



**PRIVATE EQUITY  
INTERNATIONAL**

# THE DEFINITIVE GUIDE TO CARRIED INTEREST

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Best practices for GPs, LPs and their advisors

By  
**Mariya Stefanova, PEAI**



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## About the author



**Mariya Stefanova** is a founding partner of PEAI (formerly Private Equity Accounting Insights), a private equity consultancy and training firm with offices in London and the Bahamas, providing specialist technical advice and training to GPs, LPs and private equity service providers. Since 2015, Mariya's focus has shifted towards carried interest/fee verification for LPs and waterfall model validation/certification for GPs. In partnership with technology company AcordIQ, Mariya has designed the AcordIQ/PEAI carried interest platform to help LPs validate, and GPs model and analyse carried interest and management fees.

She has more than thirteen years experience in private equity accounting and investor reporting, and over nine years experience training thousands of fund accountants, CFOs, COOs and other senior executives on the GP, LP and the service providers side. Mariya has previously worked for Augentius Fund Administration, Mourant International Finance Administration (now State Street), Patron Capital Partners, and French investment bank Calyon.

Mariya Stefanova is also the author of *Private Equity Accounting*, published by PEI in October 2011, and *Private Equity Accounting, Investor Reporting and Beyond*, published by Financial Times Press in April 2015.



# Preface

By Mariya Stefanova, PEAI

This book is your technical guide to one of the most complex topics in private equity accounting – carried interest. Initially designed as a simple tax-efficient incentive profit-sharing tool, carry is currently a topic of great controversy between limited partners (LPs) and general partners (GPs), with the former now trying to peel away the layers of the subject.

GP reporting on carry is, at best, for the most part fragmented and inconsistent, which prevents LPs performing their fiduciary obligations to beneficiaries (trustees, retirees and other stakeholders). The lack of granularity of the information historically captured by LPs, even when GP information is present, further exacerbates the issue. Even identifying the exact amounts of carry paid to GPs is a struggle for LPs, often forcing them to ‘bake’ the carried interest into the net performance. This makes LPs unable to separate and report on carry, which caused public outrage in 2015 and triggered the new processes we have witnessed over the last couple of years, and which are referenced throughout this book.

There is also much misunderstanding and confusion around the mechanics of, and how the different components of the waterfall calculation work on both the GP and LP side. On the LP side, the complexity of the calculation and the lack of an easy check can, in many cases, prevent investors from validating the amounts of carry paid to GPs.

The impact of carry on LPs’ net returns through the ‘fee drag’ is significant, and LPs need to understand it. The lack of transparency often makes it difficult for LPs to make a strong case to their trustees in favour of investing in private equity. As a result, specialist private equity publications are reporting more instances of LPs choosing to reduce their allocation to the asset class or to start their proprietary investing in private equity.

In 2015, ILPA launched the ‘Fee Transparency Initiative’, which led to the release of the ILPA Fee Reporting Template (now simply called the ‘ILPA Reporting Template’ so that it does not suggest carry is a fee) and the guidance to it in January 2016. The adoption of the template in 2017 is on the rise, with 70+ LP endorsers and 20+ GP endorsers, including KKR, Carlyle, Blackstone and Apollo. Seventy percent of ILPA members have requested (at the time of writing), or are planning to request, the template and ILPA expects 53 percent of GPs to provide the template by 2017 (see chapter 16).

In September 2016, in response to public pressure, the state of California in the US adopted a new fee transparency legislation (California Assembly Bill (AB) No. 2833 Public

Investment Funds: disclosures (AB 2833)), intending to increase the transparency of fees paid by public investment funds (PIFs). Other US states are set to follow suit.

As a result of these developments, carry/fee validation is becoming common practice among LPs, and GPs are now trying to pre-empt LPs' scrutiny by having waterfall models validated by third-party independent experts.

Another trend is the convergence of carry terms. Jurisdictional differences are fading with the whole-fund/European-style waterfall becoming the norm globally. In Europe, however, an increasing number of funds are moving to deal-by-deal/hybrid models, with interim clawbacks appearing to be the trade-off in such cases (see chapter 6).

Unfortunately, the industry is still some way off from adopting more sophisticated methods of rewarding alpha creation through carried interest, as suggested in Section 7. This is mostly due to the complexities of these mechanisms. The predominant arrangement remains the 20 percent carry with 8 percent hurdle, although more complex mechanisms, such as tiered promote with two or three tiers, also occupy the space.

The aim of this book is to demystify carried interest.

For the novice reader, I lay the foundation of carry in **Section 1, chapter 1**, which explains why it is called 'carried interest', and how and why it is structured as an incentive allocation and not as an incentive fee.

In **Section 2**, a team of recognised legal experts and tax advisors explain the structuring considerations and tax aspects of carried interest, and update us on some new trends in fund terms and jurisdictional changes.

In **Section 3**, I explain what happens after the carry arrangement materialised in the LPA leaves the lawyer's 'drawing board' and arrives in the hands of the back office (in-house fund accountants or fund administrators), addressing the issues of interpreting the waterfall provisions, modelling the waterfall, calculating realised and total (realised + unrealised/accrued) carry, and accounting for and reporting on carry. This section highlights the main challenges facing both LPs and GPs, and establishes best practices.

**Section 4** discusses the issue of subscription lines of credit (also referred to as bridge facilities). This has become a topical issue and is addressed by ILPA in new guidelines released in June 2017 called *Subscription Lines of Credit and Alignment of Interest: Considerations and Best Practices for Limited and General Partners* (see the Appendix on page 307). The section analyses the impact of bridge facilities on carry and highlights that, in certain cases, it can cause anomalies to the net IRR, resulting in a negative fee drag.

**Section 5** addresses carry as an incentive mechanism – an issue that LPs are increasingly interested in – and explains some carry employee incentive structures.

**Section 6** looks at carry from an LP perspective, beginning with ILPA's view on the role of carry in GP/LP alignment. A pension plan consultant provides a case study of an LP's pursuit

for transparency, and the section closes with a detailed discussion on carry validation and the options available to LPs, including carry recalculation using new technology.

**Section 7** closes the topic. In chapter 20, a leading performance academic suggests alternative carry mechanisms, and chapter 21 discusses how to better reward true value creation in private equity through LPA terms, particularly the waterfall provisions.

This book is written with the needs of a number of industry practitioners in mind:

- GPs, as well as their CFOs, COOs, fund controllers and fund accountants, who face the challenges of designing, interpreting, modelling, accounting for, and reporting on carried interest.
- LPs that are under pressure and have dared to set foot (or are planning to do so) on the rocky path of carry/fee validation, and are seeking a reference guide to help them tackle the wide range of challenges they face, as well as LPs that are at a crossroad, wondering what their options are and needing reassurance.
- Fund administrators and other service providers, including lawyers on the GP side who draft the waterfall provisions, and lawyers on the LP side who need to know more about the traps in the carry mechanics in order to protect their clients as part of the due diligence process.

I would like to thank to all the contributors who have done a tremendous job and have added different views to my own perspective on carry.

Special thanks to Jennifer Choi of ILPA, and the whole ILPA team. They have taken in their stride the challenging task of fee transparency and have brought LPs and GPs closer together on the subject of carry. I appreciate them adding their perspective to this book.

I would also like to thank my LP clients for the exchange of ideas and opinions on the subject. Unfortunately, they prefer not to be named due to the controversy surrounding the topic, but I am truly grateful to them for their insights. The book would not be complete without the voice of LPs being heard.

I hope you will find the book helpful and good luck to those LPs that embrace the challenge of fee recalculation!

**Mariya Stefanova,**  
**PEAI**  
**September 2017**

