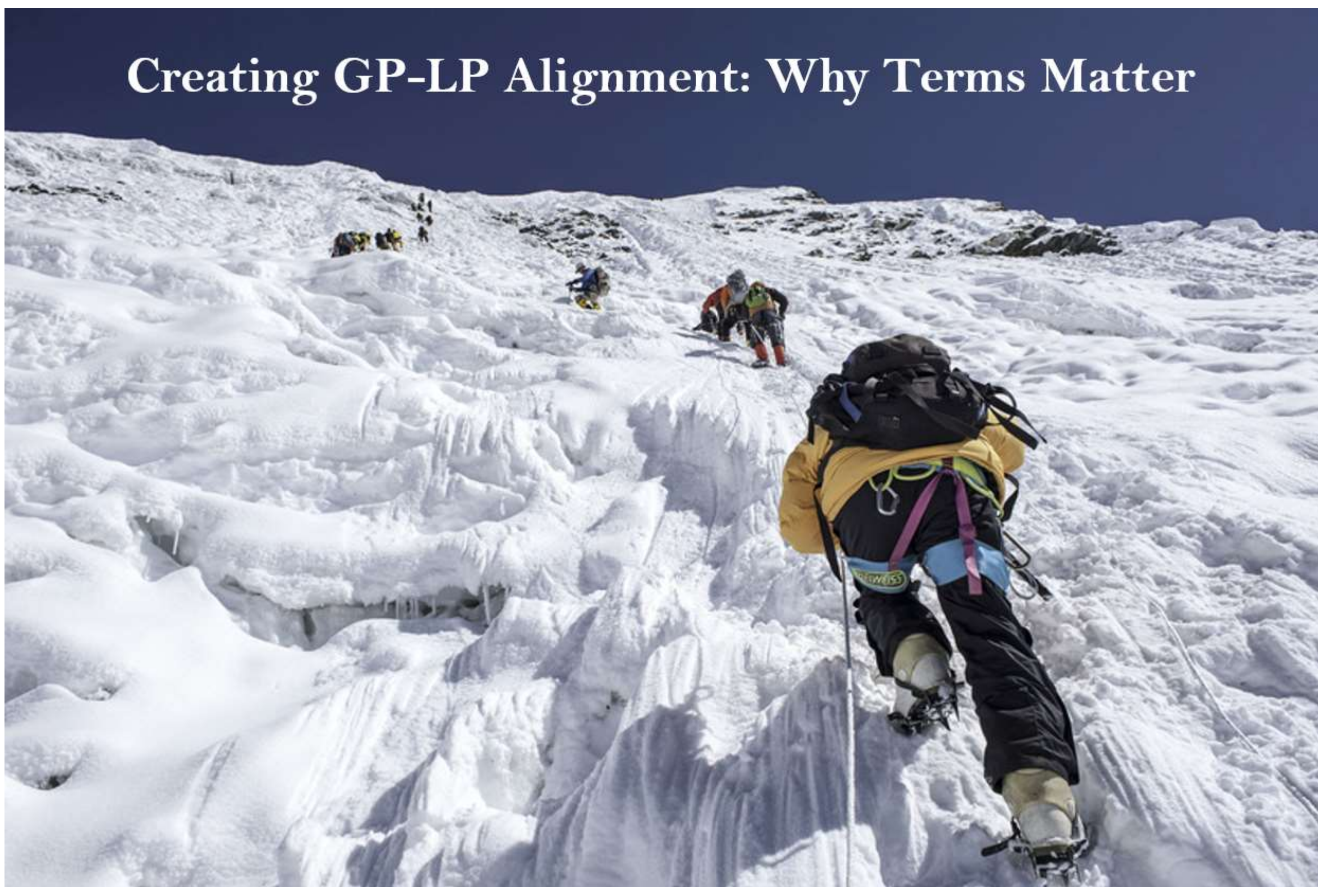

As a firm that focuses on three distinct types of venture investment, we spend considerable time and energy contemplating how these categories are intertwined and what factors drive their success. In the course of this reflection, we have noticed a common theme integral to our fund, direct and secondary efforts: the importance of deep relationships with our venture managers. As is the case with any successful relationship, alignment around a common goal is critical. In this case, our focus is on ensuring that both the General Partner ("GP") and Limited Partner ("LP") are aligned around maximizing net returns. A logical place to start in ensuring proper alignment is the Limited Partnership Agreement ("LPA"), or the legal document that governs our managers' funds. In this piece, we will explore specific terms within LPAs that have the biggest impact on fostering proper alignment between investors and managers.

Management Fees

In this analysis, our primary focus is on the terms that enhance or detract from *net returns,* or returns an investor receives after the application of fund management fees, carried interest, and fund expenses. From this vantage, the term with the greatest impact on end-of-day net returns is a fund's management fee. Traditional fund structures have not changed since the early days of venture capital, and most direct-only venture funds charge management fees at or around the industry standard of 2%. For large and even midsize firms, cumulative management fees can creep into the tens of millions over a fund's life. While some fees are necessary to properly manage a fund's operational expenses, it is important that fees do not serve as a manager's main source of longterm economic incentives.

Consider two $100 million partnerships: one charges a 2.5% management fee (slightly above the industry standard), and the other a 1.5% management fee (slightly below the industry standard). If both funds are able to generate the same gross returns on their investments, charging a 1.5% fee versus a 2.5% fee yields an 8.6% increase in net multiple to the LP. The implications are clear: when a fund charges a higher management fee, the investable capital is diminished, and, assuming the deals pursued are the same, the gross return, and therefore the net return to the LP, is lower.

$100M FUND	2.5% FEE	1.5% FEE
Upfront Management Fee (%)	2.5%	1.5%
Management Fee over Fund Life ($)	$18.75M*	$11.25M**
Investable Capital	**$81.25M**	**$88.75M**
Avg. Gross Multiple of Investments	4x	4x
Total Proceeds	$325M	$355M
Total Gain on Investments***	$225M	$255M
Carried Interest Fee (20%)	$45M	$51M
Net Multiple to LPs******	**2.80x**	**3.04x**

**Assumes a 2.5% fee paid in years 1-4, 1.875% in years 5 and 6, and 1.25% in years 7-10*
***Assumes a 1.5% fee paid in years 1-4, 1.125% in years 5 and 6, and 0.75% in years 7-10*
****Assumes fees are returned to LPs before carry is calculated*
*****Assumes no recycling*

In isolation, this data suggests that the LP community should categorically seek to reduce management fees. On the contrary, we firmly believe that overzealously reducing management fees can actually damage net performance. A reasonable management fee provides the financial resources necessary for a firm to differentiate itself. Depending on the stage and strategy focus, areas of differentiation may include value-add initiatives, specialized sourcing programs (e.g., deal scouts or enhanced data analytics), entrepreneurs-in-residence, portfolio-oriented events, and, perhaps most importantly, hiring and retaining the best talent. GPs should select a fee that is not only appropriate for the fund's strategy, but also in balance with the overall goal to outperform over the long term.

Beyond analyzing a fund's upfront management fee, we also focus on whether the GP chooses to scale down fees over time, promoting alignment by mirroring the activities of the manager. For example, during the first several years of the fund (the investment period), the GP is working tirelessly to find investment opportunities, complete due diligence, and finalize transactions. Once the partnership matures, steadier, recurring activities like portfolio management and monitoring become the norm, with activity even further reduced as investments are liquidated. Given these changing dynamics, a scaled-down fee structure is appropriate.

Recycling

In addition to management fees, the process of reinvesting realized proceeds into new investments, or *recycling*, can also meaningfully impact net returns and alignment. While management fees cut into the dollars available for investment, recycling can have the opposite effect, increasing the investable pool of capital while offsetting a proportion of management fees. To illustrate this point, we revisit our $100 million fund example, and in this case show how recycling $15 million, equivalent to the fund's management fee, positively impacts the fund.

$100M Fund	No Recycling	Recycling
Upfront Management Fee (%)	2.0%	2.0%
Management Fee over Fund Life ($)*	$15M	$15M
Investable Capital	$85M	$100M
Target Net Multiple	3.00x	3.00x
Total Proceeds Necessary for Target	$3 50M	$365M
Total Gain on Investments**	$250M	$265M
Carried Interest Fee (20%)	$50M	$53M
Gross Multiple	4.10x	3.65x

*Assumes a 2.0% fee paid in years 1-4, 1.5% in years 5 and 6, and 1.0% in years 7-10
**Assumes fees are returned to LPs before carry is calculated

The fund that chooses to recycle fees requires a 3.65x gross multiple to achieve a 3.00x net multiple, whereas the fund that does not recycle proceeds to offset management fees requires a 4.10x gross multiple to achieve a 3.00x target net multiple. [1] As long as re-invested capital is prudently deployed into opportunities capable of generating strong results, recycling is an impactful way for GPs to increase net returns, which ultimately benefits investors and themselves.

Carried Interest

Management fees may have a more direct impact on net performance, but the GP's share of the profits of the investments, or *carried interest*, is also essential in creating alignment between LPs and GPs. It is the driving incentive for GPs to outperform over the long term. While some LPs believe higher carry is categorically detrimental to net returns, we disagree. Carried interest of 20% is an industry standard, but a number of firms in which we invest (especially those with a history of outperformance) have carried interest percentages in excess of this standard. In these circumstances, we advocate for a *tiered* carried interest structure, in which the GP's share of the profits increases at certain return thresholds. For example, standard carry (20%) is paid after a fund reaches a distributed to paid-in ("DPI") multiple of 1.0x and premium carry (25-30%) is paid if the fund reaches a higher DPI target. In other words, premium carry is paid for premium performance. Especially with a tiered approach, carried interest directly ties managers to their investors. True economic upside for managers is only achieved in conjunction with the success of their investors.

Conclusion

As our platform is grounded in the relationships that we have formed with our managers, alignment is of paramount importance. While dense and full of legal disclosures, the terms within LPAs are essential in creating the framework for proper alignment.

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[1] https://www.feld.com/archives/2014/05/vcs-recycle-management-fees.html

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