FrontLine Research Paper

Are preferred rates of return a real hurdle?

If private markets had their own telenovela, it would most likely be called "aligning the interests of fund managers and investors". Already a well-known and a long-running one, it promises a series of plots and surprises spanning multiple generations of fund managers. The scenes would be set alternatively in swanky office spaces and luxury conference rooms. The action would revolve around negotiations and closings, with meetings and conference call cliff-hangers. And just like in any telenovela, the plots would revolve around attractiveness and money – that is, track records and fees in the case of private markets.

One of the few moving parts in the negotiations between fund managers and investors, the hurdle rate focuses the attention.

It is common knowledge that the scenario of any telenovela is predictable. In the case of private markets storylines, the fee structure will remain essentially unchanged with management fees in the region of 1.5 to 2%. The basis of calculation of these fees might, however, be subject to twists and turns in negotiations: will it be committed or invested capital? What will happen after the investment period expires? A series of thrilling debates will ensue. Likewise, as usual, the carried interest would essentially always be a handsome threshold of 20% of the profit of funds. But will it be associated with a swashbuckling American waterfall or a more suspenseful European one?

Often, the secondary plots are the real sources of action. They become the topic of the heated watercooler conversations: will there be a keyman clause? What about the preferred return rate[1]? Will it be the usual level? A higher or a lower one? Will there even be one at all? How will the fund manager justify any divergence from the convention? Being one of the few moving parts in the negotiations between fund managers and investors, the preferred rate of return indeed focuses the attention. The question of its relevance is regularly raised.

Thanks to the high quality and granularity of the data provided by eFront Insight, it is possible to explore how relevant hurdle rates are. This issue of FrontLine will focus on US VC and LBO funds reporting in US dollars, to eliminate biases from foreign exchange. As the hurdle rate is sensitive to time, we will focus on funds with a significant level of maturity. Thus, to avoid distortions in the analyses as far as possible, it will focus on funds with vintage years up to 2012.

Are hurdle rates difficult to reach?

Most hurdle rates featured in private equity funds are set at 8%. Although the origin of this specific figure is unclear, it is still largely applied to this day. It is of crucial importance for the fund manager: if this rate of return is not reached, then fund investors collect the full profits of the fund.

The hurdle rate is most of the time calculated as an internal rate of return. It is therefore sensitive to time. Technically, it is easier to reach this threshold if a fund holds assets for a shorter period of time. The hurdle rate is computed as an annualized performance between a capital call and a corresponding distribution. This implies that the use of credit lines[2] can help the fund manager to reach this performance threshold.

The hurdle rate is not risk-adjusted. Moreover, it does not take into account exceedingly favourable or unfavourable macroeconomic and business environments. This is a potential issue. The carried interest is expected to reward the value creation of a fund manager. If the hurdle rate is too easy to reach, then it rewards the fund manager for practicing in a favourable environment. If it is too difficult to reach it, the fund manager might simply focus on other funds or renegotiate the terms of the fund.

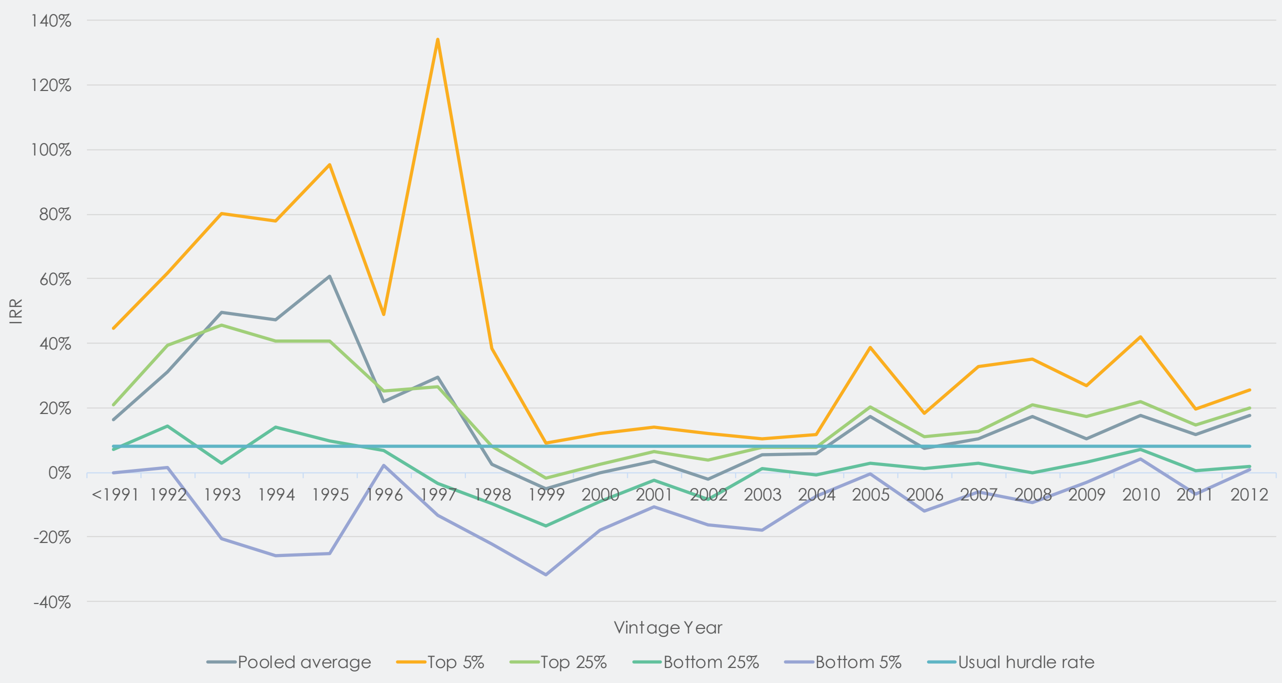
[1] Often also referred to as "hurdle rate".

[2] Often also referred to as "equity bridge financing".

The latter case might keep fund investors up at night. But how often does it really happen? In the case of venture capital (Fig. 1), the overall pooled average IRR of 14.44% of the funds created until 2012 is in line with the historical average of funds created up to 1991 (16.26%). But this average hides significant discrepancies. Out of the 21 individual years tracked, eight do not reach the 8% performance threshold. One came close to it: 2006 with a pooled average of 7.62%. This can trigger some challenges in aligning interests between fund managers and investors.

Reaching the hurdle rate, in venture capital, remains indeed a real challenge.

Figure 1 – Performance of American venture capital funds and usual hurdle rate

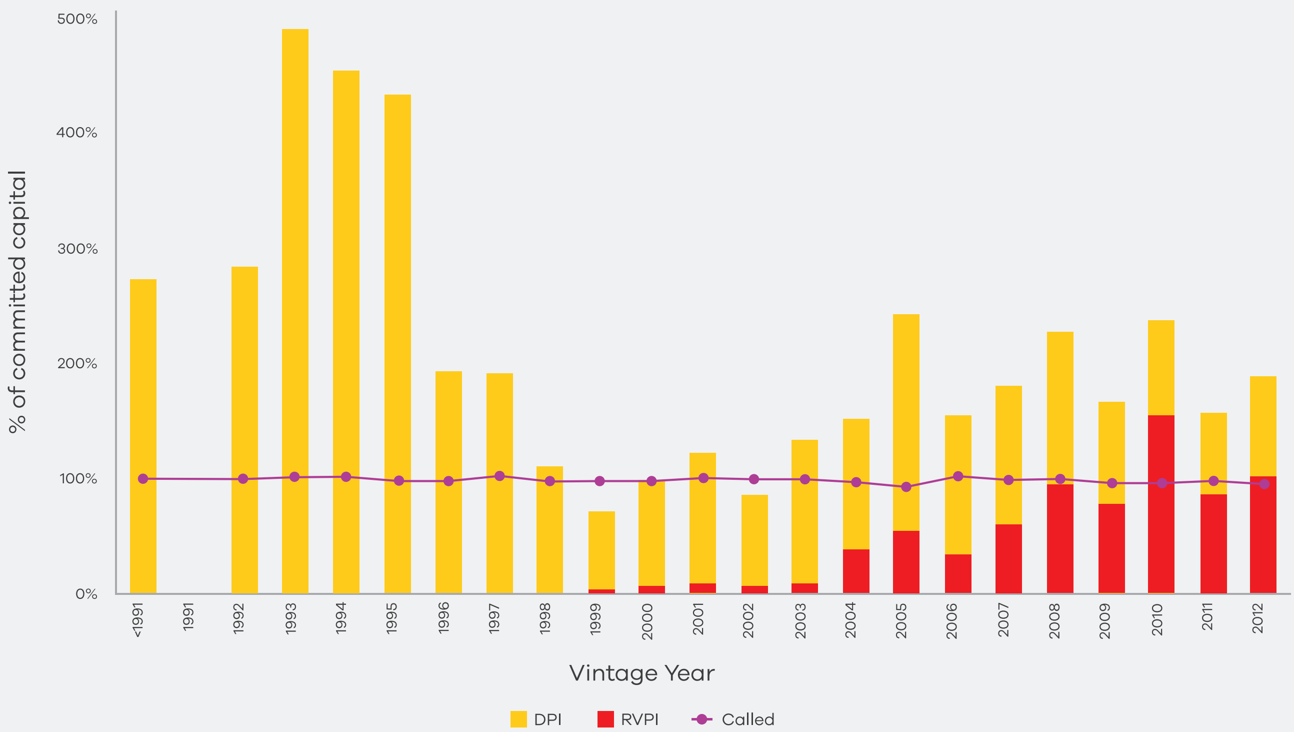


Source: eFront Insight, as of Q4, 2018.

A closer look shows that the top 5% systematically managed to exceed the hurdle rate, even for the vintage year 1999 with an 8.98% IRR. The bottom 5% effectively never reached the hurdle rate. As for the top 25%, only in four instances did it not reach the 8% threshold. Vintage years 2003 and 2004 came close with respectively 7.76% and 7.74%. Reaching the hurdle rate, in venture capital, remains indeed a real challenge.

Macroeconomic and business factors play a significant role. Significant capital inflows between 1998 and 2001 have had consequences on the performance of funds. Another explanation is the rather long holding periods in venture capital. Funds of vintage years from 2004 on still have significant assets in portfolio (Fig. 3). As the hurdle rate is time sensitive, this puts venture fund managers at a disadvantage, especially since venture-backed companies tend to stay private longer. On average, the time-to-liquidity was 3.6 years for funds of vintage years 1992 to 1998 and it was 5.7 years for funds of vintage years 1999 to 2012. In the case of early stage funds, the time-to-liquidity was similar for vintage years 1992 to 1998 but jumps to 6.5 years thereafter.

Figure 2 – Multiples of investments of US venture capital funds



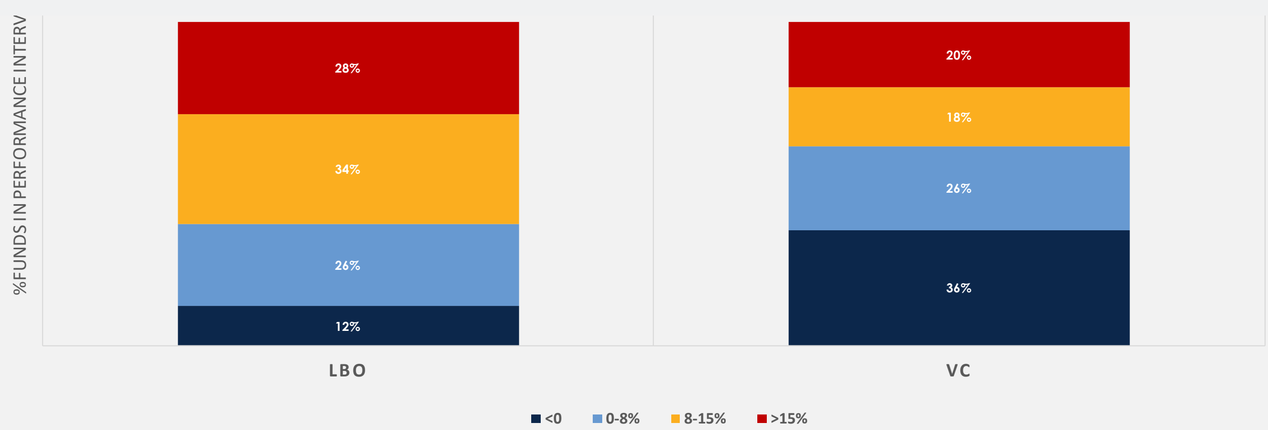
Source: eFront Insight, as of Q4, 2018.

Contrasting with LBO

Do LBOs differ significantly from venture capital? Figure 3 shows the distribution of historical internal rates of return delivered by LBO and VC funds of all vintage years. More than 60% of LBO funds managed to beat the hurdle, while only 38% of VC funds exceeded the 8% threshold. This confirms that shorter holding periods characteristic for buyout strategy go in favour of LBO fund managers.

The hurdle rate is time sensitive, putting venture fund managers at a disadvantage as companies stay private longer.

Figure 3 – Performance distribution of American LBO and VC funds

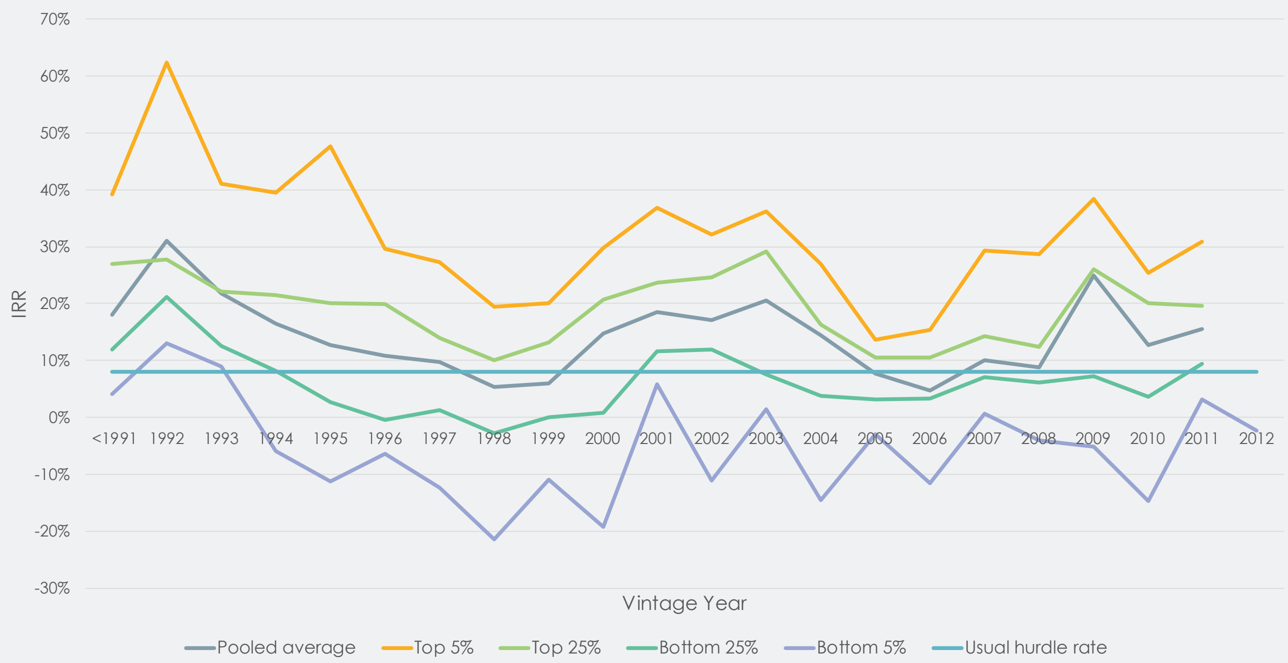


Source: eFront Insight, as of Q4, 2018.

The overall pooled average IRR for LBO funds is 12.11% until 2012, compared with 18% up to 1991. For out of the 21 individual years tracked (Fig. 4), 4 miss the 8% mark. 2005 came close (7.76%). Here again, the top 5% exceeded the hurdle rate comfortably in all instances. Top quartile funds too, meaning that the best fund managers on aggregate were entitled to collect some carried interest. Bottom quartile fund managers managed to hit the hurdle rate 6 out of 21 years and came close to it with three more vintage years (2003, 2007 and 2009).

Here again, macroeconomic and business factors play a role: LBO performs less well when the economy is at the top of the economic cycle. But this time, shorter time-to-liquidity plays in favour of LBO fund managers, with an average of 4.22 years peaking in vintage year 2006 (6.4 years).

Figure 4 – Performance of American LBO funds and usual hurdle rate



Source: eFront Insight, as of Q4, 2018.

 |

Conclusion

The first conclusion from these analyses is that the hurdle rate remains a challenging target to reach for fund managers. The second is that adverse macroeconomic and business conditions can deprive fund managers of the reward of their work. It is difficult to argue that LBO fund managers collectively did not suddenly create any value if they raised funds in 1998 and 1999 or in 2006. Third, a one-size-fits-all hurdle rate calculated as an internal rate of return appears as inadequate: it might unjustly punish venture fund managers for example, as they require more time to develop their assets. The logical conclusion is that if the hurdle rate is useful, it is long overdue for a revamp. A possible solution could be to negotiate a variable rate, computed as a premium on a public market equivalent. This might, however, open Pandora's box: fierce debates about the level of the expected premium, as well as the relevant index to choose, would, no doubt, give birth to plots and sub-plots in our telenovela – if not a spin-off more akin to an action movie.

A one-size-fits-all hurdle rate calculated as an internal rate of return appears as inadequate

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

 |

About eFront

eFront is the leading pioneer of alternative investment technology, focused on enabling alternative investment professionals to achieve superior performance. With more than 850 Limited Partner, General Partner, and Asset Servicer clients in 48 countries, eFront services clients worldwide across all major alternative asset classes. The eFront solution suite is truly unique in that it completely covers the needs of all alternative investment professionals end-to-end, from fundraising and portfolio construction to investment management and reporting. For more information, please visit www.efront.com

About eFront Insight

eFront Insight is a sophisticated web-based analytical platform dedicated to alternative investments and combining granular, high quality investment data reported by General Partners, leading market benchmarks and other relevant sources in order to generate unique insights and facilitate investment decision making. eFront Insight is available to both General Partners to digitize data exchanges with investors and to Limited Partners to enhance decision making.

Learn More:

request@efront.com

Our Offices:

Montreal | Jersey | Beijing | Hong Kong | Santo Domingo (DR) | Paris (HQ) | Cologne Mumbai | Tokyo | Luxembourg | Belgrade | Singapore | Cape Town | Abu Dhabi | Dubai | Seoul London | Boston | New York City | San Francisco |