Waterfalling income

GPs establishing debt and infrastructure funds must decide how to treat interest and other income in the partnership

By David Snow

When liquidity comes gushing through the "distribution waterfall", limited partners tend not to care as much about the exact order in which everyone gets paid. But when distributions come out at a more modest rate, the distribution waterfall formula gets far more attention, because small tweaks can make meaningful differences to the net IRR.

The waterfall – shorthand for the order and terms by which distributions are paid to various partners in a limited partnership – is one of several economic terms that are getting increased scrutiny in today's less buoyant fundraising market. In addition to this, the rise of debt funds and infrastructure funds managed by private equity firms has brought the treatment of interest and other types of current income to the fore.

If they are successful, traditional private equity partnerships return capital to LPs mostly in the form of realised investment proceeds. But funds that purchase debt tend to generate consistent interest income. Infrastructure funds, too, tend to generate income – in fact, the current income generated by these funds is among the chief reasons the strategies are now popular.

Just as there generally is no standard distribution waterfall formula for traditional private equity funds, there certainly is no uniform set of terms governing the distribution of interest and other forms of current income for the various types of debt focused funds, says Bruce Ettelson, the head of law firm Kirkland & Ellis' Private Funds Group. "The market continues to evolve and there is a wide range of distribution waterfall structures," he says. "We've done a survey of debt funds and I can tell you that terms vary widely."

Waterfall: performing loans lie upstream

When constructing a distribution waterfall for a debt fund, Ettelson says that GPs first need to decide whether their fund is going to be more "hedge fund-like" or more "private equity-like." Generally, hedge funds tend to target a trading strategy and calculate the GP's incentive allocation at the end of each year. Hedge fund profit allocation formulas typically split all profits, including current income, annually on an 80/20 basis, subject to any preferred return. Debt funds principally focused on historically low return strategies often are subject to a preferred return hurdle.

A fund with a traditional "private equity" strategy typically views its investment activities as long-term business-building exercises, with any dividends or interest income expected to be incidental to long term equity gains. The current income from such funds is more likely to go through a traditional private equity-style waterfall, with current income such as interest and dividends (other than extraordinary dividend income) distributed 80/20 and not first distributed as a return of LP paid-in capital.

According to Ettelson, with the private equity model, the more the target investments are or are like senior secured debt, the more likely that all investment proceeds and interest income distributions are first used to return the investors' cost basis in the applicable investment or sometimes in all investments. The more the target investments are debt investments with the primary purpose of control or influence stakes, the more likely that any regularly occurring interest income will not be distributed as a return of capital.

Limited partners tend to strongly favour any waterfall that prioritises the return of as much capital to them as possible.

Ettelson stresses, however, that not all GPs are of the mind that distributing current income 80/20 is ideal. Many see benefits to using current income to first return capital to LPs because it satisfies the preferred return hurdle. Also, the faster capital is returned to LPs, the better the net IRR. In addition, an earlier return of capital minimises the size and likelihood of clawbacks at the end of a fund's life.

Indeed, clawbacks, which once haunted the venture capital industry, are now a real issue for some buyout funds, which may have overpaid their GPs through dividend recaps only to underperform later on. Ettelson says that, though rare, he has seen an increased request for interim GP clawbacks, an added complexity in the waterfall that calls for a pause halfway through a fund's life to rectify any overpayment of carry that may have taken place as of that time. ■

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