

# Adopting a different waterfall – where will your profit flows end up?

As managers look at alternatives to a standard 8% preferred return and 100% catch-up waterfall, how does this affect how profits flow to investors and the manager? Goodwin’s *Michael Halford* and *Benjamin Yeoh* modeled them to find out

Over the last decade, the percentages which comprise the waterfall – or how profits flow to investors and the manager – have proved remarkably resilient. A 8 percent preferred return and 100 percent catch-up is a standard that has been adopted by the vast majority of private equity funds over the years despite interest rates falling significantly.

Recently we have found this resilience being tested by the twin trends of highly successful funds which can command changes to their fund terms and funds which may need to concede terms to successfully raise capital. This has created pressure toward tilting the initial profit flows towards the manager or conversely towards investors.

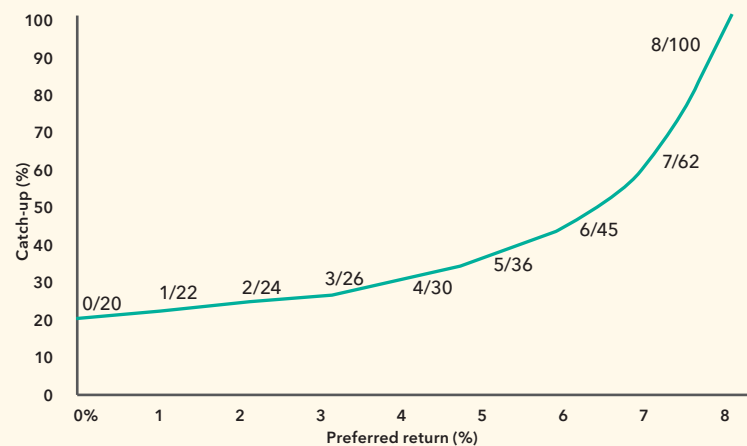
As an understanding not only of the legal drafting but also of the economic impact of terms is crucial to providing comprehensive advice, we have delved into the economic implications of this trend to unpack how changes to the standard percentages affect the initial profit flows to investors and the manager.

Looking at the basics first, a higher preferred return and a lower catch-up delays the payment of returns to managers, or tilts the initial profit flows towards investors. The inverse (a lower preferred return and higher catch-up) tilts the timing of the initial profit flows towards the manager.

More complex is how a lower preferred return and a lower catch-up compares with a higher preferred return and higher catch-up. As a lower preferred return

## Realization in Year 7

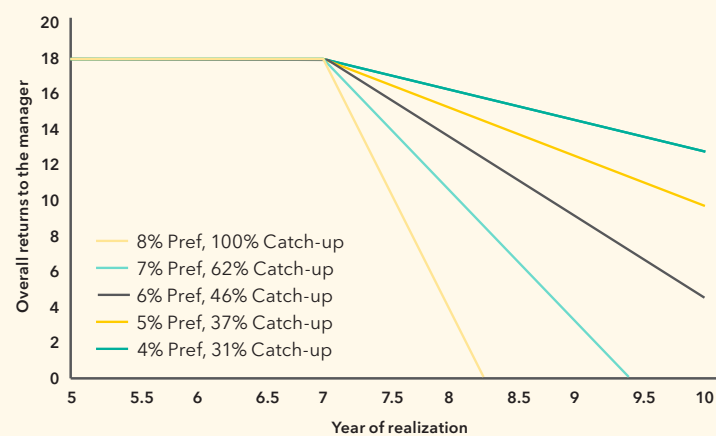
Points below the trendline favor the investor



\*Assumptions: 100 units are drawn from investors on day one; the preferred return compounds annually; there is only one realization at the start of year 7; we have not modeled expenses or management fees but have assumed a typical waterfall priority of preferred return, catch-up and then carry

## Realizations after Year 7

Initial profit flows swing more quickly against the manager with higher catch-up



Source: Goodwin

favors the manager but a lower catch-up favors investors – does this tilt the initial profit flows towards investors or towards the manager?

To get a feel for this we put together the first chart, which shows different combinations of preferred returns and catch-up percentages which are essentially equivalent – that is they all reach the same split of returns between investors and the manager as the standard waterfall at the same time.

As the magic threshold for managers is the point at which the fund has gone through the catch-up and is on the brink of carried interest, we looked at this point to compare combinations which were equivalent to the standard waterfall. We calculated the threshold as it would stand in the seventh year of the fund – a realistic date on which a fund might reach this point in the waterfall.

The first chart roughly shows which combinations are more favorable to the manager in terms of initial profit flows. Any points above the trendline provide an advantage for the manager in initial profit flows. For example, a 6 percent preferred return with a 50 percent catch-up is actually more advantageous to the manager than the standard waterfall. Any points below the trendline are less favorable to the manager. For example, it would not be advantageous for the manager to ask for a lower hurdle rate of 7 percent in exchange for a 50 percent catch-up. Of course for investors, the converse is true.

The first chart, however, isn't the full story. If returns take longer to be realized and on the assumption there are fixed returns from the fund, the impact of a higher preferred return brings us to a case where returns are insufficient to fully go through the catch-up. What this means is even with any equivalent combinations from the first chart, a lower preferred return favors the manager (as less preferred return will accrue).



Halford: charting waterfalls



Yeoh: modeling returns

“A higher preferred return and a lower catch-up delays the payment of returns to managers, or tilts the initial profit flows towards investors”

Michael Halford

To explore how this would impact the cashflows for the manager, we plotted a second chart to examine the impact if realizations are slower. This shows how with any equivalent combinations from the first chart, the initial profit flows (and overall returns) swing more quickly against the manager with higher preferred returns – demonstrating a lower preferred return always favors the manager when realizations are slower or lower.

Our exploration above has drawn out how nuanced the relationship between the preferred return and catch-up is, and shifting to a new waterfall should not be undertaken without thorough preparation. Managers embarking on this journey should consider modeling whether these new waterfalls provide an advantage or disadvantage compared with the standard waterfall and consider the impact if realizations are slower, or lower than anticipated. Investors likewise should be prepared. After all, before adopting an unfamiliar waterfall, it is good to know where you might end up financially. ■

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