Evaluating Private Equity Fee Structures

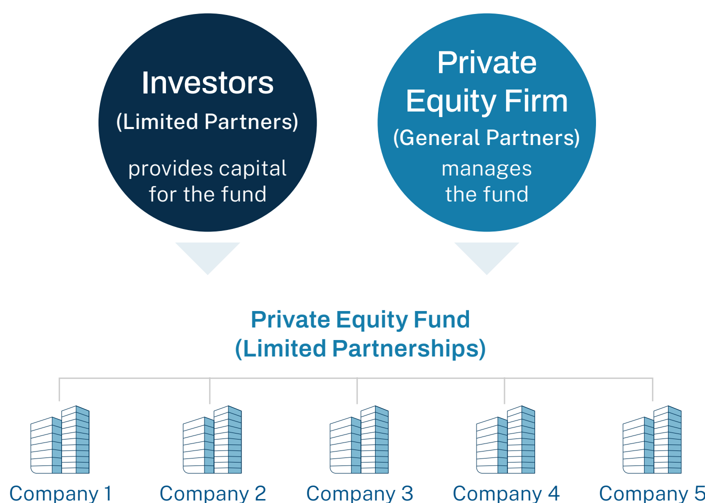
"What about the fees?" is a question that advisors and investors regularly ask when evaluating whether PE makes sense for them. And for good reason – PE fees are quite involved. PE strategies, such as buyouts, are complex and the role that PE firms play in orchestrating and executing these private market investments involves more active management than one might think. Let's review the basics of PE fees to help you evaluate nuances and net costs of PE investing.

WHAT YOU SHOULD KNOW:

- Private equity (PE) fees involve nuance because overseeing private capital requires high-touch active management, including industry-specific research to find and fund the right investments.
- PE firms charge a variety of fees to cover operational expenses and align their interests with those of the fund's investors.
- For some PE funds, such as open-ended (evergreen) funds, different fee types account for monthly or quarterly redemptions and may serve different purposes in a diversified portfolio.

Why Are There Different Types of Fees for Different Private Equity Fund Structures?

There are different types of PE fees to accommodate different alternative investments structures. In general, PE firms charge fees to cover operational expenses and align their interests with those of the fund's investors. Some fees are triggered or paid out based on different investment milestones, sometimes referred to as 'hurdle rates' that PE firms and general partners (GPs) must meet (more on that below). Because the PE investment process typically takes 10–12 years, fees may change based on what stage of the life cycle the fund is in. Here's how it generally works:



First, PE firms or GPs create a fund targeting a specific investment theme like co-investment or secondaries or sector focus like healthcare or emerging technology. Then, they raise capital from limited partners (LPs) such as pensions and family offices. Once the capital has been raised, the GP agrees to invest it in private companies fitting the outlined fund theme, either as a minority or majority share. After the capital is fully invested (typically within three to four years for closed-end funds), the portfolio companies execute the agreed-upon business strategies, such as cost-cutting. Finally, the fund collects the realized returns from portfolio companies that have reached their investment goals and/or were merged, acquired or went public, and then distributes the profits to the parties involved.

This process requires different kinds of fees. And fee structures often vary based on factors such as the size of the fund, the investment theme or sector focus and the negotiating power of the LPs. In general, GPs charge fees because they lead the changes and improvements to increase their portfolio companies' value.

What Are the Most Common Private Equity Fees?

There are three main fee types that PE firms and GPs use to align their success with the success of the portfolio companies in their funds. Below are three types of fees that may impact returns.

A Breakdown of Key Private Equity Fees

	Calculation	% of Committed Capital, Net Asset Value or Profit	Frequency
Management Fee	Calculated as a percentage of the committed capital or net asset value (NAV) and covers operational expenses.	1% - 2.5%	Annually
Net Invested Capital Fee	Following the initial investment period, management fees are customarily based on net invested capital.	0.09% - 2.25%	Annually
Carried Interest	A fee calculated as a percentage of profits above the hurdle rate.	8%	Upon reaching hurdle

Management Fee

As the table shows, these fees have different timeframes and milestones to incentivize investment performance. Management fees are used in PE investments across the board. They account for operating costs incurred by the PE firms and GPs managing the fund. Calculated as a percentage of the NAV, these fees are charged annually until the initial investment period is completed (typically three to four years).

Net Invested Capital Fee

Following the initial investment period, net invested capital fees kick in. These fees pay for the ongoing costs that active managers sustain while administering the fund but are based on a different measurement – the overall amount of money invested in the PE fund. Think of net invested capital fees as the management fees used to administer the fund after the initial investments have been made. Have You Considered Private Market Expenses?

Carried Interest

Finally, carried interest, often referred to as “carry,” is charged when investments reach or exceed a certain predetermined hurdle rate. Hurdle rates vary based on relevant levels of risk and can be used to help companies decide whether or not to pursue specific projects. For example, riskier projects typically have higher hurdle rates than less risky ones. This fee is performance-based and designed to incentivize greater potential returns for both the portfolio companies being managed and the PE firms or GPs managing the fund.

What Other Fees Can Potentially Affect Returns Over Time?

You should also consider any additional fee types which can include, but are not limited to: Clawback provisions, fund expenses and portfolio company fees.

Clawback Provisions

Clawback provisions allow LPs to reclaim some of the carry that they paid to the GP if the fund’s performance declines. For example, if the fund distributes 25% of its profits to the GP in year one, but loses money in the second year, LPs have the potential to claw back some of that performance fee to account for lower returns.

Fund Expenses

More broadly, fund expenses are costs associated with fund operations. They may include legal, accounting or marketing fees, among others. The fund is typically responsible for paying these fees as they are deducted from the fund’s assets. In some cases, funds may separately charge LPs for these expenses in addition to their management fee.

Portfolio Company Fees

Finally, portfolio company fees may be charged for services such as transaction or exit fees. Each of these fees has its own specific parameters, but typically generate additional income for the GP managing the fund. Some portfolio company fees may be used to offset the management fee, while others may contribute to another source of revenue for the fund.

How Do Private Equity Fees Fit into a Portfolio?

As outlined above, PE fees vary. They can change from company to company and fund to fund. For example, traditional, closed-end fund fees are different than those associated with newer fund structures, such as open-ended (evergreen) funds, which invest all of the capital committed to the fund on day one and then allow for monthly or quarterly redemptions. These nuances make it important to understand how each type of fee and fee structure may affect your bottom line. Completing a cost-benefit analysis may help you determine where and how PE fees fit into a particular portfolio.

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