

Carried Interest and Performance Fee Incentives

Link'n Learn – 5 February 2025

Getting Started

Here with you today



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Agenda

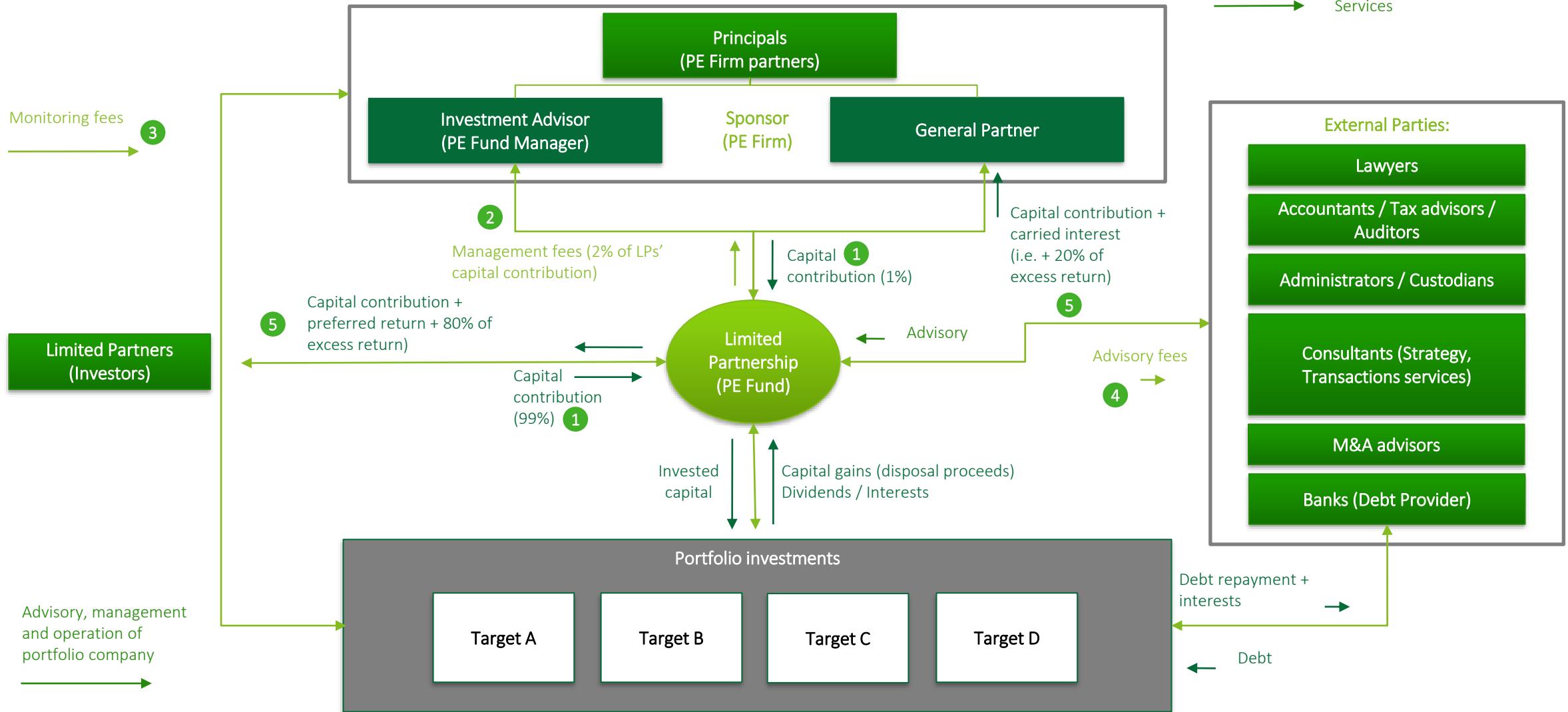
- 1** Accounting and disclosure of carried interest
 - Clawback
 - Accounting
 - Disclosure Requirements
- 2** Economics
 - Waterfall main features
 - Other components
- 3** Valuation
 - A brief introduction
- 4** Management and Performance Fees
 - Overview
 - Performance Measurement

Accounting and Disclosure of carried interest

Introduction & Overview

Carried Interest

Introduction



Carried Interest

Introduction

The prospectus of the Fund or the Limited Partnership Agreement defines the set-up of carried interests through the set up a specific class of shares giving right to the allocation of “carried interests”.

Example of set-up: The Manager/General Partner of the fund is entitled to receive a carried interest of 20 % of the excess of a performance above 8% (hurdle rate).

In practice this means, the profit of the fund will be first allocated to the investors until these profits reach a cumulative IRR of 8% calculated on the capital amount that have been contributed by the investors, including the General Partner who usually holds a small portion (1% to 5%) interest in the fund. Above 8%, the subsequent profits will be split using a ratio of 20% for the manager and the remaining 80% for the other investors.

Carried Interest

Overview

Carried Interests / Performance Fees

...Usually GP is granted a fixed percentage (e.g. 25%) of a preferred return (e.g. profit after a hurdle rate of 8% allocated to the LP). The remaining part is usually divided between LP (80%) and GP (20 %)

Type of settlement (usually on a whole basis)

- Cash settlement
- Equity settlement

Accounting treatment

- Expense (“Service Model”; expense, Contingent Liability, Provision, Accrued Liability)
- NAV Allocation (“Ownership Model”; Adjustment of NAV per Investor; Dilution)

Issues

- First Time recognition
- Disclosure Requirements

Accounting and Disclosure of carried interest Clawback

Carried Interest Clawback

Clawback:

- Limited partners' right to reclaim part of the general partners' carried interest, in cases where subsequent losses mean the general partners received excess compensation
- A look-back to review the total profit distribution at the end of the Fund's term
- Ensures that the LPs received their capital contributions, expenses and any specified preferred return promised in the LPA before the GP receives carried interest
- Recaptures any overpayments made to the GP above their stated carried interest

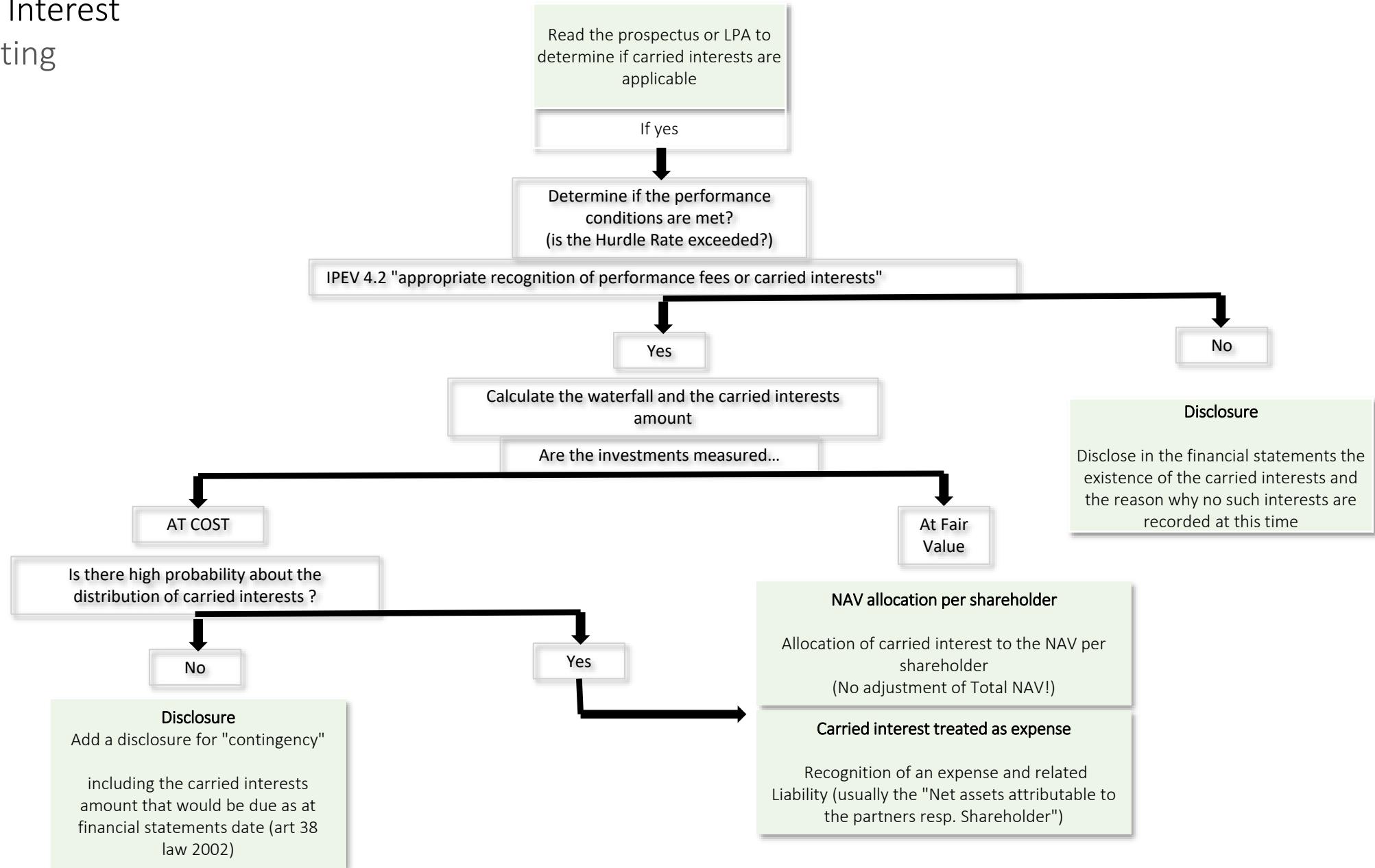
Presentation and disclosure:

- Ownership Model => Reallocation from GP to LP equity
- Service Model => Recognition of a receivable with corresponding income for the Fund (with appropriate disclosure of the collectability)

Accounting and Disclosure of carried interest

Accounting

Carried Interest Accounting



Accounting and Disclosure of carried interest

Disclosure Requirements

Carried Interest

Disclosure Requirements

Lux GAAP

- Description of the mechanism (including sufficient information of the calculation) and accounting policy retained (Art. 65 (1))
- Specific disclosure Requirements for AIF, SIF, SICAR, RAIF and SICAR (eg NAV per share)
- In case of expense model Art. 38 might be applicable (Financial Commitments)

IFRS

- “Useful information” (IAS 1.112)
- IAS 24 “Related Party Disclosures” to be applied in case of Ownership Model
- In Case of Service Model, IFRS 7/IAS 32 or IAS 37 to be applied

Carried Interest

Disclosure Example NAV Allocation

7.6. Capital Account

Statement for all LPs - Capital account since inception to 31 December 2017

Investor	% Ownership	Commitment			Realised portfolio gains/ (losses)	Unrealised portfolio gains/ (losses)	Investment income/ (expense)		Non portfolio income/ (expense)	Carried Interest allocation	Capital account at Fair Value
			€000	€000			€000	€000			
Investor No. 1	25%	25,000	26,583	(15,684)	4,833	5,554	1,905	(2,188)	(313)	(1,956)	18,734
Investor No. 2	20%	20,000	21,266	(12,547)	3,866	4,443	1,524	(1,750)	(250)	(1,565)	14,987
Investor No. 3	8%	8,000	8,506	(5,019)	1,546	1,777	609	(700)	(100)	(626)	5,995
Investor No. 4	10%	10,000	10,633	(6,274)	1,933	1,208	719	(875)	(125)	(580)	6,640
Investor No. 5	6%	6,000	6,380	(3,764)	1,160	1,333	457	(525)	(75)	(469)	4,496
Investor No. 6	7%	7,000	7,443	(4,392)	1,353	1,555	533	(613)	(88)	(548)	5,245
Investor No. 7	9%	9,000	9,570	(5,646)	1,740	1,999	686	(788)	(113)	(704)	6,744
Investor No. 8	5%	5,000	5,317	(3,137)	967	1,111	381	(438)	(63)	(391)	3,747
Investor No. 9	5%	5,000	5,317	(3,137)	967	1,111	381	(438)	(63)	(391)	3,747
Investor No. 10	4%	4,000	4,253	(2,509)	773	889	305	(350)	(50)	(313)	2,997
General partner	1%	1,000	1,063	(627)	193	222	76	(88)	(13)	(78)	749
Total for Investors	100%	100,000	106,331	(62,736)	19,331	21,201	7,575	(8,750)	(1,250)	(7,621)	74,081
Carried interest partner										7,621	7,621
Total	100%	100,000	106,331	(62,736)	19,331	21,201	7,575	(8,750)	(1,250)	-	81,702

Economics

Waterfall overview

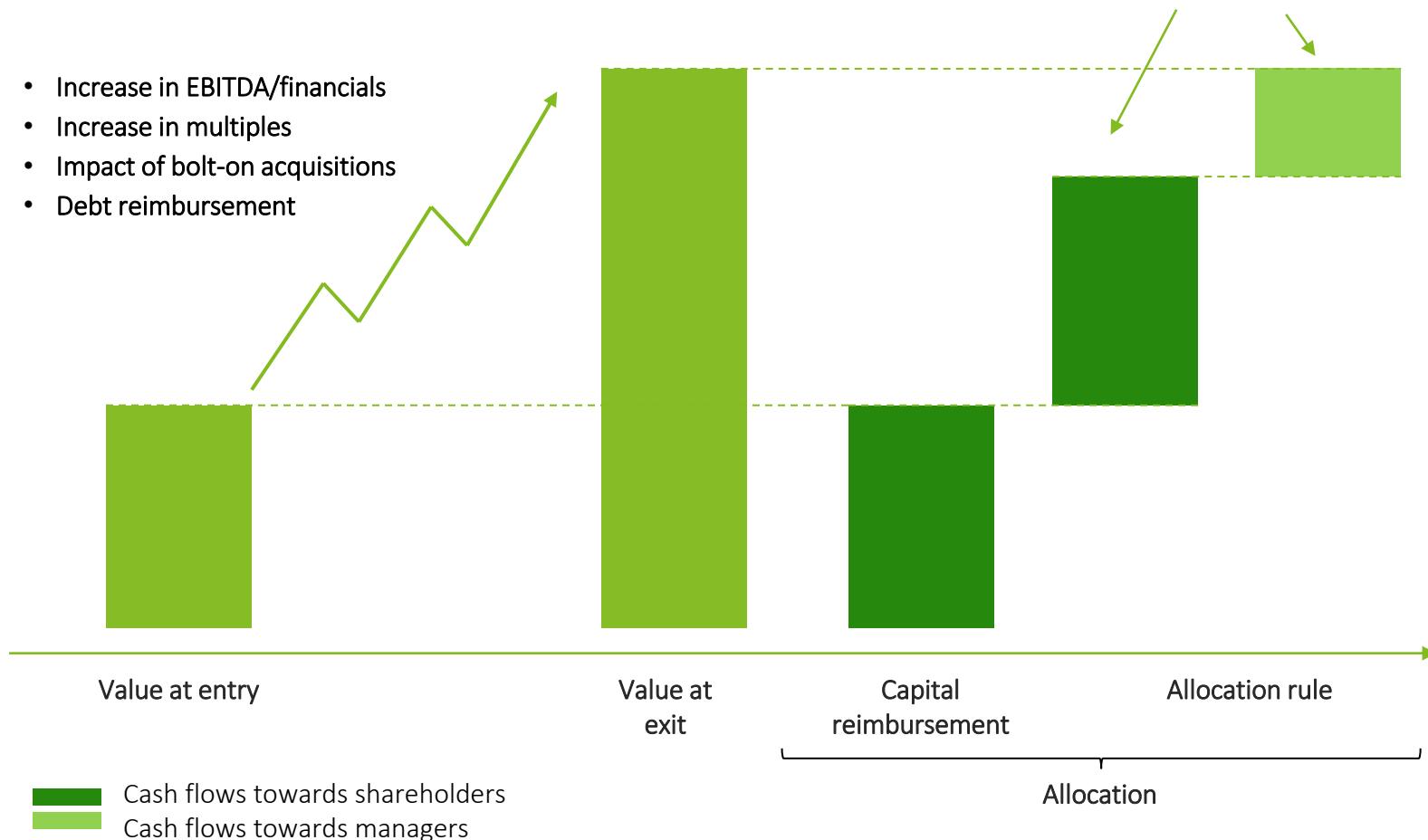
Waterfall economics

Main features

Simple target allocation principles...

- Increase in EBITDA/financials
- Increase in multiples
- Impact of bolt-on acquisitions
- Debt reimbursement

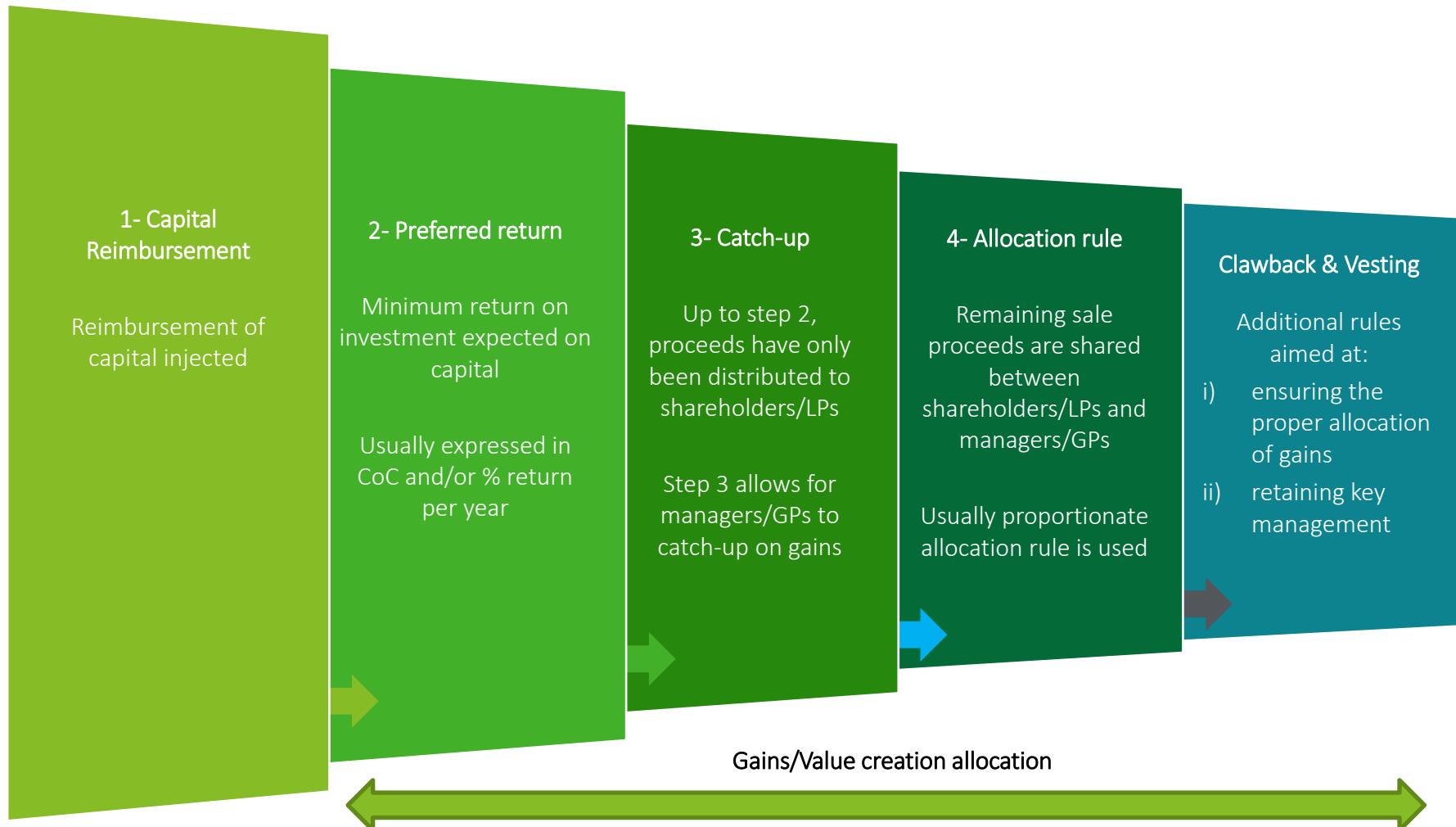
Target allocation results from
negotiation between shareholders
and managers:
e.g. 80%/20%



Waterfall economics

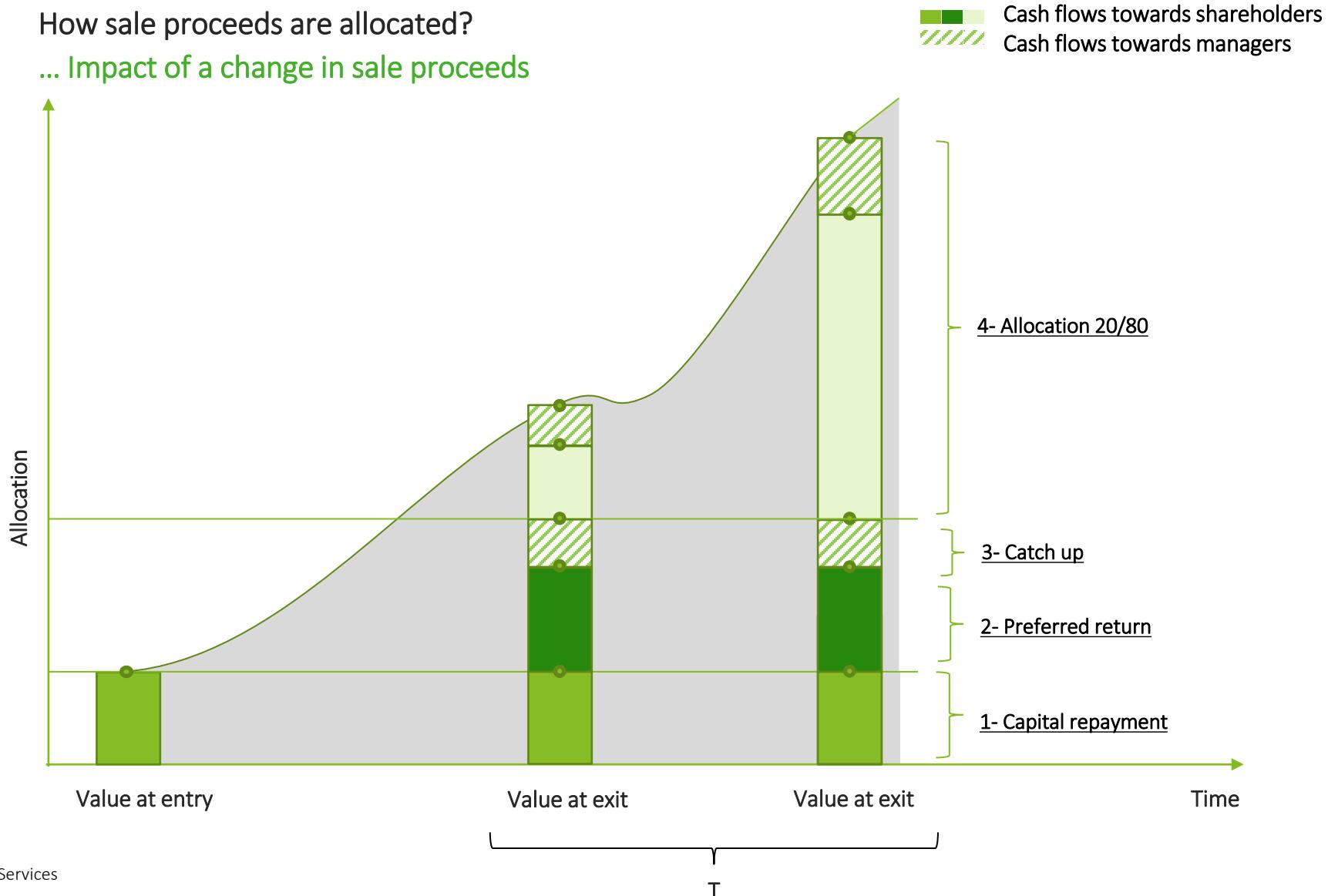
Main features

...Slightly more complicated in practice



Waterfall economics

Main features



Waterfall economics

Main features

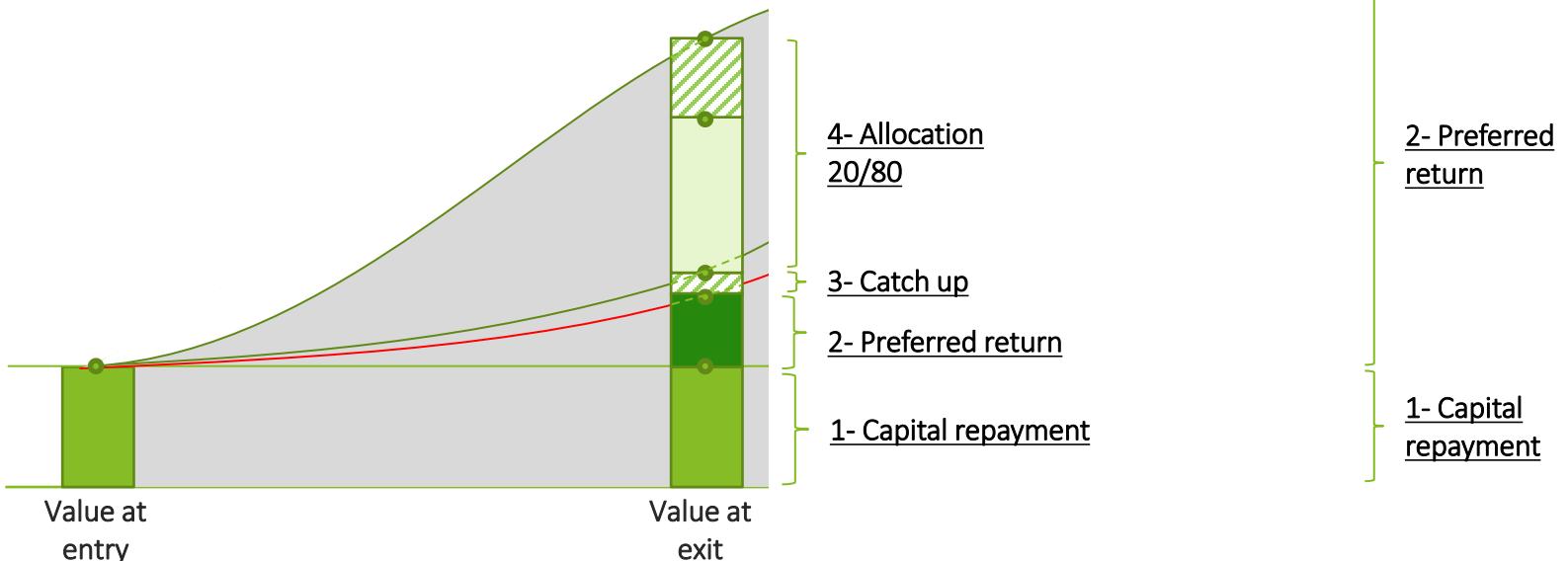
How sale proceeds are allocated?
... Impact of a change in exit date

 Cash flows towards shareholders
 Cash flows towards managers

Allocation of sale proceeds

Despite waterfall occurs only once, upon exit...

... allocation of value is dynamic as
preferred returns are time dependant



Economics

Other components

Waterfall economics

Other components

Vesting

Right to share gains is progressively acquired over time, e.g. 20% of the plan vests at each anniversary of the grant date

Good leaver

Any person who leaves the company because of retirement, disability, death, is dismissed for economic reasons, etc.

Bad leaver

Any person who resigns, is dismissed (for gross misconduct), etc.

Claw back

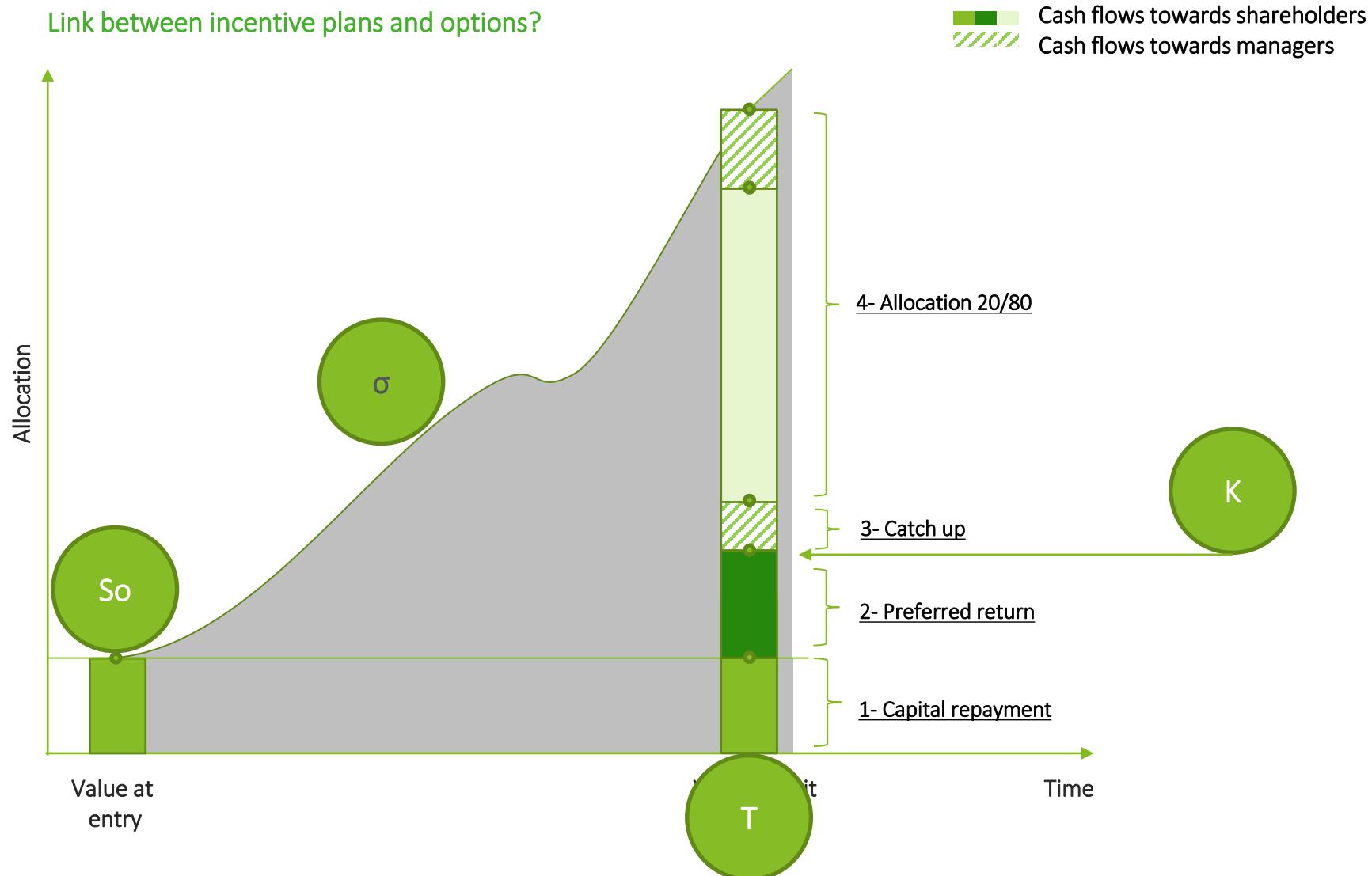
Participants might be obliged to reimburse (part of) their payments upon occurrence of predefined events (e.g. claims from third parties, etc.)

Valuation

A brief introduction

Valuation

Using financial theory, a carried interest scheme can be assimilated to an option considering its cash flow pattern



Valuation

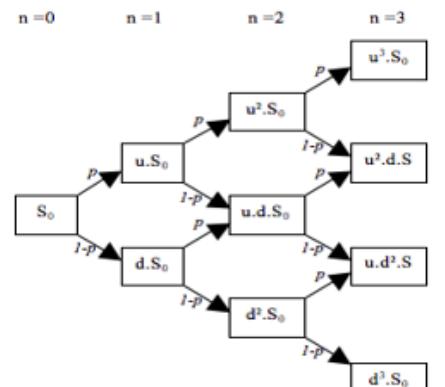
Find the appropriate valuation methodology?

3 main valuation methodologies used

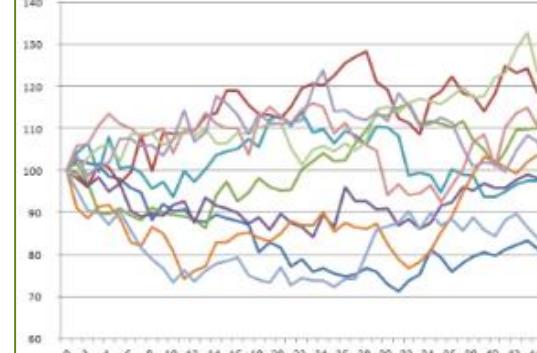
Black & Scholes formula

$$c = S_0 N(d_1) - K e^{-rT} N(d_2)$$

Binomial approach



Monte Carlo approach

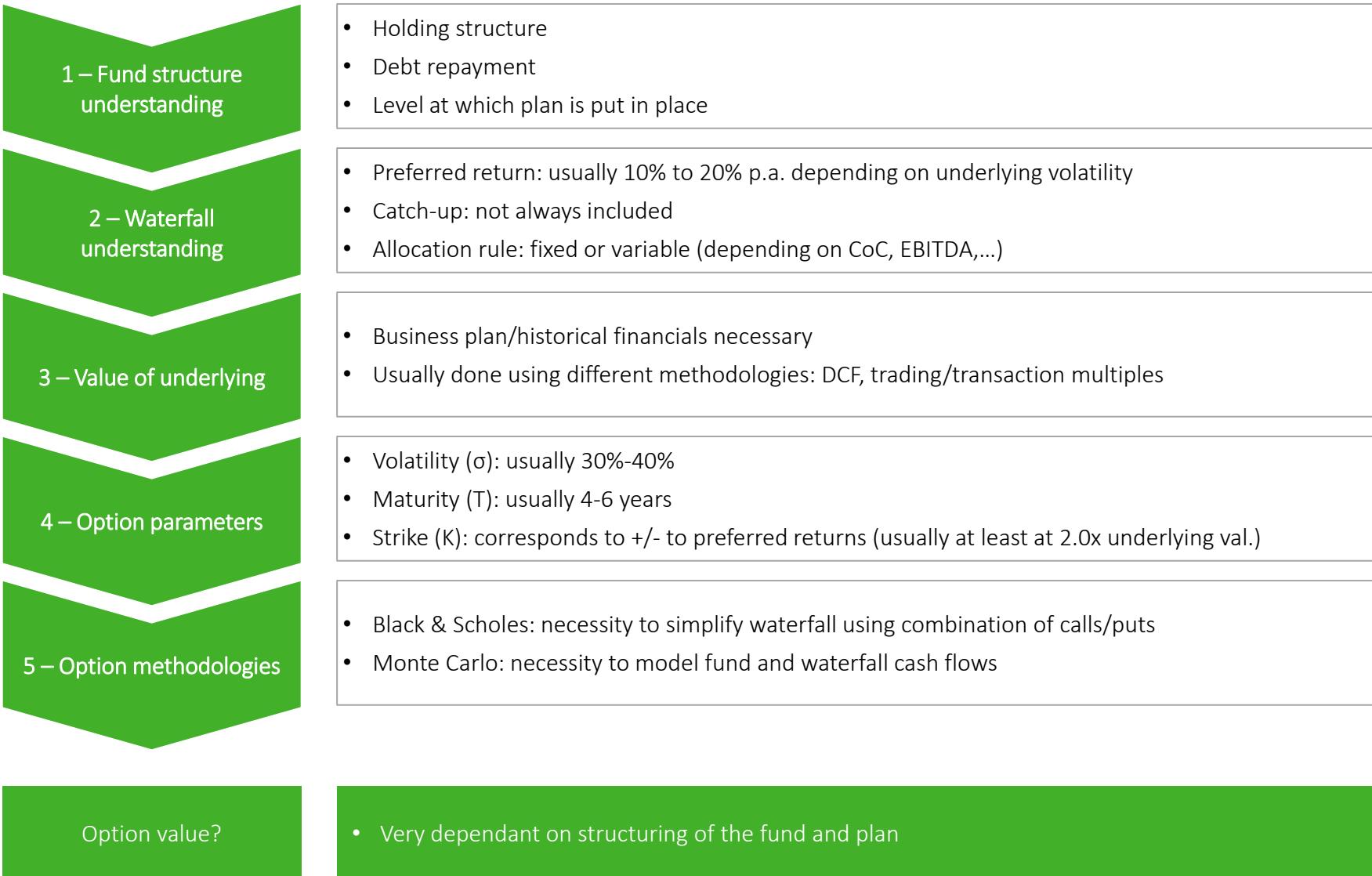


Increased Tailoring/Increased Flexibility

Increased Simplicity

Valuation

Valuation process



Management Fees & Performance Fees

Management Fees & Performance Fees

General Overview

Portfolio Manager / General Partner receives a remuneration for services rendered – Split between:



Both fixed and variable remuneration need to be disclosed in the pre-contractual documents - Investors need to be aware of and agree to:

1. Fixed and variable fee structure;
2. Calculation mechanism („translation“ of legal wording into mathematical model)

Management Fees & Performance Fees

Performance Measurement



- Driven by the new EU Regulation (SFDR / Taxonomy)
- Can be set-up either as
 1. Remuneration for achieving ESG targets
 2. Penalty for not achieving ESG targets

Next Link'n Learn webinar

Date: 19/02/2025

**Topic: Alternative Investments |
Accounting for Alternative
funds: reporting aspects of
different GAAPs and NAVs**



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