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INVESTMENT GROUP

Private Markets Fees Primer

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This primer describes the most common fee and profit sharing arrangements associated with private market investments. It attempts to answer common questions when considering an investment across the range of private market asset classes, including private equity, private debt, infrastructure, real estate, and natural resources.

Most private market vehicles have the following fee and profit sharing components:

I. Management fees
II. Carried interest:
- → **Preferred return**
- → **Catch-up provision**
- → **Carried interest rate**

The above terms will be explored throughout this primer, including definitions, common structures, and their expected impact on net returns to the Limited Partner ("Investor"). Finally, this primer will examine industry trends by investment strategy, as well as how the structuring of fees and profit sharing arrangements impacts the alignment between Investors and the General Partner ("Manager").

While there are a variety of fee and profit sharing structures found across the private markets universe, for the purposes of this primer we focus on one of the most common, the so-called "2/8/20" model that prevails for closed-end vehicles ("Funds") executing a private equity buyout strategy. Note that, in the Appendix, common variations from this structure—seen with other strategies—are outlined.

What is a management fee?

A management fee is a fee paid in regular intervals (typically quarterly, semi-annually, or annually) to the Manager in order to compensate them for managing the Fund. The management fee is generally used by the Manager to cover the overhead costs associated with executing the Fund's strategy, such as, but not limited to, salaries and benefits, office rent, and day-to-day administrative costs incurred by the Manager.

It is important to note that costs incurred by the Fund relating specifically to the Fund's investment activities and operations, such as costs connected with the acquisition, holding, and liquidation of investments, and the use of service providers such as attorneys or accountants, are generally not covered by the management fee and are borne by the Fund (and thereby the Investors). The Manager will generally use operating cash flow generated from the Fund's portfolio, or call capital from Investors, to cover these costs as necessary.

Management fees were originally intended to solely cover the operating expenses of the Managers of private market Funds. As Funds have grown increasingly larger, however, these fees have become a potential source of meaningful profit for Managers. As such, it is increasingly important for Investors to negotiate fees and/or take advantage of discounts offered for participating in early closes or for large commitment sizes. In addition, as it is now possible for certain managers to receive attractive compensation *even without earning carried interest*, it is important for Investors to consider the potential impact on alignment between Investors and Managers.

How are management fees calculated?

Management fees are charged over the life of a Fund and are typically calculated as a percentage of *committed* capital during the investment period, and then as a percentage of remaining *invested* capital following the conclusion of the investment period. Depending upon the type of investment strategy, investment periods generally range from as few as three years to as many as six years. The graphic below depicts the hypothetical annual management fee basis for an Investor with a ten million dollar commitment to a buyout fund, with an investment period of six years and a total term of twelve years.

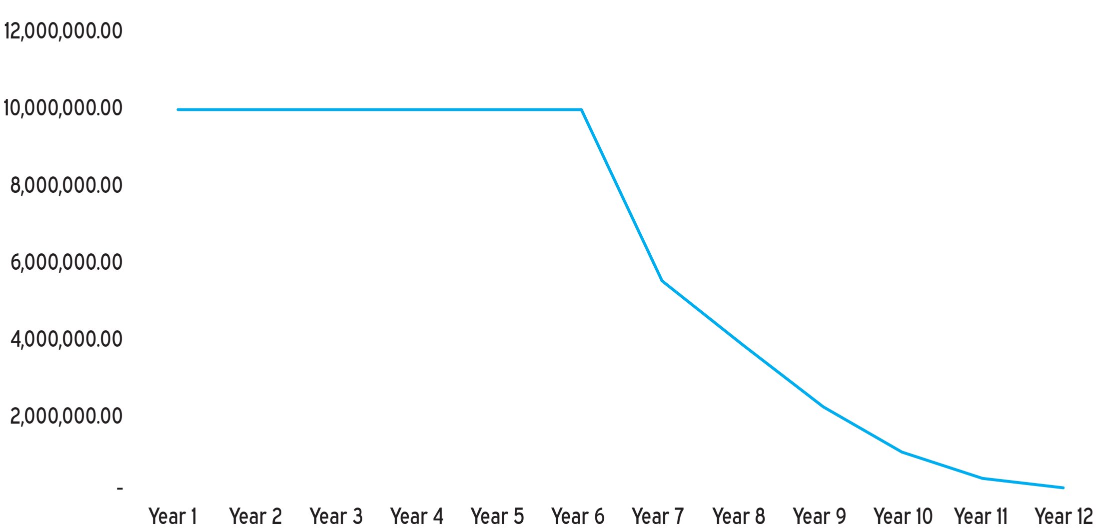

CHART 1
Management Fee Basis

Management fees are typically 1.5-2.0% of aggregate committed capital during the investment period, though this can vary depending on the investment strategy, the size of the fund, and the size of an Investor's commitment.

The investment period tends to be the most costly for Managers due to the increased workload involved in sourcing and executing investments. Accordingly, it is common for a step-down[1] in the management fee rate, the basis,[2] or both, to occur following the end of the stated investment period. For example, following the end of the investment period, the majority of private equity buyout funds transition from charging a percentage of committed capital to charging a percentage of remaining invested capital (i.e., the capital already used to fund investments less the cost of investments that have been sold or written-off). In many cases, the Manager will structure the terms of the management fee step-down such that it will occur upon the earlier of, (i) the end of the investment period or (ii) a successor fund being raised.

Management fees are traditionally paid until the Fund is fully liquidated or dissolved. If a Fund's life is extended beyond its stipulated term, management fees may still be collected, often at a further reduction of the step-down rate.

What is carried interest?

Carried interest is a profit-sharing arrangement in which the Manager is allocated a portion of portfolio returns, provided a specified "preferred" return is achieved. As carried interest allows the Manager to earn a portion of the portfolio's profits, it acts as an incentive for the Manager to maximize returns.

The mechanism through which Funds pay the Manager carried interest has four primary components:

- carried interest rate (e.g., 20% of profits);
- preferred return (e.g., net 8% annualized internal rate of return, or "IRR");
- catch-up rate (e.g., 100% of profits);
- carried interest structure (e.g., deal-by-deal or whole-fund basis).

Carried interest rate

Standard private equity buyout fund terms dictate that Investor profits be split 80/20, with 80% of profits going to Investors and 20% of profits going to the Manager once the Investors have been allocated profits equivalent to their capital contributions and the associated preferred return. The carried interest rate dictates the *percentage* of profits the Manager is ultimately eligible to receive; however, the *manner* in which the Manager earns carried interest is dependent on the stipulated preferred return, catch-up rate, and carried interest structure (as discussed below).

[1] A step-down in management fees is a reduction in the management fee after a certain period of time. Generally, the step-down occurs after the Fund's investment period has concluded, as outlined by the Fund terms.

[2] The management fee basis refers to the type of capital on which the management fee is charged. For example, a management fee may be charged on committed capital, invested capital, or the net asset value of the Fund's entire portfolio.

Preferred return

For most private market Funds, Managers are not eligible to earn carried interest until the returns of the Fund have surpassed a stipulated preferred return. A preferred return ensures that Investors receive a certain baseline level of return before the Manager is entitled to be paid a portion of the portfolio's profits. The most common preferred return today, 8% net of fees and expenses, was established decades ago when it was close to the risk free rate on government bonds. Note that, in today's low interest rate environment, 8% is well above the risk free rate and provides more protection for Investors than was originally intended.

A preferred return of 8% means that the Manager must return Investors' contributed capital, plus an amount equal to an annualized 8% return on that capital, net of management fees and expenses, before the Manager is eligible to receive their pre-determined portion of the portfolio's profits (commonly 20%, as discussed earlier). Thus, a preferred return provides a specific incentive for managers to drive portfolio returns to exceed 8%.

Catch-up rate

Once Investors have received profits equivalent to their capital contributions and associated preferred return, many Funds employ a "catch-up" mechanism in order to ensure that the Manager receives its full carried interest percentage of portfolio profits. In practice, this generally entails the Fund distributing a significant percentage of profits to the Manager until it has received its stipulated carried interest rate on all profits (in excess of contributed capital). For most funds, this catch-up rate is in the range of 50% to 100%.

> The structure of a Fund's carried interest mechanism will ultimately determine the time at which a Manager is eligible to earn carried interest.

Please see the appendix for a graphical example illustrating how a catch-up provision works. In this example, given a preferred return of 8%, the Fund first distributes proceeds *to the Investors* that equate to 100% of their contributed capital plus an 8% return on such contributions, before it distributes any carried interest to the manager. From that point, the Fund distributes all of the subsequent profits *to the Manager*, until it has received 20% of inception to date profits (assuming a 100% catch-up rate and an 80/20 split on carried interest). Once the Manager has "caught up," all future distributions of profits are split 80/20 between the Investor and Manager, respectively.

Carried interest structure

The structure of a Fund's carried interest mechanism will ultimately determine *the time* at which a Manager is eligible to earn carried interest. Carried interest structures generally fall into one of two categories: whole-fund basis (i.e., "European" style) or deal-by-deal basis (i.e., "American" style). Under a whole-fund basis structure, Investors must receive profits equivalent to 100% of their capital contributions to the Fund plus the associated preferred return, prior to the Manager earning any carried interest. Under a deal-by-deal basis structure, Investors must receive profits equal to their capital contributions *for the specific investment* (i.e., deal) giving rise to such profits and the preferred return associated with such capital contributions, prior to the Manager earning carried interest on the profits earned from such investment.

The deal-by-deal basis carried interest structure is generally viewed as more favorable for Managers, as they are eligible to earn carried interest *as individual assets are sold* rather than having to wait until all capital contributed to the Fund, as well as the associated preferred return, has been returned to Investors. Hence, the deal-by-deal basis usually results in the Manager earning carried interest sooner in a Fund's life than they would have under a whole fund basis. Regardless of the structure utilized, the Manager's share of total profits under either basis should be the same once the Fund has been liquidated. Today, the whole-fund basis is the predominant carried interest structure in Europe, but it has been increasing in popularity throughout the United States as well. With that being said, the deal-by-deal structure remains commonplace across the US, particularly among buyout funds.

Impact of fees and profit sharing on fund performance

Below is a set of estimates of the impact that the 2/8/20 fee model[3] has on the gross return generated by a typical buyout fund. Although market dynamics, strategy execution, and timing of cash flows will have a significant impact on the ultimate returns generated by any given buyout fund, the table below provides a general baseline for evaluating the expected returns of a "2/8/20" model.

[3] Assumes a 100% GP catch-up rate.

Gross IRR to Investor	0%	5%	10%	15%	20%	25%	30%
Net IRR to Investor	(3.6%)	1.4%	6.3%	9.2%	13.2%	17.3%	21.3%
Impact	(3.6%)	(3.6%)	(3.6%)	(5.8%)	(6.8%)	(7.7%)	(8.7%)

TABLE 1
Impact of Fees and Profit Sharing on IRR

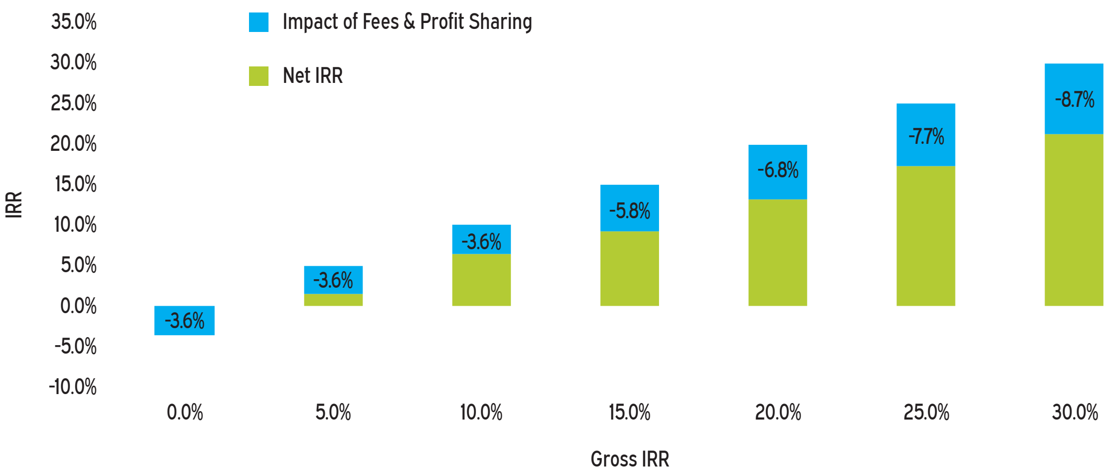

CHART 2

Impact of Fees and Profit Sharing

As shown in the graphic above, as returns surpass the preferred return, the impact of fees and profit sharing begins to increase substantially as a result of the Manager earning carried interest. Although the impact of fees for lower gross return scenarios may not be as significant on an IRR basis, they represent a larger portion of the gross returns generated by the fund than in the higher return scenarios.[4]

[4] Please note that the above estimates relate solely to the impact of management fees and carried interest, and do not include the impact that expenses borne by a Fund may have on a Fund's ultimate returns.

Summary

Evaluating the fee and profit-sharing structures for private market investments can be intimidating for even the most experienced investor, given the complexity of the arrangements and the numerous variations found across private market strategies and asset classes. These arrangements typically have a meaningful impact on the net performance of a fund and can be particularly complex due to the incorporation of both a traditional management fee component and a profit-sharing component. Understanding these components individually, as well as in the aggregate, is essential to understanding the appeal of a Fund and the alignment of interest between the Investor and the Manager.

Meketa Investment Group believes that fee and profit-sharing arrangements should be thoroughly evaluated, and negotiated when possible, during the due diligence process for any private markets Fund. Investors should seek to thoroughly understand how fees will be calculated, and how profits will be shared, prior to making any private markets investment. Additionally, investors should work to take advantage of any early closing, commitment size based, or other similar fee discounts. Meketa Investment Group seeks to provide context around these fees for our clients and to negotiate them, whenever possible.

Appendix

Common variations of fee and profit sharing arrangements by strategy/asset class

TABLE 2

Strategy	Management Fee Rate	Management Fee Basis	Preferred Return	Carried Interest Rate	Carried Interest Structure
Venture Capital	2.00–2.50%	Committed Capital (w/ annual reduction post-investment period)	0%	20–30%	Whole-Fund
Private Debt	1.50–2.00%	Committed Capital / Remaining Invested Capital	8%	20%	Whole-Fund
Real Estate	1.50%	Committed Capital / Remaining Invested Capital	8–9%	20%	Whole-Fund
Infra-structure	1.50–1.75%	Committed Capital / Remaining Invested Capital	8%	20%	Whole-Fund
Natural Resources	1.50–2.00%	Committed Capital / Remaining Invested Capital	8%	20%	Whole-Fund
Fund-of-Funds	0.75–1.00%	Committed Capital / Committed Capital or Remaining Invested Capital	8%	5–10%	Whole-Fund

Appendix

Catch-up provision example

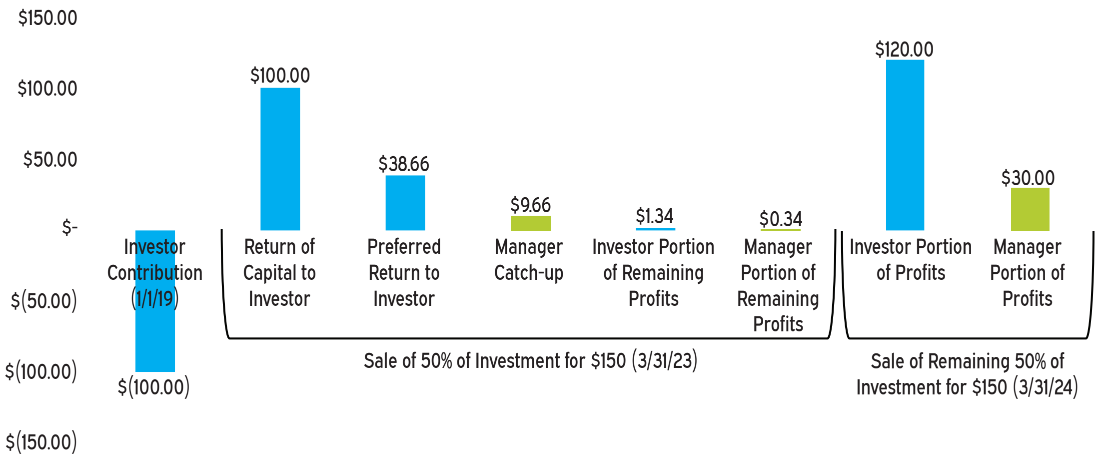

CHART 3

Single Investment Carried Interest Distribution Example

Appendix

Fee Data

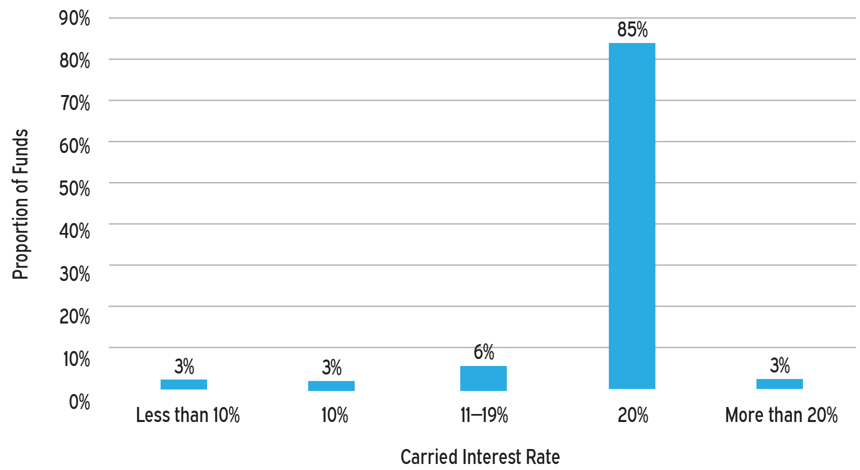

CHART 4

Carried Interest Rate Used by Direct Private Capital Funds[5]

[5] Preqin: The 2018 Preqin Private Capital Fund Terms Advisor, Fig. 10.4, Carried Interest Rate Used by Direct Private Capital Funds (Funds Raising & Vintage 2017/2018 Funds Closed).

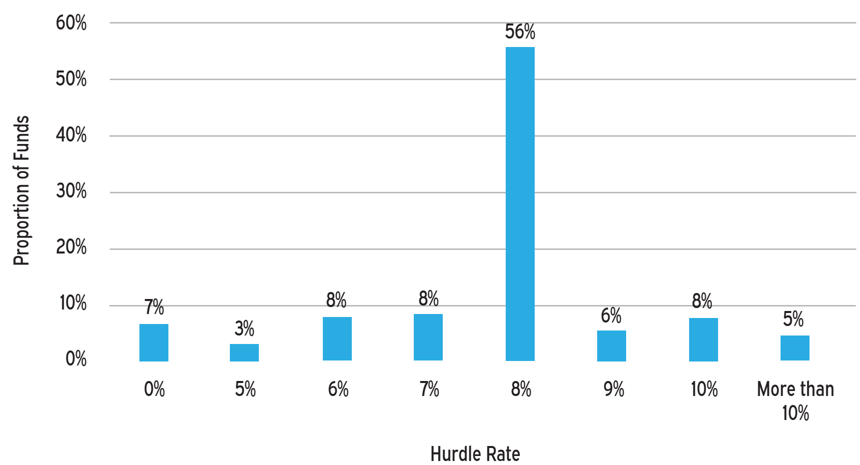

CHART 5

Preferred Return Used by Direct Private Capital Funds[6]

[6] Preqin: The 2018 Preqin Private Capital Fund Terms Advisor, Fig. 10.6, Hurdle Rate Used by Direct Private Capital Funds (Funds Raising & Vintage 2017/2018 Funds Closed).

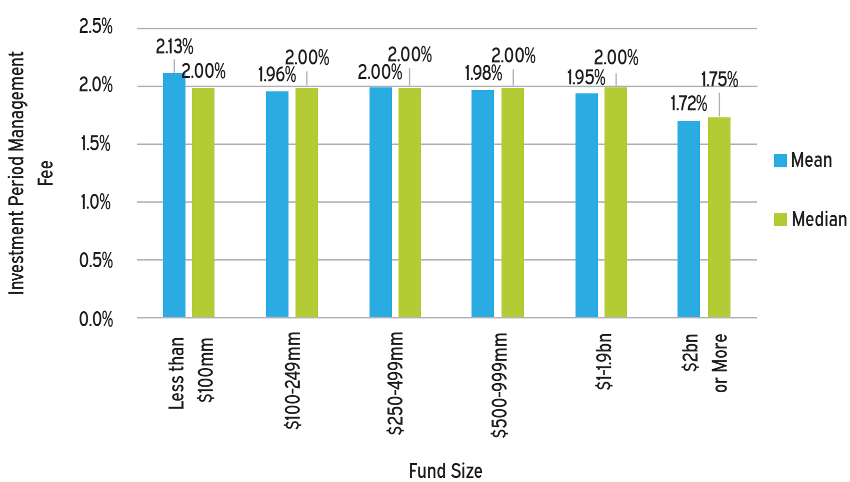

CHART 6

Buyout Funds—Average Management Fee by Fund Size[7]

[7] Preqin: The 2018 Preqin Private Capital Fund Terms Advisor, Fig. 9.5, Buyout Funds – Average Management Fee by Fund Size (Funds Raising & Vintage 2017/2018 Funds Closed).

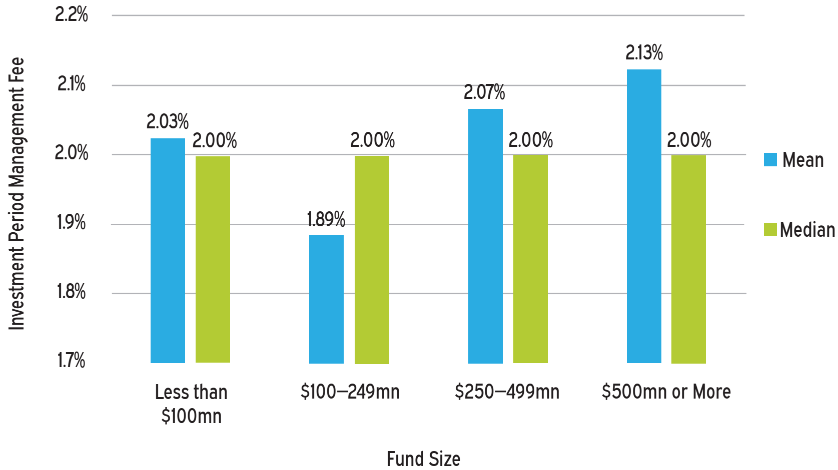

CHART 7

Venture Capital Funds—Average Management Fee by Fund Size[8]

[8] Preqin: The 2018 Preqin Private Capital Fund Terms Advisor, Fig. 9.5, Venture Capital Funds – Average Management Fee by Fund Size (Funds Raising & Vintage 2017/2018 Funds Closed).

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