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Who pays for Added Value?

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Are venture capitalists intrinsically delusional? After all, some would argue that a qualifying requirement for the job is to be aspirational, bordering on delusional. That said, there are some conceits to which VCs are particularly prone. For instance:-

- My fund performance is upper quartile;
- This deal has 'home run' written all over it;
- And, most common of all, "we add value"

The concept of venture capitalists adding value is entirely commendable. Indeed, the very best VCs appreciate that success with their investments is down to those elements they can provide in addition to money, such as access to networks, operational skills and exit experience.

So, delusional or not, VCs, their LPs and the ultimate investee companies all believe that value can – and should – be added. But who pays for it?

LPs believe it should be the GP through fund management fees, which is why they allow GPs to charge the fund up to 2.5% annually, but there is continuing downward pressure on such fee levels, particularly in larger funds. In addition, some LPs seek to restrict the level of fees that GPs can levy elsewhere, including transaction fees, monitoring fees and NED fees. Finally, LPs can seek restrictions on raising new funds which can further affect fee income for GPs.

The investee company is probably an innocent victim in this debate. To the extent that they have a view, it will likely be that the GP should bear the cost. The investee has bought the value add story – indeed, it's the reason they chose a particular VC – and believe that it should come as part of the package, along with the funding. Somewhat grudgingly they will accept other fees.

Last, the GP believes that everybody else should pay: the LP through fund management fees and the company through transaction fees, NED fees and monitoring fees.

In truth, though, nobody emerges from the debate with much credit. This is particularly true when considering the following:-

Myopia of LPs – Good GPs need proper remuneration; perhaps not on the scale of investment bankers or Premier League footballers, but certainly at realistic market levels so as to attract talented individuals into the industry. Attempts to overly restrict the ability of GPs to cover their costs are ultimately self-defeating, and this is most apparent when LPs attempt to restrict the ability of GPs to raise new funds. A well run multi-fund GP needs both individual funds of proper scale and the ability to raise new funds on a regular basis. This way, costs which could never be borne by a single fund without compromising returns can be efficiently shared in a multi-fund environment.

Arrogance of GPs – The starting presumption of most GPs is that management in their investee companies needs considerable help, both pre and post-investment, which needs to be paid for by transaction fees and ongoing management fees. But many GPs probably over estimate the degree to which they actually add value. It would be interesting to consider the most successful deals in any fund, and explore the degree to which they actually needed value add. I suspect that more effort (cost and GP management time) is expended on the lost causes than on the home runs.

This persistent problem of who pays runs across the whole PE industry, but becomes most acute with smaller funds and earlier stage investing. This is because earlier stage investing consumes more resource per pound invested than later stage funding. Early stage investing calls for intense involvement by the VC which could involve making a deal investor ready, assembling a management team and taking a company through a number of funding rounds whilst still helping the underlying business to establish itself and grow. There is probably no equivalent elsewhere in PE with the possible exception of turnaround. In addition, early stage GPs often have fewer funds under management, and can struggle to maintain a sensible critical mass of investment management skills and expertise, paid for by fund management fees alone.

In this continuing struggle over fees there is a risk that all parties can lose sight of the ultimate goal: a growing and successful investee leading to a great realisation. Arguments over fees don't add value, while all costs in a transaction ultimately diminish value for everybody. The central question remains whether more value is added than is consumed in fees.

One aspect which can get overlooked in this debate is the importance of carry. Carry should be the ultimate motivator. It aligns the interests of LPs, GPs and the investee companies – and, in well managed funds, keeps GP teams together over the long-term. Fees are, in effect, carry in advance, and a reminder of the relative significance of carry versus fees is long overdue.

We are living in an era of lower general returns and fees can become a significant drag on overall returns. In the increasingly acrimonious debate about fees, all parties might usefully reflect on this.

Ernie Richardson is an experienced VC fund manager who now runs his own advisory business, Eastwood Langley Ltd.