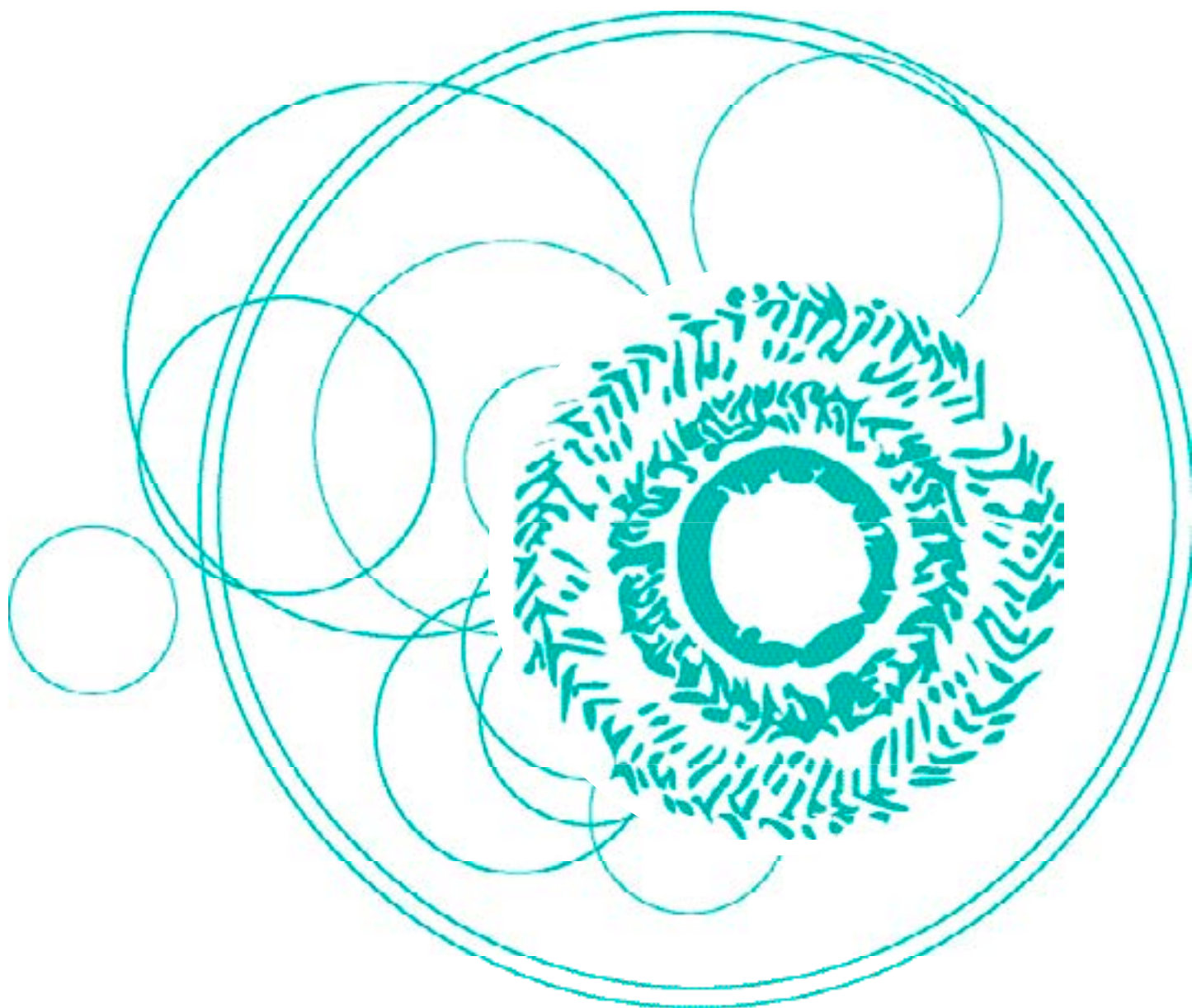


A fairer deal on fees

Our thoughts on alignment of manager fees



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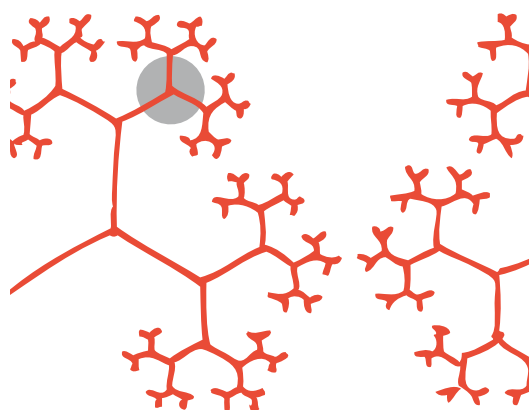
We outline our views on the often complex fee structures involved when investing in infrastructure.

About Towers Watson

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A Fairer Deal on Fees

Originally published February 2008 by Watson Wyatt Worldwide



Fee structures in the asset management industry are too high for the value they offer.

It is time for institutional investors to take a hard look at the fees they are paying to their active managers, and what it is they are paying for. For example, total annual costs of running a pension scheme have increased by around 50% over the past five years, according to our research, and now average around 110 basis points for large funds compared with around 65 basis points in 2002. The vast majority of these costs are paid in fees to external investment managers and brokers.

A key reason for this is the rise in investors' focus on alpha, which has increased their appetite for alternatives, such as hedge funds, private equity and real estate. Hedge funds typically charge an annual base fee of 1-2% on the value of committed capital, plus a 20% performance fee; and private equity fees are similar. This is far more than the typical annual fees charged by traditional long-only managers (which would often be below 50 basis points).

Investors naturally assume that they are paying these high fees to reward manager skill, or alpha. But in most cases they are wrong. Instead, they are paying 'alpha' fees for 'beta' performance, because the main driver of returns in recent years has been the strength of the markets. This has encouraged managers to leverage their portfolios to boost returns, which means that investors are often paying up for leveraged beta (market returns multiplied by gearing).

This is clearly a very good deal for the managers, but not necessarily for their investors. We strongly believe that managers should be compensated for a job well done. But fees are too high for the value they currently represent, particularly if we are moving to an environment in which market returns are lower.

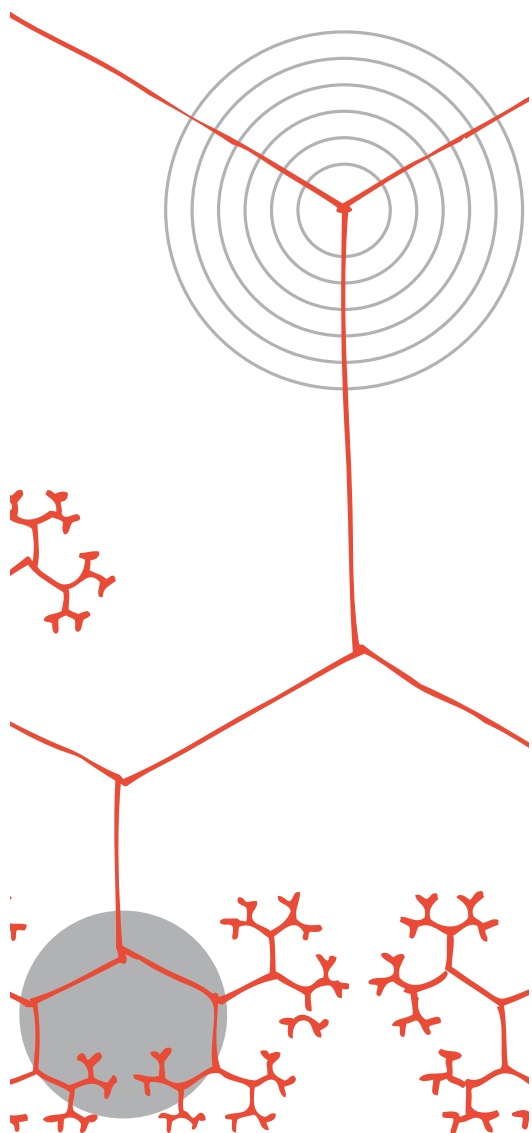
Easy pickings

Performance fees have two main functions. One is to provide managers with an incentive to perform; the other is to align the managers' interests with those of their clients. It is this alignment of interests that is seriously lacking at present.

A couple of very simplified examples illustrate just how easy the pickings have been for managers, and how far fee structures are tipped in their favour. Take a long/short equity fund that is 100% long and 30% short, charging a 1.5% per annum base fee on net asset value, plus 20% of absolute performance (a fairly typical situation). Assume the manager can add an impressive 5% per annum alpha on both the long side and the short side for every 100% gross exposure (it should be noted that over the long term this would be a remarkable result), on top of a long-term annualised market return of 10% and an annualised cash return of 5%. On this basis, the gross annualised return would be 15%¹, so investors pay an annual fee of 4.2%², or 65% of the alpha produced by the manager (4.2%/6.5%). In order to pay the manager only

¹ (70% x 10% + 30% x 5% + 130% x 5%)

² (1.5% + 20% x (15% - 1.5%))



50% of the alpha in fees (the client is taking all the risk after all), the manager must generate about 7.5% per annum alpha on each side, and that is Warren Buffett territory! Now admittedly this does not allow for the fact that the manager can add value by varying the gross and net exposures over time, but that typically does not have an enormous effect, and certainly does not alter the key message.

Of course, most pension funds achieve hedge fund exposure through a fund of hedge funds, which might charge an additional 1% annual base fee and 10% of net returns as a performance fee. Under this scenario 95% of the alpha is paid away in fees, and remember that in this example the manager is doing a great job!

Another major problem with the fee model is that annual performance fees amount to a free option for the manager, as the upside is uncapped but the downside is limited to the base fee. High water marks reduce the option value but do not remove it as all the positive performance could come in the initial period. The more volatile the performance stream produced by the manager, the greater the option value. An unskilled manager who produces volatile results can make a very decent living in this way.

Now it should be noted that long-short equity funds with higher gross exposure and lower net exposure would look better on these calculations so it is important to understand the nature of the fund.

We can do a similar calculation for private equity fees, which have been deplored by critics as shamelessly high. Assume that the manager holds 30% equity and 70% debt (which we might say is approximately twice the leverage inherent in public equity markets), and charges a fairly typical 2% base fee plus 20% of performance. Let's again assume that long-term equity market returns are 10% per annum, cash returns are 5% per annum and borrowing costs are around 6% per annum. If the manager again adds 5% per annum alpha per 100% gross exposure, then the fee would be 64% of the leveraged alpha (note that whilst private equity managers often claim to have a 'preferred return' which is needed before the performance fee is payable, there is almost always a catch-up provision such that with positive market returns they effectively have no hurdle rate of return to beat).

Then of course there is the slice of the fee taken by a fund of funds, which would lead to 91% of the alpha being paid away in fees. And this is before we allow for the fact that clients pay fees on money waiting in cash to be drawn down for investment, and ignores hidden deal costs.

Once again, it should be noted that different private equity funds can have very different levels of gearing, and that gearing can change dramatically over the life of the fund, hence the detailed fee analysis needs to be done in each case.

Without delving into too many details, real estate fees can be even worse – many leveraged real estate managers charge fees on the gross exposure rather than committed capital. This means that clients again pay nearly all the alpha produced by the manager in fees, even if the manager is doing an exceptional job.

It should also be noted that this is not just a problem in the alternatives world, as many performance fee structures in the more traditional mandates have also been badly structured.

Some solutions

The industry needs to act now to get fees back into line, and the first step is for investors to understand what proportion of alpha their managers are taking in fees, even if they are doing a good job. This needs to be set at a reasonable level, and be better structured to align interests.

We suggest that managers should always set hurdles, such as T-bills or a realistic fixed percentage reflecting the expected long-term beta exposure (which may even be leveraged beta). They would then collect fees only on performance above this benchmark rate. Far too few alternatives managers do this and even some managers in the more traditional mandates are starting to remove the benchmark in performance fee calculations.

Setting the benchmark at zero when cash is returning around 5% per annum means that a performance fee of 1% is levied on clients' money (as well as the base fee), even before it is put to work.

As mentioned, the hurdle rate should also reflect a fund's market exposure. For instance, a long/short equity fund with an average net exposure of 70% should base its hurdle rate on 70% equities and 30% cash. This is clearly

complicated territory as average exposures and alpha contributions are difficult to pin down ex ante, but it is unfair for the manager to be paid for beta.

Instead of calculating performance fees based on annual results, these should be charged on a rolling three-year basis, or longer. This reduces the 'option value' and makes performance fees a fairer deal for investors.

It also makes sense for base fees to reflect actual costs. Calculating base fees on the value of assets under management (the 'ad valorem' structure) encourages asset gathering, which can harm performance. It is ironic that only a few years ago investors welcomed performance fees as an antidote to this problem.

Finally, it makes no sense for fee structures to be as standardised as they are across the industry when investment strategies are so different. A low capacity strategy, or one that requires a costly global infrastructure, is justified in charging higher than average base fees. Conversely, a strategy that can absorb several billions of dollars, or has low infrastructure costs, should not have that luxury. High base fees on an ad valorem basis were put in place at a time when assets under management were low, and were designed to cover the base costs of the manager, with performance fees being the mechanism for paying good bonuses. It is clearly inappropriate that these base fees have not been cut as assets under management have grown significantly.

Summary

The whole area of fees and incentives is extremely complex, and the solutions will take some time to work through. However, there are signs of movement. Flaws in fee structures tend to become exposed when markets falter, and many managers will no longer be able to justify their charges without beta to bail them out. Larger pension funds are also aware of the roles played in their portfolios by alpha and beta, and are embracing new products and risk management tools that separate the two. If active managers want to win over more of this sophisticated, long-term money, as they often say they want to, they will need to offer institutional clients a fairer deal.

Further information

For more information on this subject please contact:

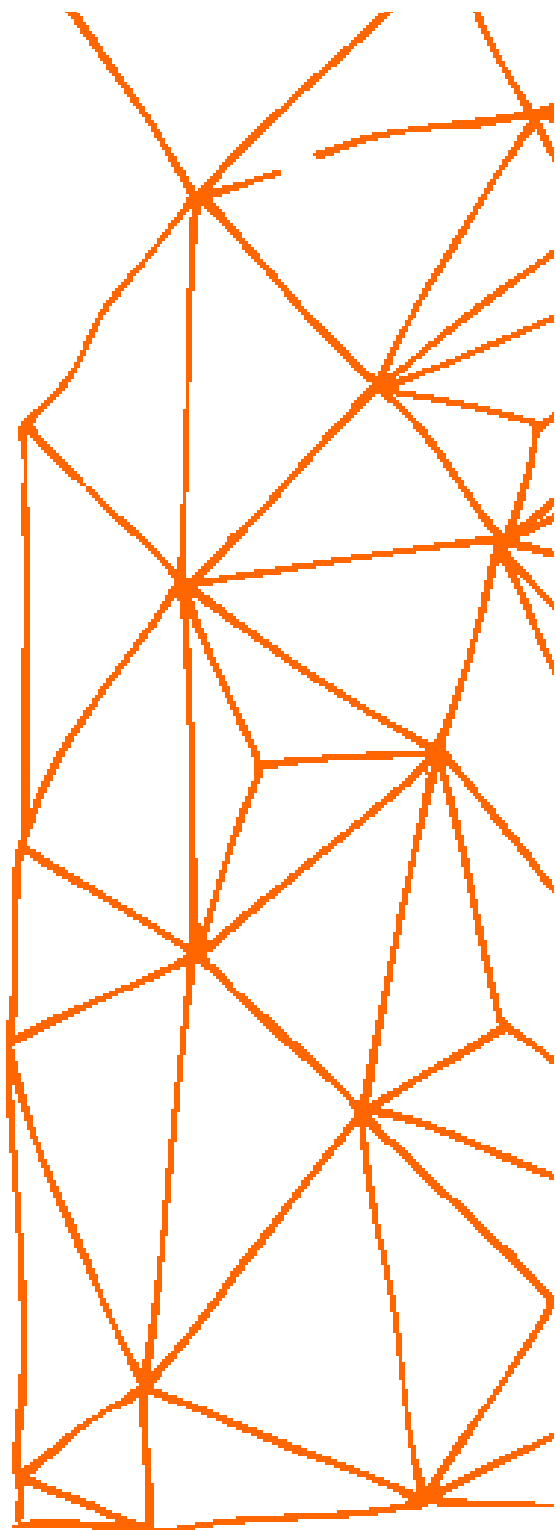
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Private Equity

Fees and Terms

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Introduction

Negotiating terms has previously been challenging due to limited capacity in high quality general partners (GPs) and the restricted ability of limited partners (LPs) to pool their bargaining power. The former has clearly contributed significantly to the latter.

This paper:

- Highlights how Watson Wyatt thinks about fees across asset classes and explains how we are applying this thinking to private equity.
- Discusses currently accepted fees and terms in order to encourage debate in the LP community, with the ultimate purpose of eliminating some of the more egregious terms seen in private equity.
- Discusses additional features of terms that are not yet common in the private equity community but would represent significant progress in improving alignment for LPs.

In this paper we emphasise that management fees form too high a share of a GP's compensation and are therefore the most significant factor misaligning the interests of a GP relative to those of its LPs. This misalignment is exacerbated by the manner in which performance fees are most commonly calculated in the US. We believe that the following changes would represent significant steps in redressing this imbalance:

- The basis upon which a manager sets its management fees must be reconsidered. For example, there is a strong case to budget for management fees on the basis of the number of investment staff and other fixed costs.
- GPs should consider phasing in management fees over the investment period to reduce the significant fee drag from paying on commitments early in the life of a fund.
- GPs should not generate additional fees from working with portfolio companies. Where they do this, fees should accrue to the fund.
- All GPs should employ a European waterfall – that is, the LP receives all its capital and its preferred return before the GP receives carry.

We also explore additional changes that are likely to be simple to implement, such as a significant step-down in management fees after the investment period, as well as other changes that represent a more significant step-change from the status quo, such as the introduction of a hurdle rate (rather than a preferred return).

What proportion of the alpha generated represents fair compensation to an investment manager?

We recognise that private equity attracts much of the highest quality talent in the investment world and that these strategies require a high level of skill to generate outperformance. As such, we accept that investment professionals in this asset class need to be compensated appropriately. In aggregate, this should entail a higher level of fees than in traditional asset classes and a different fee structure, for example, a performance fee to better align the investor and the manager.

However, we strongly believe that accepted fee conventions in alternative asset classes need to be more effectively compared to traditional asset classes, to better assess whether, on a forward-looking basis, these alternatives truly represent an attractive net of fees proposition. In many instances, current structures do not effectively align the investor and the manager. More specifically, management fees per professional are often so high that investment professionals can become very wealthy before consideration of performance fees.

We have had significant traction in negotiating our clients' fees in the hedge fund space by asking a simple question: **What proportion of the alpha generated represents fair compensation to an investment manager?**

This question is effective in challenging the concept of absolute returns, encouraging debate on what out-performance ('alpha') the manager has previously generated and what we expect the manager to generate on a forward-looking basis. It also encourages fee discussions with an investment manager in a manner that directly relates fees to skill.

Applying the concept to private equity

Applying this concept to private equity is relatively simple for the majority of buyout managers as it is essentially a long-only equity investment with additional leverage applied. The challenge is in estimating the likely cash flow profile of the fund and accounting for different fee conventions. We accept this analysis is even more challenging in venture capital and other specialist strategies such as 'distressed for control'.

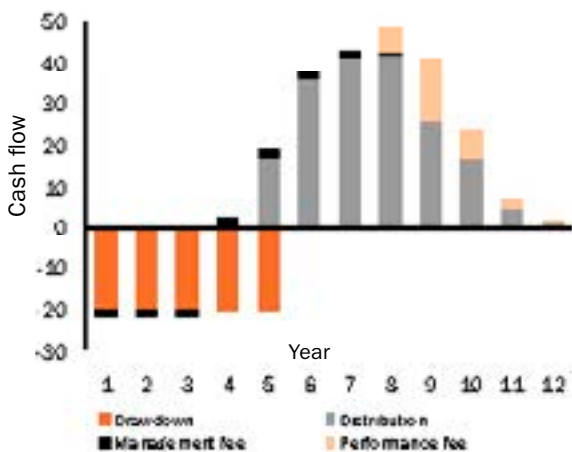
As such, we run this analysis below under the following assumptions:

- We use a simplified set of terms in private equity:
 - 1.75% management fee based on commitment size for an investment period of five years, reducing to 1.5% of the cost of remaining investments after the investment period.
 - 0% carry over a preferred return of 8% and GP 'catch-up' of 100%.
 - European waterfall – that is, the LP receives all its capital and its preferred return before the GP receives carry.
- We assume capital is drawn down evenly over five years and that the average holding period for an investment is four years (with some volatility applied to this to adjust the total fund life to approximately 12 years).
- A benchmark of 8% (an approximate long-term expectation of public equity returns) adjusted for average leverage 50% higher than that commonly found in publicly listed securities and a cost of debt capital of 5%.
- No transaction fees or monitoring fees are paid to the GP. In practice, both of these are relatively common terms and serve to increase the proportion of alpha paid to the manager as these fees are paid by companies owned by the LPs.
- The GP consistently generates 10% of alpha over the benchmark returns on a gross basis – that is, before the manager's fees are paid. This results in a gross internal rate of return (IRR) of approximately 20%, greater than we would expect from the average private equity manager. This assumption also ignores optionality in the performance fee; that is, a private equity manager cannot earn negative performance fees.

The resulting cash flow profile is shown in **Figure 01** and the split of alpha is shown in **Figure 02**.

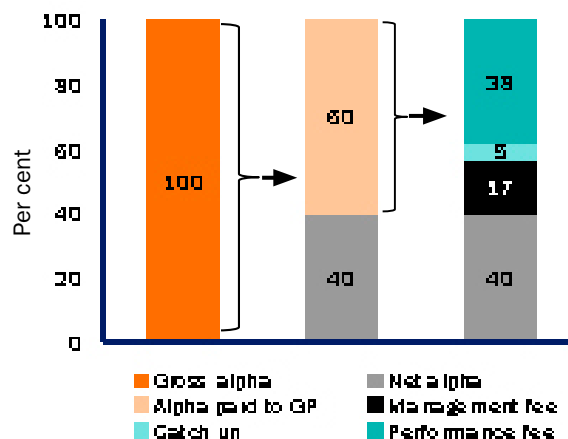
Figure 02 shows that approximately 60% of the alpha generated is paid to the GP, far too high a proportion for the disproportionate amount

Figure 01. Cash flow distributions



Source: Towers Watson

Figure 02. The split of alpha – base case assumptions



Source: Towers Watson

of risk being taken by the LP. **Relating this to performance, a gross IRR of approximately 20% is reduced to a net IRR of 13.7%.**

It is important to emphasise that, in this example, many of the more egregious terms in private equity have not been included, and as such, the proportion of alpha paid to the GP is often greater than that outlined above. We therefore look to challenge some of these conventions in the next section with the purpose of better aligning GP and LPs' interests.

Management fees and related terms

We believe that management fees should give GPs the ability to pay competitive salaries without diminishing the team's desire to generate strong performance. Attempting to set a standard percentage management fee is challenging given it is not obvious that you are paying for the same service from all private equity firms.

As such, we do not believe there is a single answer as to the level of management fees that are appropriate across the asset class. The appropriate level of management fees should be a function of the overall costs of the firm – that is, budgeted in some way. This should include:

- What is the volume of the firm's assets under management on which they charge fees?
- How much is the GP being paid per investment professional across all of its existing funds?
- What are reasonable expenses for professionals outside of the investment team that are necessary for the manager to perform its strategy?
- What other reasonable fixed costs does the GP incur, for example, the number of offices to achieve the necessary geographical reach of its strategy?
- What other fees does the manager generate?

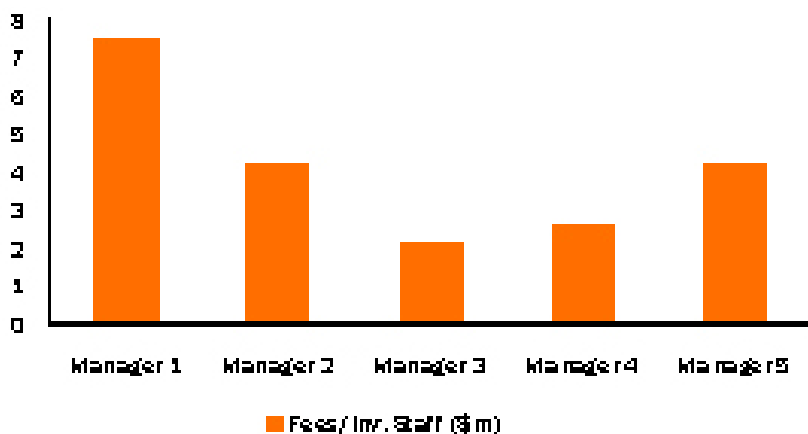
Figure 03 is an example of how a selected group of GPs differs in terms of annual management fees per investment professional on all existing funds, excluding non-management fee sources of GP income.

In this example there is considerable disparity across managers. We therefore need full transparency in terms of total fees earned to understand a manager's economics more clearly. For example, Manager 1 charges no transaction fees whereas this is a significant component of remuneration for Manager 3. Ideally these other sources of income would be removed. If not, fee revenues need to be considered as holistically as possible.

It is important to consider carefully the terms that dictate the management fee calculation as this can make a significant difference to the expected fee level or can weaken alignment of interests. Below are the key terms we believe should become standard moving forward:

- **For the purpose of calculating management fees, the investment period (also termed the commitment period) must end once the GP raises a successor fund and it holds a first closing.** This has become increasingly important as we have seen investment periods being extended to six years for some funds that have recently come to market.
- **Once the investment period has ended, management fees must be reduced significantly and be rebased to the cost of remaining capital employed.** This is particularly important as basing the fee calculation on drawdowns less the cost of realisations essentially means paying fees on fees. We also believe a fair reduction in the percentage basis to be approximately 50%. The cost of remaining capital employed should then be recalculated with the same frequency as that with which management fees are paid.

Figure 03. Example of management fee revenues to staff ratios per annum



Source: Towers Watson, managers

- **All other fees related to the GP's interaction with portfolio companies on behalf of the fund must accrue to the fund.** This includes transaction fees, monitoring fees, any compensation from investment banking related activity and compensation linked to GP professionals assisting a portfolio company, for example, a board seat. This emphasises the need for transparency as to how the GP is being compensated.

Figure 04 reruns the previous analysis assuming the GP raises a successor fund after three years, not uncommon prior to the credit crunch, and that the percentage basis for calculating management fees is halved from 1.75% to 0.875% once the investment period has ended. Again it is important to note that all other fees are excluded.

These terms would reduce the proportion of alpha paid to the GP to approximately 53%. **From the original gross IRR of 20%, the net IRR is increased from 13.7% under our original assumptions to 14.5% in this scenario.**

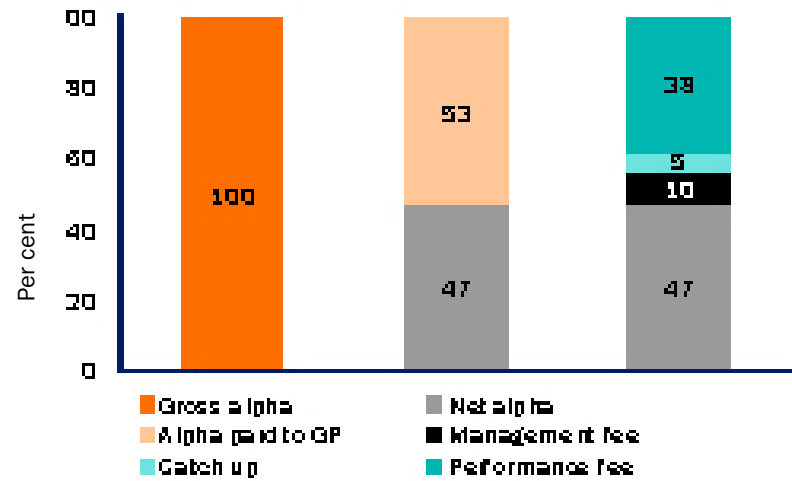
A more fundamental shift that the LP community should consider is management fees being phased in throughout the investment period. Phasing in of management fees minimises the impact of fees being charged on commitments and ensures fees broadly increase as the invested assets increase.

In **Figure 05** we continue the example above but assume that fees are phased in over three years at 0.875% on committed capital in year 1, 1.3125% in year 2 and 1.75% in year 3. As can be seen, this significantly reduces the proportion of alpha that is paid to the GP to approximately 49%, a broadly equal share of the alpha generated. **Relating this to performance, the net IRR is increased to 15% from 13.7% under our original assumptions.**

We should note that, as the gross alpha assumption is increased, the proportion of alpha paid to the GP falls. The converse is true in periods of poor alpha generation. Under the final scenario, gross returns of approximately 27.5% are required for the split of alpha to fall to a 67:33 split in favour of the LP (arguably an equitable split between manager and investor). Under our original assumptions the gross returns required to achieve this split would be 32.5%.

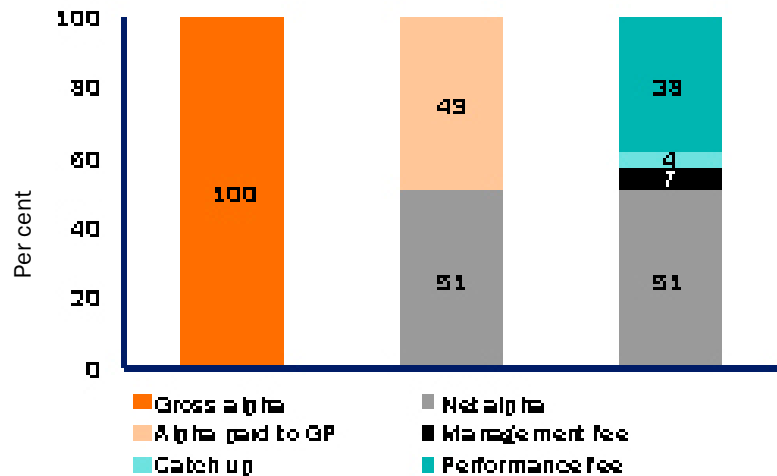
One additional consideration is to assess what proportion of the GP's commitment is being paid via a management fee waiver. Whilst we accept this currently offers tax advantages over committing cash, we do not believe that the GP commitment being largely funded in this way provides the same level of alignment of interests. It increases the GP's need to generate additional sources of income, such as monitoring and transaction fees, which are not in the LPs' interests.

Figure 04. Successor fund raised after three years triggering reduction in management fee



Source: Towers Watson

Figure 05. The split of alpha – management fees are phased in



Source: Towers Watson

Carry and related terms

Carry is an important element in aligning the interests of the GP with its LPs. However, it becomes considerably less powerful where management fees comprise a large part of the GP's compensation. With this covered above, we believe that the manner in which carry is currently structured must be adjusted to better serve LPs who bear a disproportionate amount of the risk. The terms we consider to be most important are:

- **GPs must employ a European waterfall — that is, the LP receives all its capital and its preferred return before the GP receives carry.** This is already largely in place with European GPs and significantly reduces the LP's risk. In contrast, a US waterfall entails carry being paid deal by deal, with the performance of all prior realised and written-off deals included in each successive calculation of carry. The US waterfall calculation leads to problems with the clawback provision. Note that the analysis in this paper is conducted based on a European waterfall.
- According to a paper in The Institutional Real Estate Letter⁴, moving from a US waterfall to a European waterfall has the same effect on net IRRs as shifting from a 20% carry to a 17% carry. Additionally, this represents a significant opportunity cost to the LP as capital used to pay carry early in the fund could have been re-invested elsewhere.
- **Should a GP not consider adopting the European waterfall, carry must be paid into an escrow account with carry recalculated and paid on a predetermined frequency.** We believe LPs should be 'made good' on overpaid carry at regular intervals as opposed to when a fund terminates in order to minimise the issues outlined above.
- **Management fees must be included in the definition of capital contribution in the preferred return calculation.**

Next we highlight two further considerations for LPs, recognising these represent somewhat more fundamental shifts in terms and conditions within the private equity community. We note that these changes would both improve alignment of interests and result in a fairer distribution of proceeds relative to the respective risks taken by GPs and LPs.

- **A preferred return is a very poor substitute for a hurdle, in that it is equivalent to a 0% hurdle if the preferred return and GP catch-up is exceeded.** It provides the GP with an incentive to hold onto otherwise poor investments in the hope public markets will provide some tailwind to achieving the preferred return. This means LPs are often paying for market beta, an issue that

could be avoided with either an equity-linked or 'hard' hurdle – that is, no GP catch-up.

- **An alternative (or potential complement) to a hurdle is to introduce ratcheted carry that is based on multiples as opposed to, or as well as, IRRs.** For example, once the GP achieves its preferred return (or hurdle) it is paid a 10% carry, with this increasing to 20% once a multiple of 2x is achieved and extending to a 25% carry on a multiple exceeding 3x. This ensures the manager is well compensated for significant out-performance, is not overly rewarded for average performance and is not incentivised by an IRR hurdle to exit without meaningful cash on cash returns.

However, as with all of the potential changes to fee structures, LPs need to be watchful for unintended consequences. For example, in the case of ratcheted carry, there could be a danger of creating an incentive to focus on high beta industries and/or to take excessive amounts of risk with LPs' capital.

Other potential areas of concern

There are a number of other areas where we believe the LP community could work more closely together to better align interests. Below is a (non-exhaustive) list of examples of terms that we regularly spend time considering closely:

- Key person provisions, not just which professionals are included, but also voting mechanisms surrounding replacements.
- No fault termination clauses.
- Re-investment provisions.
- Ability to raise successor/similar funds.
- Allocation policies where a manager has more than one family of private equity funds, or funds focusing on multiple asset classes.
- The powers of the LP advisory board and its composition.
- Investment restrictions.

Conclusion

The exponential growth in private equity that occurred between 2004 and 2008 has led to a significant misalignment issue in the industry. This paper provides a summary of the key changes to private equity fee structures that we believe should be considered by the LP community to address this situation. In recognition of the misalignment in the level of risk being taken by the LPs in comparison to the GP, these changes should serve to better align the LP in terms of the proportion of alpha that is being paid to the GP and to ensure the manager is appropriately aligned to generate exceptional performance for its LPs.

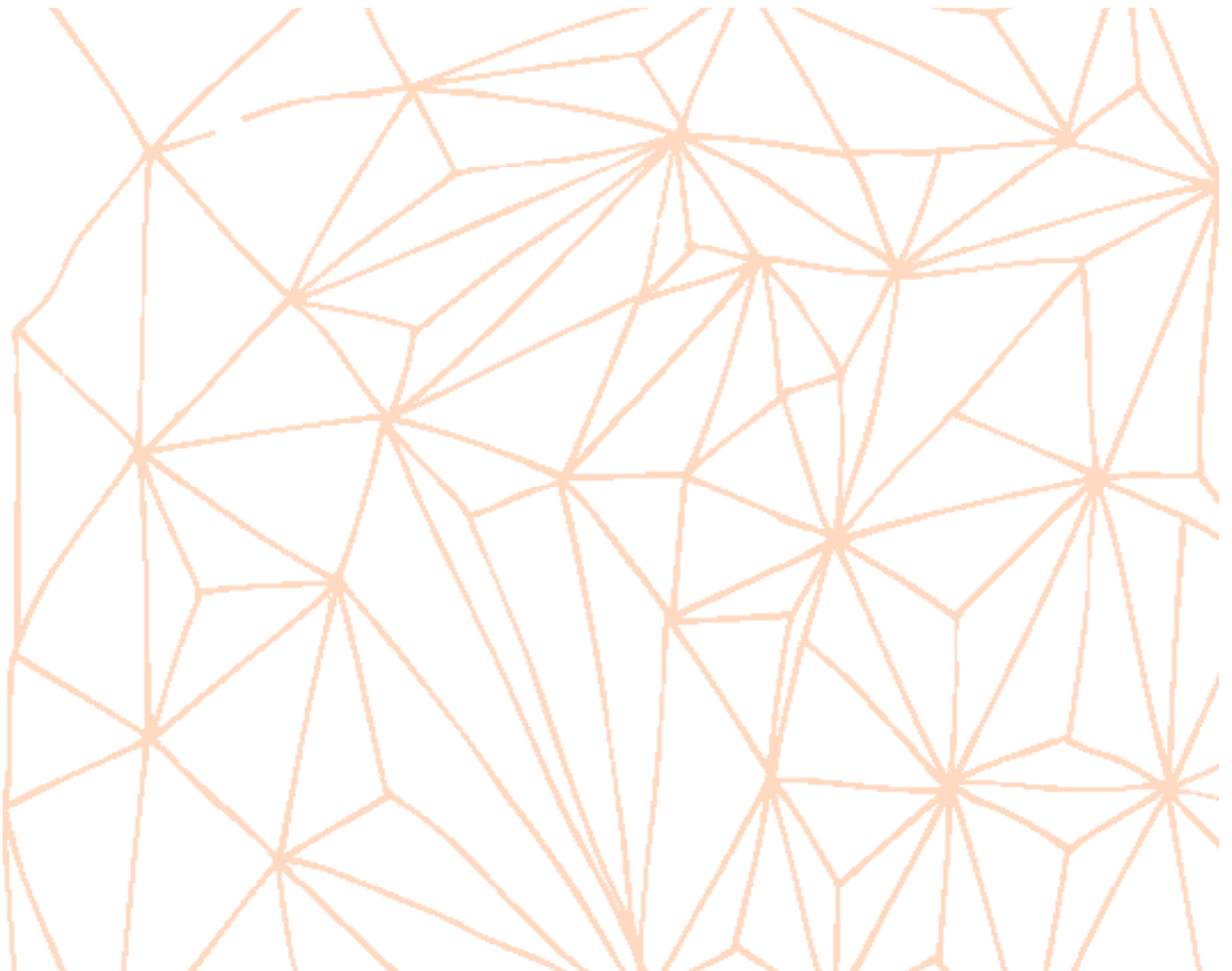
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If you would like to discuss any of the areas covered in more detail, please contact your usual Towers Watson consultant, or

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- 1 'Nothing But Net – Maximising the impact of private equity real estate fund negotiations', by Martin Rosenberg, The Institutional Real Estate Letter, October 2008, www.irei.com

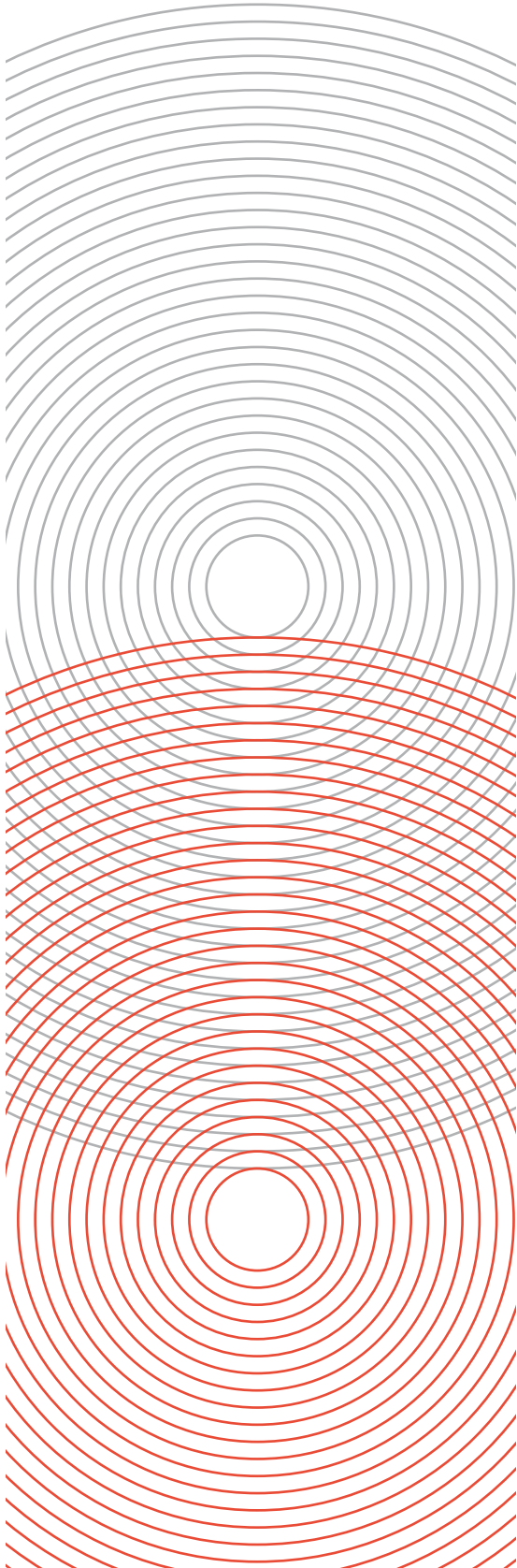


Glossary of terms

Alpha	Performance achieved in excess of a benchmark.
Clawback provision	The mechanism by which overpaid carry is returned to LPs.
Escrow account	An account in which a GP's carry is held prior to carry being recalculated and paid out on a pre-agreed date.
European waterfall	The GP is not paid carry until LPs receive distributions equal to their total contributed capital and a preferred return. Also known as back-ended carry.
General Partner (GP)	The private equity manager.
GP catch-up	After the preferred return is exceeded, this mechanism sees the GP generally receive all distributions until profits are split 80:20 between the LP and GP.
Hurdle rate	The minimum return that must be achieved before the GP is paid a performance fee. The hurdle rate usually means no 'GP catch-up'.
Limited Partner (LP)	Investors in the GP's private equity fund, for example pension funds.
Management fee waiver	The GP waives management fees to cover its commitment to the fund, as opposed to providing a cash commitment.
Management fee offset	The extent to which transaction, monitoring and other portfolio company related expenses paid to the GP are offset against management fees.
Management fee	Fixed percentage paid by the LP to the GP to make an investment into a private equity vehicle, for example 2% per annum based on commitments.
Monitoring fee	A fee paid to the GP by the portfolio company for monitoring work.
Performance fee or 'carry'	Variable fee paid by the LP to the GP for positive performance, for example 20% of profits.
Preferred return	The minimum return that must be achieved before the GP is paid a performance fee, for example an 8% IRR. The preferred return generally involves a 'GP catch-up'.
Step-down	The point at which the management fee calculation adjusts after the investment (or commitment) period ends.
Transaction fee	A fee paid by the portfolio company to the GP upon its acquisition.
US waterfall	The GP's carry is calculated and paid out on a deal by deal basis as each transaction is realised. The split of carry between the GP and LPs is rebalanced either at each subsequent transaction and/or at the end of the fund's life.

Fees in Real Estate

Originally published December 2009 by Watson Wyatt Worldwide



Introduction

For the first time in a number of years we are positive about new investment opportunities in real estate, notably those being offered by certain specialist fund managers. These so-called private equity-style real estate funds (including 'opportunity' and 'opportunistic' funds) appear well placed to take advantage of continued dislocations in property markets, including in over-leveraged portfolios or assets and among distressed sellers. There has been initial interest in these opportunities from higher governance clients who share our belief in the strategic case for long-term diversified real estate strategies, at a time when markets appear to be stabilising. However, as in other alternative asset classes, fees for these types of funds can be very high and complex. In this paper, we outline some of the main fees and terms we have come across and how we would like them to change in order to produce a fairer deal for investors. Although some of the issues identified in this paper are specific to 'opportunity', 'opportunistic' and 'value-add' strategies, the points we raise have wider implications and are applicable to all real estate vehicles.

Fees in private equity-style real estate funds ('opportunity', 'opportunistic' or 'value-add')

Many of these real estate funds that we research are structured along the lines of private equity-type vehicles with fee scales to match. Some of the features of these fee scales include:

- Fees based on commitments rather than invested capital.
- Fees based on gross asset value rather than net asset value.
- High management fees of 1-2%.
- Preferred returns of around 8% although sometimes higher.
- Carried interest of 20% (with potential for it to be paid partly in cash and partly in units of the underlying fund with a suitable lock-in period, for older funds with periodic payment structures).
- 'Catch-up', where the manager takes a proportion of the fund returns (over and above the preferred return) until it receives its target profit share. This may be taken before the investor receives any of its share of the profit or be phased over time.
- Additional fees and charges for example, transaction, development or financing fees, fund expenses and so on.
- Deal by deal payment of performance fees (with capital invested in individual assets returned) as opposed to prioritising the return of all capital first.

Naturally, individual funds structure their fees in different ways and may not include all of the above. In summary, we have reservations about a number of these features.

Fees on commitments

The rationale for fees on commitments stemmed from the days when the industry was immature. A firm raising its first fund needs to have reliable income from day one to remain in business. In addition, some managers argue that charging fees on invested capital would encourage the manager to invest too quickly. However, very few real estate funds are raised by managers who are new to the business and need the steady income to remain in business.

Fees on commitments generate a large part of the 'j-curve' or fee drag of investing in real estate and clients do not like to pay fees on uninvested cash. A well-constructed performance fee should alleviate the risk of putting money to work too quickly and in unprofitable deals.

Therefore, unless there are very strong reasons to the contrary, **Towers Watson would prefer to see real estate fund fees charged on invested equity capital as opposed to commitments although we accept that fees may be charged on commitments during the investment period, especially for newer groups.**

Fees based on gross asset value versus net asset value

Many management fee structures have been calculated on gross asset value, taking into account a fund's total size including its debt exposure. Such a fee basis may encourage managers to use gearing when it may not be most beneficial for the fund, which clearly represents a potential conflict of interest. We believe that fees should be based on equity capital invested. Other funds will charge fees on net asset value, which reduces the issue of rewarding a manager purely for taking on debt. However, such an approach ends up rewarding managers for market-related valuation increases, not only for value added through skill.

Towers Watson would prefer to see management fees calculated based ideally upon equity capital and, failing that, on net asset value but not on gross asset value.

High management fees

Fee levels for more specialised vehicles tend to be in the region of 1-2% per annum. Whilst we would expect modest management fees given that even tracking the real estate market requires a degree of 'active' management, fees which are over 1.5% have the potential to negate any underlying outperformance over the market average in all but the most opportunistic strategies. Our belief is that management fees should just cover the cost of running the fund on a day-to-day basis and should not contain a significant element of profit particularly where there is a profit-sharing mechanism in place.

Towers Watson would prefer to see management fees which reflect the budgeted costs of running the real estate fund.

Preferred return, hurdle rates and catch-up provisions

Not all real estate funds appear to have adopted the same hurdle rate as private equity (often 8%). In our view, the preferred return/hurdle rate should reflect the long-term return for the real estate market as a whole (adjusted for any inherent leverage) so that the manager only earns a performance fee for added value. Preferred returns/hurdle rates should be calculated with reference to the nature of the underlying fund and its relationship to market average, for example a property index or risk-free rate plus a margin.

Towers Watson believes that a lot more thought should go into the setting of a preferred return/hurdle rate that reflects the particular strategy being followed and should ensure that the manager only earns a performance fee if it is generating real outperformance in excess of the market (net of its management fee).

A well-designed performance fee should reward added value not just returning the market average return. Catch-up provisions¹, whether phased in or paid up front, reward both.

Towers Watson believes that in real estate, there should not be any catch-up and that carried interest should only be payable on excess returns above a hard hurdle (taking into account management fees) and not on total returns.

In the event that a catch-up mechanism does exist, it should be appropriately structured and weighted in favour of the investors.

Carried interest

The carried interest proportion, which is typically 20%, is probably not unreasonable if the hurdle and catch-up provision are properly designed. However, we see a number of fee arrangements where the carry does not go to the investment teams which we do not believe aligns interest well.

We believe that a high proportion of the carried interest should go to the team running the fund rather than to the parent organisation.

In addition, we see funds falling into two groups in terms of how and when carry is payable. In the first, carry becomes payable once the investor has received its capital back. In the second, carry is payable either on a deal by deal basis or on a periodic payment structure.

¹ Whereby once the preferred return has been achieved, the manager looks to recoup its share of the overall return achieved rather than just its share of excess returns over and above a hard hurdle.

We believe that performance fee payments (calculated above the preferred return/hurdle) should only be paid once capital plus fees has been returned to investors. Periodic payments might be acceptable for open-ended funds, but these ideally should be calculated on a rolling period basis.

Where periodic performance fees are acceptable, there should be a suitable claw-back mechanism in place with appropriate safeguards (such as placing an appropriate percentage of any fee in an escrow account) to protect investors.

Additional fees and charges

Some real estate funds make additional charges. This is particularly the case for specialist vehicles that follow defined strategies such as 'opportunity', 'opportunistic' or 'value-add' funds. Some are reasonable and relate to the establishment of the fund (although they should always be justifiable), auditing the fund, valuation and so on, and do not benefit the manager. In other cases, the fees are not justified, for example, transaction fees for undertaking the project management of a refurbishment/development and so on, or financing fees. Whilst these have been the traditional practice for a large number of real estate funds, we do not believe they are justifiable as the services provided should be part of an appropriately skilful manager's 'tool box' and covered by the management fee. Should a manager not be able to provide these services 'in house', it may attempt to instruct third parties and recharge the cost. In this case the manager's skills should be carefully examined against the strategy of the fund and the level of the management fee.

Towers Watson's view is that the fund manager should not make incremental charges like transaction, development/project management or financing fees. This work should be covered by the management fee.

In some cases, there will be related-party fees, for example, advisory fees or property management fees charged by other divisions within the fund manager's organisation. These charges would be payable whether or not the fund manager uses its sister company for the advisory work. Such fees should be considered very carefully against the quality of the in-house service being provided compared with using external professionals and the level of fees being charged. The key consideration should be value for money.

Towers Watson's view is that advisory and other fees payable to a related entity should be transparent. A fee scale and the scope of the instruction should be agreed in advance so that benchmarking can be conducted and the actual fees paid should be communicated to both investors and prospective investors on a regular basis.

Summary

We are positive about the strategic case for 'opportunistic' real estate investing as part of a diversified real estate asset strategy for long-term investors with good governance. Unfortunately, the fee arrangements make us much less positive on backing many of the vehicles that are actually available for clients to invest in. We believe it is important to take a 'fund-by-fund' approach to negotiating fees as each situation will be different. However, we must reiterate that certain practices in the real estate industry around terms and fees need to change.

Towers Watson Investment

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Improving Fees in Infrastructure

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Introduction

While we are positive about the strategic case for investing in infrastructure as part of a diversified asset strategy for long-term investors, the fee arrangements make us much less supportive of some vehicles in which clients can invest. As a result, we are more in favour of cheap beta options, such as the low cost PPP/PFI (Public Private Partnership/Private Finance Initiative) strategies, than the abundance of higher fee core infrastructure funds. We are also more positive about higher-return value-added strategies, which verge on private equity, although we recognise that the fees that these managers charge are still very high. The large number of funds in the middle will, despite their strategic attractiveness, be of much less interest until we see a more attractive fee structure for our clients.

In this paper we therefore outline our views on the often complex fee structures involved when investing in infrastructure. Most of the infrastructure funds we research are structured as private equity type vehicles with similar fee structures that include:

- Fees based on commitments rather than invested capital.
- High management fees of 1-2%.
- Hurdle rates of around 8%.
- Carried interest of 20%.
- Full catch-up (sometimes phased in).
- Additional fees and charges, such as transaction or financing fees and fund expenses.

We have concerns about a number of these features and outline the main issues on the following pages.

Fees on commitments

Infrastructure funds have, in many cases, adopted private equity type fee scales. In private equity, the rationale for charging fees on commitments stemmed from the days when the industry was immature. A firm raising its first fund needed to have reliable income from day one to remain in business. In addition, some managers argued that charging fees on invested capital would encourage the manager to invest too quickly. However, in infrastructure, very few funds are raised by managers who are new to the business and the argument for steady income is less compelling. Also, a well constructed performance fee should alleviate the risk of putting money to work too quickly and in unprofitable deals.

Fees on commitments generate a large part of the fee drag of investing in infrastructure and investors do not like to pay fees on uninvested cash.

Therefore, unless there are very strong reasons to the contrary, **we would prefer to see infrastructure fund fees charged on invested equity capital, not on commitments.**

High management fees

Management fees of 1-2% are high relative to traditional active listed equity or bond mandates. Infrastructure as an asset class often generates lower returns than private equity, which is aggravated by charging similar fees. Management fees should just cover the cost of running the fund on a day-to-day basis. Given the size of the funds being raised and the size of the teams involved, we would suggest that, in many cases, infrastructure managers view the management fee as a significant source of profits.

We would like to see infrastructure management fees that reflect the actual costs of running the fund.

Hurdle rates

Infrastructure funds appear to have adopted the same high hurdle rate as private equity funds despite the fact that the asset class is unlikely to generate the same level of return, or involve the same amount of risk. In our view, the hurdle rate should reflect the long-term return for the beta of the asset class so that the manager only earns a performance fee for added value. The hurdle rate should be different for a secondary PPP/PFI fund than it is for a development or more private equity type fund. In many cases the hurdle should be structured around inflation plus a margin or perhaps inflation-linked bonds. **We believe that an infrastructure fund's hurdle rate should reflect the particular strategy being followed and the manager should only earn a performance fee if it is generating alpha.**

Carried interest

A carried interest is probably not unreasonable if the hurdle rate and catch-up are properly designed. However, we see a number of fee arrangements where the carry goes to the firm rather than the infrastructure team, which we do not think is ideal from an alignment perspective. **We believe that the majority of the carried interest should go to the responsible team rather than the wider management firm.**

Catch-up

A well-designed performance fee should reward added value rather than beta. Catch-up provisions, whether phased in or 100%, reward both. **We believe that in infrastructure there should be no catch-up and that carried interest should only be payable on excess returns, not on total returns.**

Additional fees and charges

Many infrastructure funds make additional charges. Some are reasonable and relate to the establishment of the fund, such as auditing the fund, and do not benefit the manager. In other cases, for example transaction or financing fees, the charges are not justified. They appear to have followed the practice of real estate funds but for no justifiable reason. In our view the manager should not make incremental charges such as transaction or financing fees. This work should be covered by the management fee.

In some cases, there will be related party fees, for example advisory fees charged by an investment bank that is connected to the manager. These charges would be payable whether or not the manager uses its sister company for the advisory work. **We believe that advisory and other fees payable to a related entity should be transparent. A fee scale should be agreed in advance so that benchmarking can be undertaken and the actual fees paid should be communicated to current and prospective investors on a regular basis.**

Summary

To demonstrate what we believe to be appropriate fee structures, we outline model fee structures for PPP/PFI income infrastructure funds and for higher return, private equity like funds (that is, closed end funds).

While these examples can be seen as Watson Wyatt's ideal fee structures, we recognise that the individual circumstances surrounding individual funds will need to be reflected in the fee structures.

Given our research process attempts to re-evaluate a manager's ability to generate strong net risk-adjusted returns, our analysis of a fund's fee structure is an important part of our overall assessment of a product.

Fees for infrastructure funds

- **During the investment period** the management fee should be linked to the expenses incurred by the team on running the product, limited to no more than 1% per annum of committed amounts for income infrastructure funds and 1.5% for higher-return targeting infrastructure funds.
- **Post the investment period** the fees are rebased to the acquisition cost of investments. This should not be based on net asset value (NAV) as this incentivises increased valuations. As follow-on funds are raised, the fee level steps down to reflect the revenue (and focus) being generated by other funds.

- For **income infrastructure (PPP/PFI) funds, the carried interest** ('carry') is based on the net yield and should be above a benchmark that links the yield to inflation (for example, inflation plus 4-5% per annum). Carry should be based on three-year rolling cash-flow. There is also no catch-up on the carry, which means it is a true hurdle not a preferred return. The management fee plus the hurdle must be returned before the manager starts taking carry.
- For **higher-return targeting infrastructure funds, the carry** should be based on total return (above a hurdle rate that is appropriate to the strategy employed) with no catch-up. It should be calculated on net cash-flow returned to investors. When carry is earned it will be placed into an escrow account. The management team can access a third of the carry every year and there is a requirement for the total return to continue to be met to access the escrow.
- If this is a fund that can make bids for primary PPP/PFI projects, it is reasonable to split **bid costs** between the management company and the fund.
- If there are **start-up costs** it is reasonable for these to be shared with the fund for first time funds, although there should be no placement agent fees.
- There are **no transaction costs** and all fees earned by the manager in the management of the fund (monitoring fees, break fees) are offset against the management fee.

Towers Watson Investment

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