



Carried Interest & Promote Modeling

FINANCIAL EDGE¹

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Management Fees

Carried Interest – Distribution “Waterfall”

Waterfall – Four Stages:

- Return of Capital
- Preferred Return
- Catch-up Provision
- Carried Interest

“Promote” Versus Carried Interest

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Management Fees

How are Private Equity Fund Managers (General Partners - GPs) rewarded?

General Partners receive a **management fee** (based on the funds raised)



SALARY



RETURNS

(INVESTOR)



MANAGEMENT FEE



SHARE OF PROFITS

(CARRIED INTEREST)

Management Fees

How are Private Equity Fund Managers (General Partners - GPs) rewarded?

Small funds fees **-2% to 3%** / large funds – **1% to 1.5%**



SALARY



RETURNS

(INVESTOR)



MANAGEMENT FEE



SHARE OF PROFITS

(CARRIED INTEREST)

Management Fees

How are Private Equity Fund Managers (General Partners - GPs) rewarded?

Management fees are used to cover the **operating cost**
– employment costs, partners salaries and other operational costs



SALARY



RETURNS

(INVESTOR)



MANAGEMENT FEE



SHARE OF PROFITS

(CARRIED INTEREST)

Management Fees

How are Private Equity Fund Managers (General Partners - GPs) rewarded?

Management fees accrue **whether or not** the fund itself is **successful**



SALARY



RETURNS

(INVESTOR)



MANAGEMENT FEE



SHARE OF PROFITS

(CARRIED INTEREST)

Management Fees

How are Private Equity Fund Managers (General Partners - GPs) rewarded?

When the **funds increase in size** (assets under management), the GPs tend to make **large profits** from the management fee – the **cost structure increases** at a much **slower rate** than the increase in the management fees received

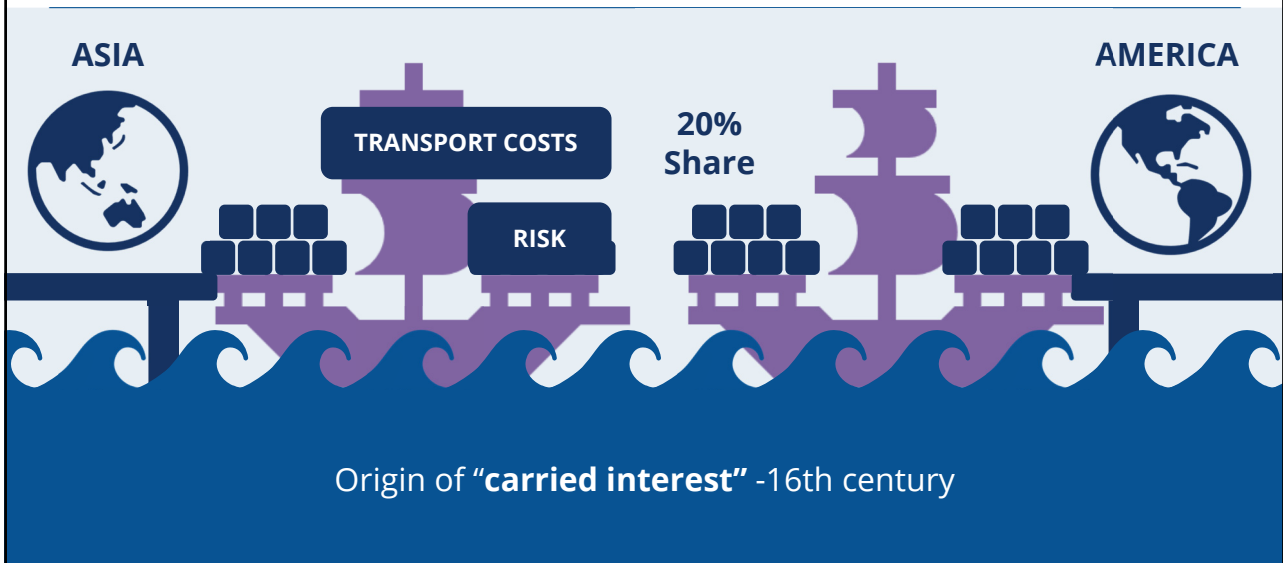

SALARY


RETURNS
(INVESTOR)

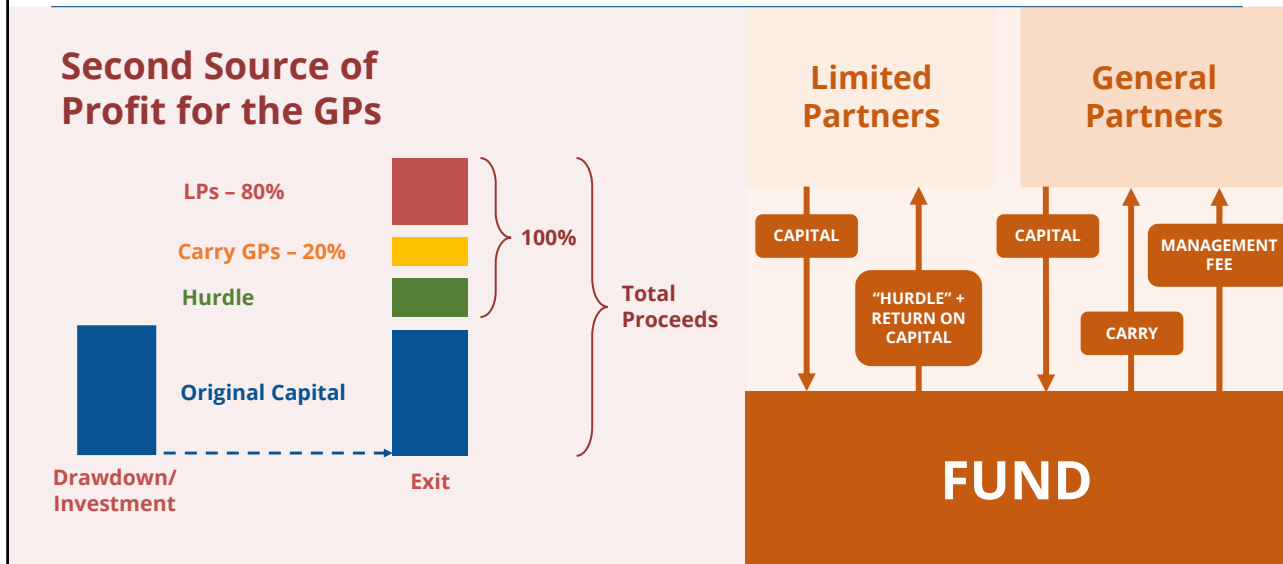

MANAGEMENT FEE


SHARE OF PROFITS
(CARRIED INTEREST)

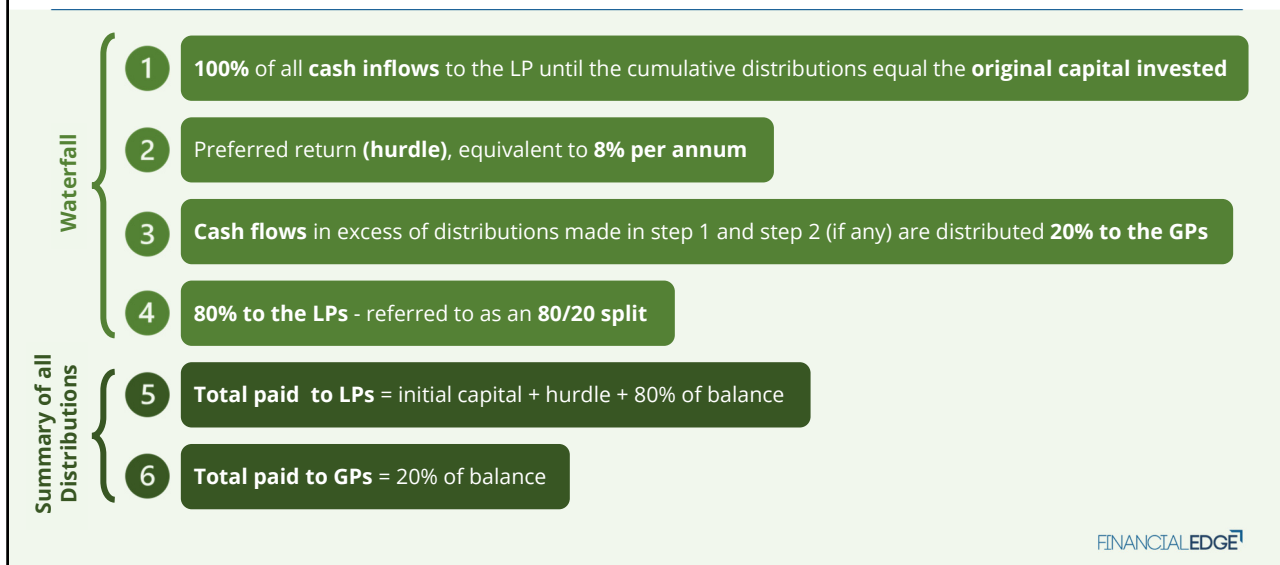
Carried Interest - Origins



Carried Interest



Waterfall – Stages “Modeling”



Catch-Up

Private equity funds can have a ***catch-up clause*** in the **Limited Partnership Agreement (LPA)**

The **purpose** of catch up is to **tie the GPs total return to the profit share** (carry)

As an example, if the fee structure was **2%/20%** for the GPs (i.e., GPs get **2%** management fee and **20%** carry), with a “catch-up” after an **8%** hurdle:

Investor would get **100%** original capital + **8%** hurdle

The **GPs will receive 100% of distributions until they receive 20%** of the total distributions– the catch up

The **balance** would then be **split** on an **80%/20% basis**, **80%** going to **LPs** and **20%** going to **GPs**

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"Promote" in Commercial Real Estate

Carried Interest

Promote

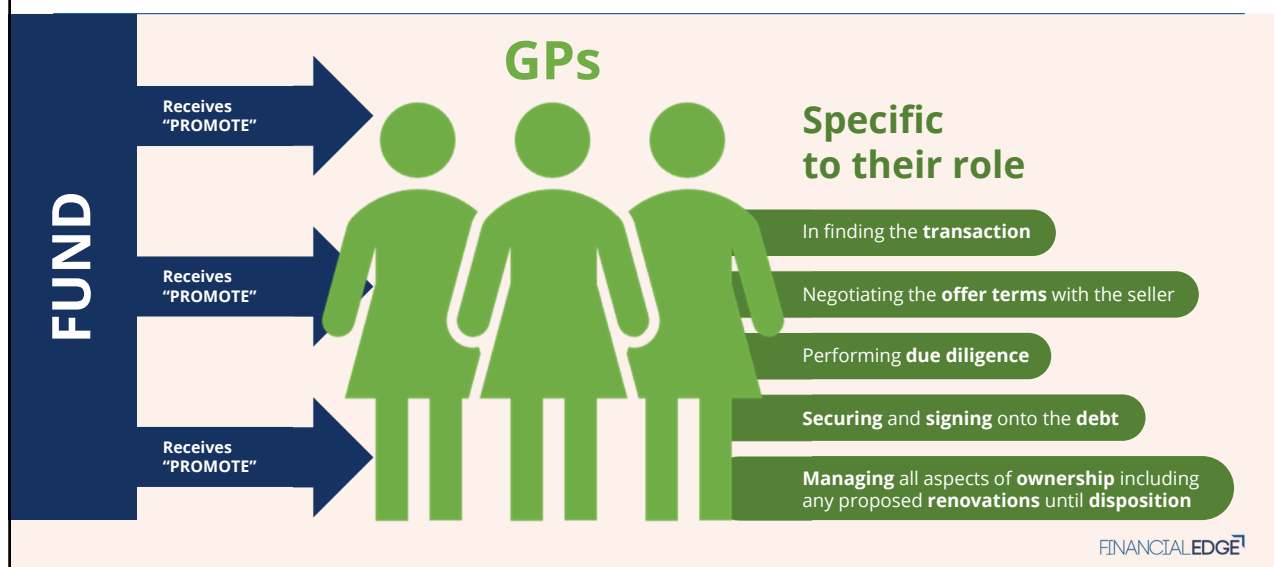
Disproportionate **share of profits** in a real estate deal above a **predetermined return threshold**



WHY DOES THE SPONSOR DESERVE TO EARN A PROMOTE?

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"Promote" in Commercial Real Estate



The Equity Waterfall

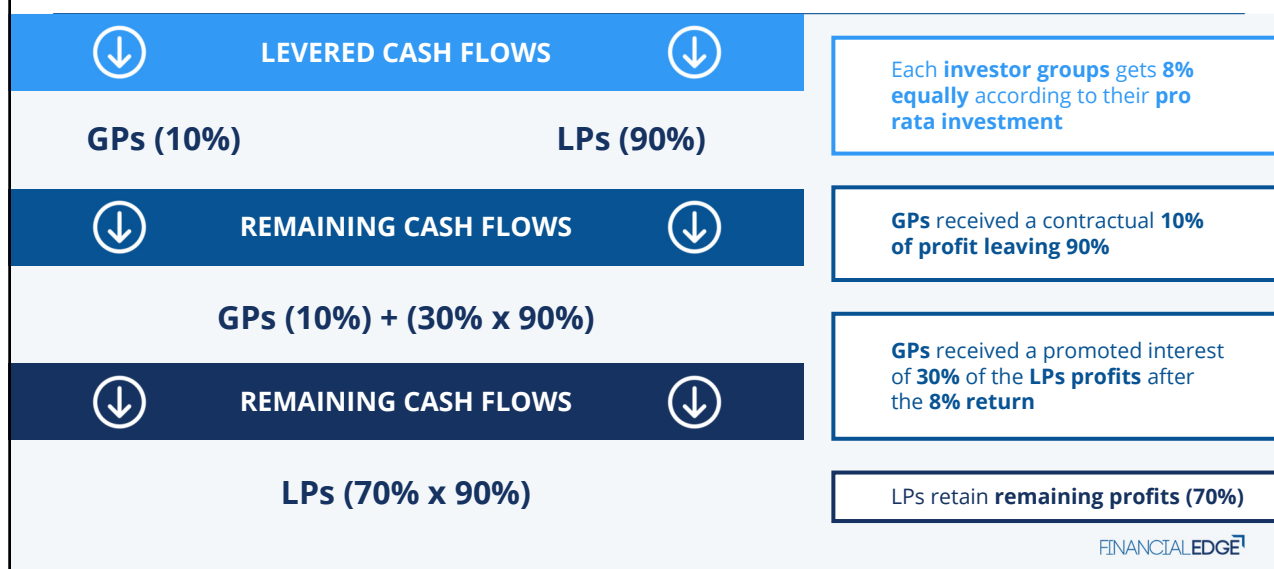
DEAL TERMS	
Purchase price of building	1,000,000
Debt funding	60.0%
Equity Funding	40.0%
GP Funding of equity	10.0%
LP Funding of equity	90.0%
Debt funding	600,000
GP equity funding	40,000
LP equity funding	360,000
Hurdle rate	8.0%
GP promoted interest of LP share over hurdle	30.0%

The **hurdle rate** is a **guaranteed rate** of return for the investors before the promoted interest kicks in

After the hurdle rate, the GP takes **30% of LP profits**

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The Equity Waterfall



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