The Deal

Advent's Latest, and Largest, Fund Includes a Wrinkle: No Hurdle Rate

Absence of a preferred return may move GPs' interests out of alignment with those of LPs, but not seen as a trend.

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Would you put money in a bank that proudly proclaims its disdain for deposit insurance? One that, in fact, doesn't offer customers the security of the FDIC?

Is that what institutional investors did when they signed up to capitalize the latest fund being raised by Advent International?

Advent, based in Boston and London, and which boasts of being one of the largest and most experienced global private equity investors, announced last month that it completed fundraising for Advent International GPE VIII Limited Partnership.

The fundraising initiative included a wrinkle unusual for an Advent fund: this time there was no stipulation for what's known in the PE business as a preferred return, otherwise dubbed a hurdle rate. It's a move that raises questions as to whether the interests of the general partner and its limited partner investors are in complete alignment.

The preferred return is utilized as a way in which general partners' interests align with those of limited partners. By definition, the preferred return, or hurdle rate, is a way of guaranteeing that LPs get returns on investments before GPs can get their taste. It's a way of compensating limited partners for the relatively long duration of their investments in private equity, and a way to incentivize buyout fund GPs to go out and make deals, rather than sit on the capital.

The convention is that GPs set the hurdle rate at eight percent - meaning that GPs have to distribute that amount of return before they can start collecting carried interest on deals.

The majority of private equity firms establish the conventional eight percent hurdle. According to Preqin, 56% of PE funds pegged the preferred return at the eight percent level in funds dating to the 2014 vintage.

Sources with knowledge of the situation confirmed that Advent's eighth fund didn't include a hurdle. Advent itself declined to comment on the details of the fund. (Documents from the state of New Jersey Treasury Department's division of investment, which invested $100 million in the fund, affirmed that there was no hurdle provided by the fund.)

To be sure, Advent isn't the only PE firm with a fund that doesn't include a preferred return. According to data collected by the research firm Preqin, 19% of the funds raised by private equity firms dating to the 2014/2015 vintage had no hurdle rate.

Several prominent firms, including Warburg Pincus LLC and Hellman & Friedman LLC, have historically eschewed including hurdles in their funds. Neither firm, obviously, has come up empty in the fundraising front. Warburg closed on the fundraising for its Warburg Pincus Private Equity XII LP in November, securing $12 billion after just six months on the fundraising trail. Hellman & Friedman Capital Partners VIII closed in November of the preceding year having garnered $10.9 billion for its efforts. (Both Warburg Pincus and Hellman & Friedman declined to comment for this story.)

What makes the Advent fundraising initiative unusual is that predecessor funds raised by the firm did include the hurdle rate.

"It's that change in the practice that's anomalous," Thomas Bell, a partner at Simpson Thacher & Barlett LLP, who is head of the private funds practice at the New York firm, said in an interview. "But then you're looking at a firm with a top decile or top quartile performance, with a sustained track record of repeated success.

"Especially in a period when returns on almost all categories of investments have been going down, if as a limited partner you can achieve a double digit return, you're delighted," Bell added. "Conversely, as a GP, being subject to an eight percent preferred return doesn't really matter if you're confident you can achieve a 20% gross return."

Of course, if 19% of private equity funds eschew the hurdle rate, it means that the overwhelming majority of funds - in excess of 80% of the fund universe - includes preferred returns in fundraisings.

The question is whether that overwhelming majority of private equity funds using preferred returns shrinks in coming months or years. That is, will Advent's move start a trend?

"I don't think so," said Brendan Tyne, managing director of Augentius, among the largest independent private equity and real estate administrators in the world, who described the Advent decision to drop its preferred return as an outlier.

"I'd really be surprised if it became more common," Tyne added.

Robert Annas, a senior managing director of SOLIC Capital, a restructuring and capital advisory firm based in suburban Chicago, said Advent's ability to successfully raise its fund without including a hurdle rate is a reflection of market conditions.

"If you look at the outflows to limited partners - and in 2015 we saw a tsunami of cash coming from the exit activities of PE funds - and the capital calls from general partners, then a firm that's going without a preferred return is totally attributable to market conditions," Annas said in an interview. "You won't see it much when the capital call and distribution ratios reach a more normal equilibrium."

Market experts said that the ability to raise a fund without affording institutional investors the conventional protection of a preferred return is going to be limited to the cream of the private equity crop.

"Look, if you're a top quartile fund, you're in the catbird seat," said Kevin Scanlan, partner at Kramer Levin Naftalis & Frankel LLP in New York, where he works in fund formation. "Institutional investors want to partner with the best."

Advent certainly has the track record that ranks it among the premier performers. Its fourth private equity fund, which it closed in 2001, generated a net IRR of 52%. The succeeding fifth fund, which it closed in 2005, posted a 44% IRR, according to data from PitchBook.

Its successor funds - the 2008 vintage sixth fund, which scored an 18% IRR, and its 2012 seventh fund, which has netted 10% - didn't match those outsized returns, though with some dry powder available in the later funds, there's still opportunities to ratchet up that return performance.

Clearly investors are persuaded by Advent's performance. One notable feature of the firm's fundraising initiatives is that each fund is bigger than its predecessor, a streak it was able to maintain even in the teeth of the fiscal crisis. The latest fund, by far its largest, targeted $12 billion, and ended up with $13 billion. (By comparison, the firm's seventh fund raised €8.5 billion, just under $10 billion, back in 2012.) Rumors suggested the latest fundraising effort could have netted the firm as much as $20 billion, if it had taken every dollar offered.

What's more, Advent completed its fundraising in relatively short order: just six months. The fund is also among the largest raised recently, dwarfed only by the $18 billion Blackstone Capital Partners VII, which concluded fundraising in December.

One argument against using a hurdle set at eight percent, some critics argue, is that the figure is an anachronism: the eight percent became a convention at a time when 10-year government Treasurys - arguably the lowest-risk investment available - were yielding somewhere in the mid single digits. Eight percent gave LPs a little bit of a premium over the yield on the 10 year - again, to compensate those investors for the long-time lockup of their investment capital.

Of course, with yields on the 10 year now hovering barely in positive territory, the eight percent figure looks practically gaudy. "Eight percent was historically the number," said Scanlan. "But from a fund manager's perspective that makes less sense with rates where they are now."

Still, does that mean eight percent or ... nothing?

"In a fully functioning market, that eight percent figure would presumably decline somewhat, reflecting the fact that interest rates have declined," said Simpson Thacher's Bell.

In fact, though, the rates don't float. According to Preqin, just seven percent of funds have established a six percent preferred return rate, with just four percent setting the rate at five percent or less.

What's otherwise remarkable about Advent's decision to forego the preferred return stipulation is that it effectively contrasts with the trends in the private equity business that has found institutional investors more aggressive in their negotiations with GPs.

Some firms, such as Kohlberg Kravis Roberts & Co. LP, that traditionally had eschewed the preferred interest stipulation installed a hurdle in recent fund raisings. (KKR did not respond to requests for confirmation of media reports on the matter.)

It's also widely believed that Advent made some concessions in the fundraising initiative. "They might have taken something away from their LPs" by excluding a preferred return, Scanlan said. "But they gave those investors something back." It's suggested that Advent reduced some of the fees that they'd otherwise have charged investors, though the conventional management fee - set at 1.5%, a shade lower than the traditional fee of two percent - remains in place, according to the memorandum from the New Jersey division of investment. (Some firms, notably Warburg Pincus, which, again, does not include a preferred return in its fundraising, have never collected management fees.)

"The trends that we're seeing in the marketplace suggest that management fees are being negotiated down," said Augentius' Tyne. Those trends, he said, would not augur a widespread abandonment of conventions such as the preferred interest.

"I believe there's a movement on the part of limited partners to have their general partners show more accountability," said SOLIC's Annas. Experts said that, rather than seeing LPs' entrenched interest being encroached upon, there's more likely to be changes that reflect LPs increased muscularity.

One change that could be coming is a move to what's known in the industry as a European style waterfall, rather than the American waterfall that's currently in widespread use. In the former, GPs would collect their profits - i.e., their carry - based on the performance of the overall fund, rather than on a deal by deal basis. That structure is certainly far from universal currently, but experts said the next evolution of the PE business could find it more widely embraced.

For now, though, the toughest kids in the PE playground - the ones with a track record for making big investments, raising massive funds, and demonstrating a repeated track record - are going to get to do what they want when they want. At the end of the day, Advent tossed out the preferred return provision for a very simple reason: it could.

"There is a flight to quality here," Bell said. "For those firms that demonstrate they can really move the chains, in terms of performance, there's never going to be a problem raising capital."

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