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In this month's commentary, we explore the impact of fees on private equity investors' gross returns.

Private equity fees vary from firm to firm. Annual management fees are used for general operating purposes, ensuring that a firm has adequate means to compensate talented investment professionals, source investment opportunities and perform comprehensive due diligence while investing their investors' capital. The carried interest provides the primary wealth incentive for the fund managers and aligns their economic interests with those of their investors such that the bigger the fund's returns, the greater the profit for everyone involved.

Venture capital firms typically charge a 2.0-2.5% annual management fee on committed capital and LBO firms typically charge 1.5-2.0%. Since the amount of labor performed by VC and LBO funds is fairly similar, the reason for the difference can largely be attributed to:

- Differences in fund size (LBO funds tend to be larger and can afford to charge a lower percentage on a bigger dollar amount);
- Track record; and
- Certain VC firms experienced almost no resistance when they raised their fees because they previously had generated stratospheric returns for their investors (e.g., think Google).

Carried interest fees usually range from 20-25%, with the most successful funds charging the higher amount. It is the rare firm that can charge a 30% carry but several notable managers have been able to do this recently. Nevertheless, the fee trend generally has been downward of late.

VC and LBO Fund Fees

In order to determine how these fees impact an LP's IRR, we ran the following sensitivity analysis.

VC and LBO Fund Sensitivity Analysis

annual mgmt fee	1.5%			2.0%			2.5%		
carried interest	20%	25%	30%	20%	25%	30%	20%	25%	30%
Gross IRR									
20%	14.6%	13.8%	13.0%	13.5%	12.8%	11.9%	12.4%	11.6%	10.8%
30%	23.7%	22.7%	21.6%	22.7%	21.7%	20.6%	21.6%	20.6%	19.5%
40%	32.9%	31.7%	30.3%	31.9%	30.7%	29.3%	30.9%	29.6%	28.2%

Fund of Funds Fees

Funds of funds provide diversification, professional manager selection and access to top tier venture and LBO funds for many investors. Fund of funds fees also vary from firm to firm, with annual fees typically ranging from 50 to 100 bps (or more for retail funds). The carried interest fee also ranges from 0-10% (or higher for specialized funds that are more labor intensive). We developed a similar sensitivity analysis to show how these fees affect investors' returns. The net IRR assumes a 2.0% management fee and 20% carried interest at the VC and LBO fund level. To illustrate, a group of underlying funds with gross IRRs of 30% would yield 22.7% net of their fees. In the instance of a fund of funds manager charging a 0.50% management fee and 5% carried interest, the return would be reduced to 21.1% (a cost of 160 bps).

Fund of Funds Sensitivity Analysis

annual mgmt fee		0.25%			0.50%			0.75%			1.00%		
carried interest		0%	5%	10%	0%	5%	10%	0%	5%	10%	0%	5%	10%
Gross IRR	Net IRR												
20%	**13.5%**	13.2%	12.6%	11.9%	12.8%	12.2%	11.6%	12.4%	11.8%	11.2%	12.0%	11.4%	10.8%
30%	**22.7%**	22.3%	21.5%	20.7%	21.9%	21.1%	20.3%	21.5%	20.7%	19.9%	21.1%	20.3%	19.5%
40%	**31.9%**	31.5%	30.5%	29.5%	31.1%	30.1%	29.1%	30.7%	29.7%	28.7%	30.3%	29.3%	28.2%

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Conclusion

In general, our model suggests that VC and LBO fees impact an LP's returns by 540 - 1180 basis points, while fund of funds fees impact the IRR by an additional 30 - 370 basis points, depending on gross investment returns and fee structure. Private equity fees are substantial, but we believe they are justified by the labor intensive nature of private equity investing and the high net returns investors have enjoyed over the last 20-25 years.

Fund Closing Announcement

We are closing Private Equity Partners II on June 30. We are pleased with the many new institutional investors who have joined us for this fund and with the quality and quantity of our investment opportunities. Approximately 80-90% of the commitments for the LBO Fund and the Venture Fund have already been made or identified, and we are actively seeking direct investment opportunities for the Direct Fund. In the coming weeks, we will send a more thorough update to all of you who have invested in PEP II and plan to spend the summer traveling to visit our larger investors to give in-person updates.

A Note on Our Model

Our model, on which the sensitivity analyses are based, assumes an 8-year partnership life with an investment period of 16 quarters. The model also assumes a fund of funds preferred return of 8% and that ¼ of total underlying VC and LBO fund commitments are made by the end of Q1, ½ by the end of Q2, ¾ by the end of Q3 and the fund of funds is fully committed by the end of Q4.
