CITCO

2024 WATERFALL GUIDE

The Drawbacks of Clawbacks

A Waterfall guide to mitigating Private Markets clawback risk



January 2024

Executive Summary

Welcome to the Citco group of companies' (Citco's) operational guide for Private Markets General Partners (GPs) on how to mitigate the risks of Limited Partners (LPs) clawbacks in waterfall distributions. The analysis is based on our in-house Waterfall team's wide experience in supporting Citco's overall Private Markets book of clients with more than $800B in AUA, across Private Equity, Private Credit and Real Assets.

In the current climate of geopolitical tensions and rising interest rates, Private Markets managers are facing their most difficult portfolio investment liquidation and realization market in decades, forcing many GPs to significantly delay the realization of their portfolio investments, whether through sale or IPO.

While the largely closed-end nature of these firms' capital structures mostly shields them from the obligation of liquidating investments in order to meet redemption requests, the time-weighting associated with these firms' fee arrangements – in particular the calculation of carried interest – means that the delaying of investment realizations also carries with it significant downside risk, perhaps most notably in the form of carried interest "clawback". To be clear, this is a provision that allows LPs to "claw back" any carry paid to GPs during the life of the fund on previous investment realizations, to ensure LPs receive their agreed return or do not incur a loss.

This guide focuses on the structure and implementation of carried interest waterfall calculations so as to best mitigate the risk of a fund having clawback, as well as to provide a framework for downside scenario modeling in advance of a capital distribution. In particular, it focuses on American-style waterfall calculations - which carry a greater risk of resulting in clawback than the more conservative European-style.

While various structural mechanisms could be incorporated into a fund's Limited Partnership Agreement to hedge against the risk of clawback, this guide focuses on three specific recommendations – on which we have provided detailed support to our Private Markets clients:



Non-time weighted Preferred Return calculations;



European-style expense recoupment provisions;



Carried Interest escrow requirements.

In addition to structural implementations to mitigate the risk of clawback, current market conditions are also compelling a growing number of our clients to realize the increasing importance of including supplemental scenario modeling at the time of a distribution. This helps to assess the risk of future clawback when deciding whether to realize or "defer" carried interest associated with a profitable realization event.

Here we will also discuss three scenario models of increasing interest to GPs that can be incorporated into the capital distribution process in order to mitigate the risk of a future clawback event:



Contemporaneous unrealized waterfall calculations;



"Zero Proceeds" waterfall calculations;



"Loss-to-Clawback" analytics.

While the practice of mitigating clawback risk in waterfall distributions is still in its relative infancy in the Private Markets sector, its importance is growing: Citco has seen a 35% increase in overall enquiries and active support on clawback risk in 2023 alone.

Finally, it is important to note here that the process of mitigating clawback risk does not disadvantage LPs in any way. In fact, as you will read in this guide, the opposite is true: having a defined process for clawback mitigation provides both GPs and LPs with an enhanced framework for transparently managing waterfall distributions - saving both parties the complication of enforcing clawbacks post-tax, thereby preserving the GP-LP relationship. Also, given the SEC's Private Fund Reporting Rules requirement to enhance reporting to LPs on GP and LP clawbacks, these pre-emptive measures can only be seen as a positive outcome.

Should you wish to discuss any of the details contained herein, please do not hesitate to contact our Waterfall team directly on teberle@citco.com

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Citco Fund Services (USA) Inc.

1. American-style waterfalls: the “GP friendly” option still popular with LPs

Broadly defined, a Private Markets “waterfall” is a sequential series of calculations determining which proceeds associated with a realization event are distributed to the fund’s LPs, and which proceeds are retained by the fund’s GP as a form of incentive fee known as “carried interest”. While waterfall calculations are by their nature bespoke and nuanced, they will generally fall within the hierarchy of either the “European” or “American” style.

European-style waterfalls prioritize LP distributions until they have recouped their aggregate capital contributions and the associated preferred return in a fund overall before the GP is eligible for an allocation of carried interest. In contrast, an American-style waterfall is applied to individual investment deals – or on a “deal-by-deal” basis – rather than to the fund overall, allowing the GP to realize carried interest on individual profitable realizations once the LP has received their “hurdle rate” or preferred return.

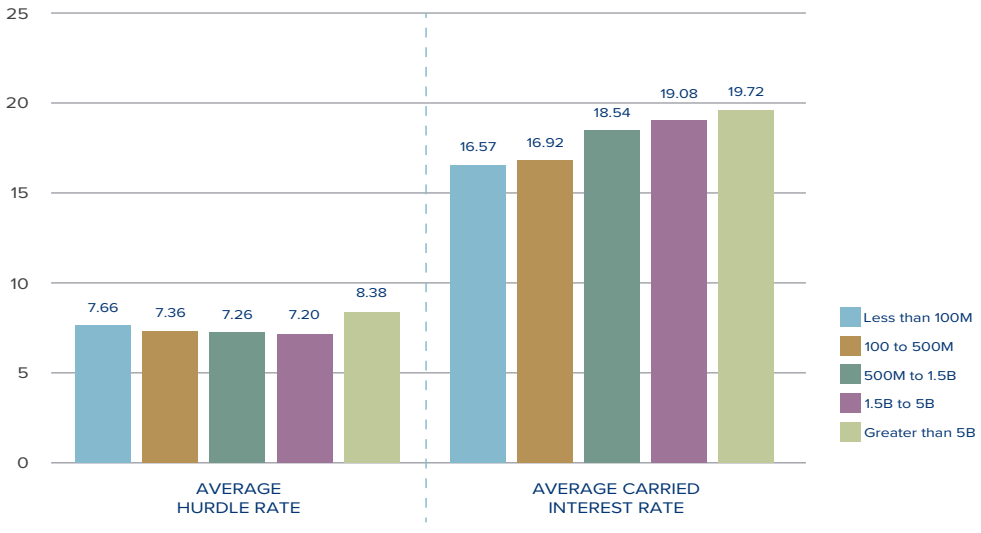
The obvious benefit of the American-style waterfall is the acceleration of carried interest to the GP, potentially allowing for the realization of carried interest years in advance of funds with comparable investment performance but with a more conservative, European-style fee arrangement – which, again, prioritizes LP distributions.

While American-style waterfalls are generally regarded as “GP friendly” fee structures, the incorporation of an American-style waterfall into a fund’s capital structure does not seem to represent a significant deterrent to LP capital commitment.

Indeed, Citco has identified a statistical correlation between fund size - when measured as a function of LP commitments - and the incorporation of American-style waterfall structures [read our Size Matters Report by clicking here]. However this could be due to the above-market performance of funds adopting said structures.

AVERAGE HURDLE RATE AND CARRIED INTEREST RATE BY FUND SIZE

As fund size increases, the average hurdle rate decreases and the average carried interest rate increases. This suggests that larger funds are able to attract investor capital while maintaining GP-friendly terms.



2. Overview: the drawbacks of clawbacks

For all of their advantages, however, the "pay as you go" nature of the American-style waterfall calculation does carry with it a significant risk – namely, the risk of LP "clawback".

While clawback terms are contractually negotiated and thus bespoke, the term "clawback" can be broadly defined as a situation in which the GP has been allocated more than a defined percentage – usually 20% - of fund profits as carried interest. For funds utilizing an American-style waterfall calculation, clawback will generally occur in instances where the GP has been allocated carried interest as a result of an early realization or income distribution, and then realized a subsequent investment unprofitably.

Despite being colloquially referred to as "deal-by-deal", American-style waterfall calculations generally include cross-collateralization provisions in which losses from underperforming investments must be recouped using proceeds generated from the realization of other fund investments. This ensures that, on an inception-to-date basis, the LP does not pay an incentive fee in excess of 20% of realized fund profits.

The implications of clawback are significant, becoming more so as the fund nears the end of its harvest period. If a fund is in an "interim clawback" situation early in the fund's lifecycle, there is generally no obligation for the GP to immediately return carried interest to the LP.

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However, at the fund's liquidation - or, in some instances, at certain "test points" along the fund's lifecycle - the LP's Limited Partnership Agreement (LPA) may provide them with legal recourse to "clawback" excess carried interest paid to the GP, which carries with it not only financial but also reputational and industry risk.

Further complicating the issue is the fact that most clawback provisions only apply to the "post tax" value of carried interest realized by the GP, meaning that, on a dollar for dollar basis, the LP may never be truly compensated for carried interest paid in excess to the GP.

However, while the risks of clawbacks are real and deserving of consideration - especially given current market conditions - there are both structural and practical measures which can be taken to significantly mitigate these risks.

While various structural mechanisms could be incorporated into a fund's LPA to hedge against the risk of clawbacks, here we focus on three specific areas – on which we have provided detailed support to our Private Markets clients:

- Non-time weighted Preferred Return calculations;
- European-style expense recoupment provisions;
- Carried Interest escrow requirements.

3. Non-time weighted Preferred Return calculations
Or Preferred Return as Multiplier On Contributed Capital

Almost exclusively, American-style waterfall calculations mandate that the LP receive a prioritized allocation of proceeds - in excess of their return of realized capital contributions - before the GP is eligible to receive carried interest. This allocation, known as “preferred return”, ensures that the LP will have achieved a guaranteed minimum rate of return on their realized contributions prior to paying an incentive fee to the GP.

There is significant variability in how preferred return is calculated across Private Markets funds, however, the majority of preferred return targets are calculated as compounding rates of return - with the majority of those being calculated as some version of an annually compounded Internal Rate of Return.

While the intention behind the compounding nature of preferred return is to compensate the LP for the time value of their contributed capital, an environment of rising interest rates - in which liquidations are becoming increasingly difficult - poses perhaps the greatest risk for clawback in the current moment.

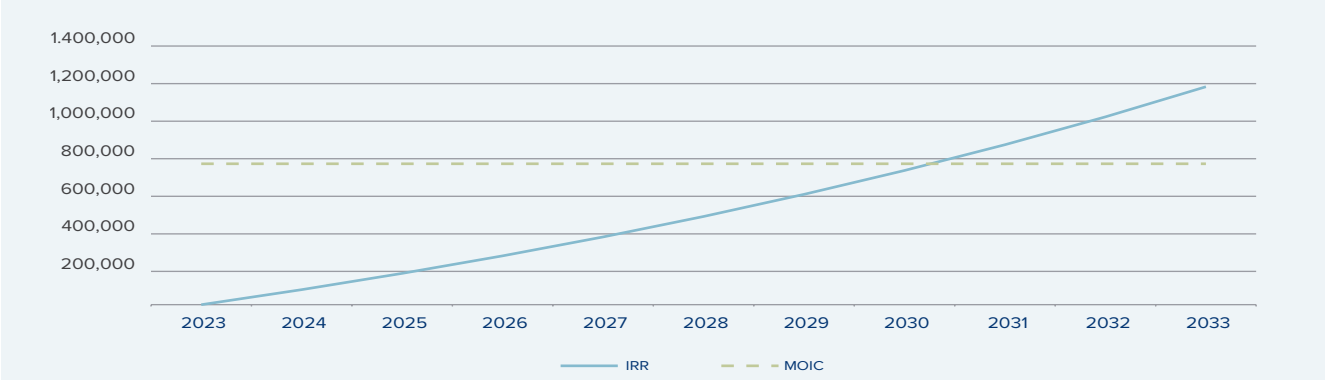
For example, a fund may realize carried interest on a distribution or income event early in its lifecycle, but then be forced to retain ownership of one or several portfolio companies past their optimal IPO or sale dates, due to a challenging IPO environment or an inability to find a partner with financing sufficient to complete a transaction. If so, the preferred return accruing on those investments may effectively eliminate all future profits on said deals when they do eventually realize - despite potentially realizing at significant multiples. In this instance, the likelihood of an interim clawback on the earlier carried interest distribution is all but ensured.

A preferred return structured as a multiplier on contributed capital (MOIC) would have the effect of reducing the time pressure on the GP, affording them the potential to increase the value of their portfolio companies without the risk of having those additional profits eroded by a compounding preferred return requirement. In this structure, preferred return would be calculated as a multiple on capital contributed for individual investments that would not increase over time, effectively setting a static target return on a deal-by-deal basis - with maintaining the aforementioned cross-collateralization provision.

While this structure certainly does not eliminate the risk of clawback, it gives GPs the ability to realize carry on profitable realizations, while providing a mechanism to mitigate future clawback risk in adverse macroeconomic conditions.

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PREFERRED RETURN AS IRR VS MOIC



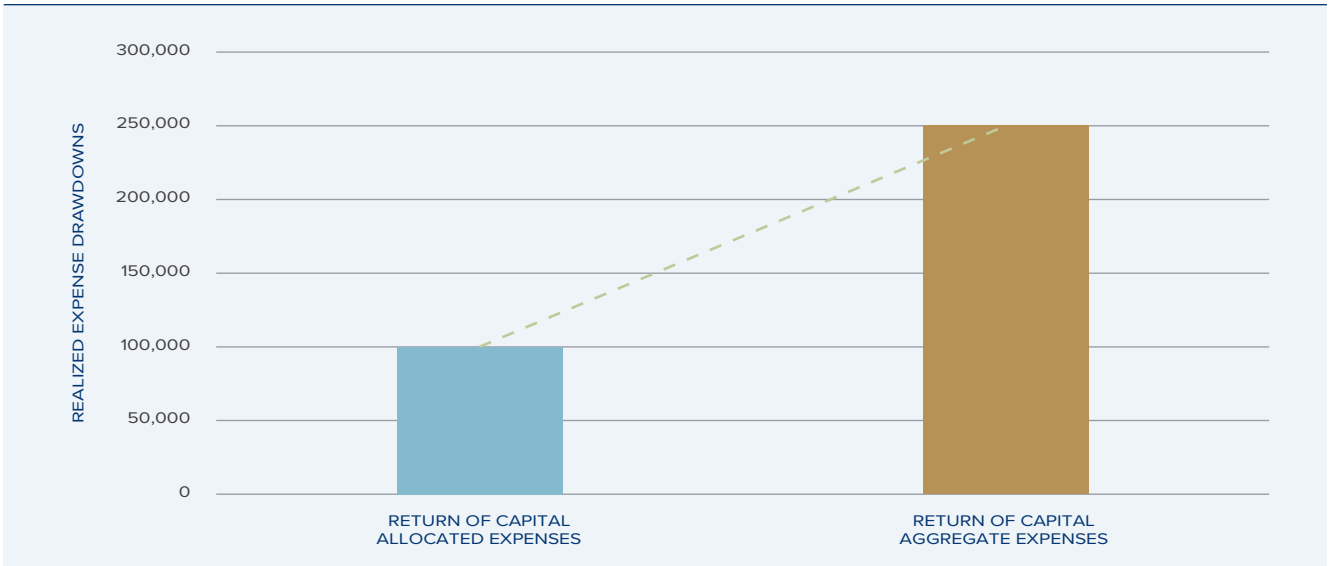
4. European-style expense recoupment provisions
Or Return of Aggregate Expenses

The mechanism by which LPs recoup capital contributed for the purpose of paying fund-level expenses – such as Management Fees, Organizational Expenses, Legal and Administrative Costs - provides an additional structural mechanism by which to accelerate distributions to the LP, and thus hedge against clawback.

In a traditional American-style waterfall structure, capital contributed for expense payments is recouped proportionately to capital contributed for realized investments. As a percentage of a fund's investment portfolio is realized over time, a proportionate percentage of the fund's expenses are likewise "realized", ensuring that when a fund's investments are fully liquidated, the LP recoups their total capital contributions used for expense payments as well as those used to fund portfolio investment activity.

However, an American-style waterfall structure, in which all expense contributions are effectively "realized" on the date of their associated capital call (an increasingly common LPA provision), ensures that the LP will recoup their total calls for fees and expenses prior to the GP being eligible for an allocation of carried interest. This acceleration of proceeds to the LP – when compared to a more traditional American-style waterfall – has the effect of incorporating a European-style waterfall provision into the fund's capital structure, effectively delaying carried interest to the GP and providing some clawback protection in the event of subsequent investment underperformance.

ALLOCATED VS AGGREGATE EXPENSE RECOUPMENT



5. Carried Interest escrow requirements

In and of themselves, carried interest escrow provisions – in which a portion of carried interest otherwise distributable to the GP is held in a segregated reserve account for a period of time – do not necessarily mitigate the risk of clawback.



As the carried interest held in escrow has been realized by the fund (and thus not "deferred" via an accelerated distribution to the LPs), carried interest held in escrow could still be subject to GP clawback. The benefit of codifying escrow provisions into a fund's LPA is the provision of a mandated mechanism which ensures that, in the event of clawback, there are dollars available to compensate the LPs in an efficient manner, thus avoiding perhaps the most contentious aspect of clawback implementation – in which the carried interest to be clawed back has already been distributed to the GP members as compensation. Contractually mandating that a portion of carried interest – as opposed to total carried interest – be held in escrow until such time, as the risk of clawback is mitigated by fund performance, would allow for the potential appeasement of LP concerns while maintaining the core nature of an American-style waterfall calculation.

6. Scenario modeling to mitigate risk

In addition to the aforementioned structural implementations to mitigate the risk of clawback, current market conditions are also compelling a growing number of our clients to realize the increasing importance of including supplemental scenario modeling at the time of a distribution. This helps to assess the risk of future clawback when deciding whether to realize or "defer" carried interest associated with a profitable realization event.

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"Deferred carried interest" refers to the distribution of proceeds that would otherwise be allocated to the GP as carried interest to the LP, effectively distributing to the LP proceeds in excess of what they would be required to per the terms of their American-style waterfall.

Carried interest deferral does run the theoretical risk of accelerating proceeds to the LP past the point of which they may be fully recouped by the GP in subsequent distribution events. However, the inception-to-date nature of waterfall calculations, coupled with detailed scenario modeling and careful cash management strategies, can ensure GPs will be able to recoup their deferred carried interest throughout the fund's harvest period.



Here we will discuss three scenario models which can be incorporated into the capital distribution process in order to mitigate the risk of a future clawback event:

- Contemporaneous unrealized waterfall calculations;
- "Zero Proceeds" waterfall calculations;
- "Loss-to-Clawback" analytics.

7. The power of hypothesis

The Unrealized ‘Hypothetical’ or ‘Contemporaneous’ Waterfall

An American-style waterfall calculation does not require that the LP be allocated proceeds sufficient to recoup their capital contributions used to fund investments that are unrealized at the time of a distribution. However, the calculation of an unrealized/ hypothetical waterfall at the time of a capital distribution provides a mechanism by which the GP can incorporate unrealized performance into the decision as to whether or not to defer carry that it would otherwise have been eligible for.

An unrealized waterfall calculation - sometimes referred to as a “hypothetical” or “contemporaneous” waterfall calculation - assumes a scenario in which all unrealized investments are run through a waterfall calculation as of a defined liquidation date, contemporaneously with all historical capital distributions. The unrealized investments in the contemporaneous waterfall are assumed to have been liquidated at their current fair market values, as a proxy for the proceeds that would have been generated had the deals been liquidated through a realization event.

In this scenario model, unrealized investments will create waterfall “targets” that must be recouped using proceeds, either realized or unrealized. An unrealized investment may not appreciate sufficiently for its own fair market value to “recoup” its cost basis, allocated fund level fees and expenses, and associated preferred return. In such a case, those targets will need to be “recouped” using proceeds from historical cash distributions - owing both to the inception-to-date nature of waterfall calculations generally, and the cross-collateralization requirements of waterfall calculations specifically. This will have the impact of reducing inception-to-date profits generated by the fund and, accordingly, the inception-to-date carried interest that the GP would be eligible for had the liquidation assumptions held true.

While a fund would generally not be mandated to defer realized carried interest as the result of an unrealized contemporaneous waterfall calculation, this calculation provides a strong indication of the likelihood of a future clawback event given current available information and valuations. As the GP will generally be permitted to defer any realized carried interest for which it would have been otherwise eligible, this scenario model provides a quantitative aspect to the carried interest deferral decision making process.

Additionally, running this same calculation - but for future date parameters - can help to compensate for the additional preferred return accruals that may be accrued due to future macroeconomic events.

8. The Zero Proceeds Waterfall

A more conservative form of the unrealized scenario model is the "Zero Proceeds" scenario model, in which all unrealized investments are projected to be liquidated at no value at the time of a cash distribution. To the extent that realizing carried interest through this mechanism would result in clawback, the delta (or a portion of the delta) between inception-to-date realized carried interest and the carried interest that the GP would be eligible for via the "zero proceeds" calculation is accelerated to the LP as a deferral of carried interest.

In the early stages of a fund's lifecycle, this calculation effectively mirrors that of a European-style waterfall, significantly delaying carried interest to the LP. In practice, a strict adherence to the "zero proceeds" mechanics would ensure that the GP would not realize any carried interest until such time as the LP has been allocated proceeds sufficient to cover not only their realized capital contributions, allocated fees and expenses, and preferred return, but also sufficient to cover all future losses.

While the "zero proceeds" calculation, if fully implemented, would effectively eliminate the risk of clawback, it also runs the risk of "over accelerating" proceeds to the LP, such that there may not be significant enough proceeds associated with liquidating investments to allow the GP to recoup all of the carried interest that they have deferred but are entitled to.

Ironically, this could lead to a situation in which the GP may be entitled to "claw back" carried interest from the LP, or draw-down a portion of an LPs un-funded commitment to compensate for the carried interest deficiency. Thus, a "zero proceeds" calculation must be coupled with a careful portfolio management strategy, in order to ensure its successful implementation.

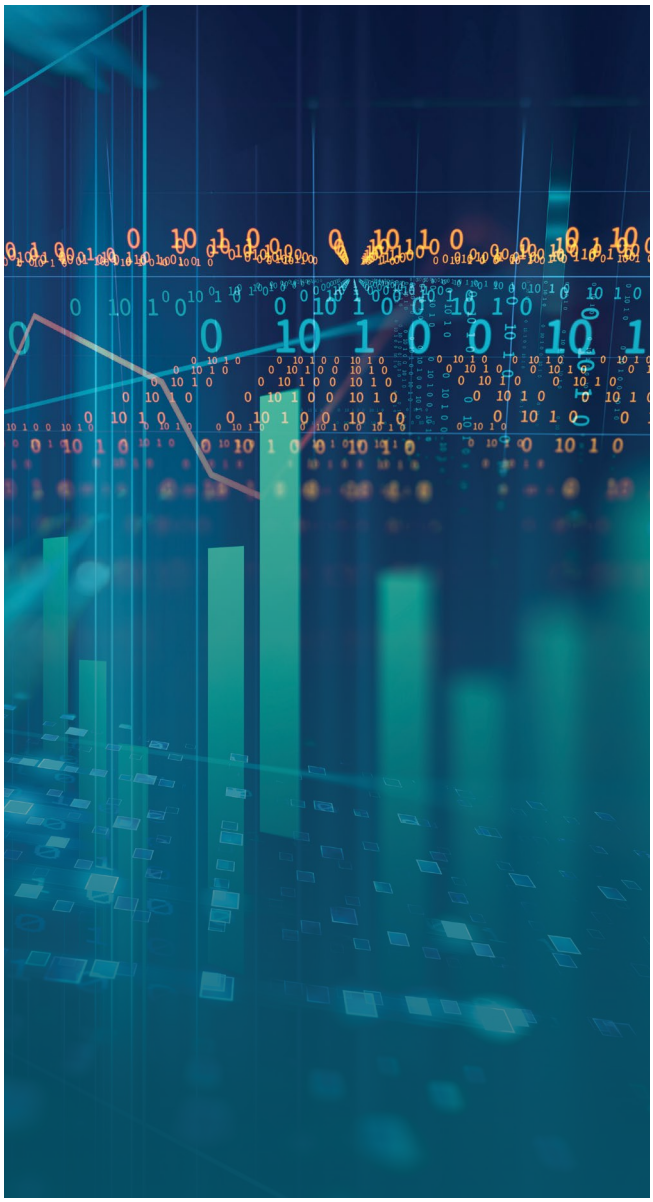
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REALIZED CONTRIBUTIONS	$50,000,000
UNREALIZED CONTRIBUTIONS	$75,000,000
REALIZED DISTRIBUTIONS	($60,000,000)
CURRENT FMV	($76,500,000)

	CASH WATERFALL	CONTEMPORANEOUS WATERFALL	ZERO-PROCEEDS WATERFALL
Proceeds	$60,000,000	$136,500,000	$60,000,000
ROC - Target	$50,000,000	$125,000,000	$125,000,000
ROC - Allocation	$50,000,000	$125,000,000	$60,000,000
Remaining Proceeds	$10,000,000	$11,500,000	$-
Preferred Return - Target	$4,000,000	$10,000,000	$10,000,000
Preferred Return - Allocation	$4,000,000	$10,000,000	$-
Remaining Proceeds	$6,000,000	$1,500,000	$-
GP Catch-Up - Target	$1,000,000	$2,500,000	$2,500,000
GP Catch-Up - Allocation	$1,000,000	$1,500,000	$-
Remaining Proceeds	$5,000,000	$-	$-
LP Promote	$4,000,000	$-	$-
GP Promote	$1,000,000	$-	$-
Total GP Carried Interest	$2,000,000	$1,500,000	$-
Deferred Carried Interest	$-	($50,000,000)	($2,000,000)

9. Loss-to-Clawback Analysis

Whether at the time of a capital distribution or intermittently throughout the life cycle of a fund, GPs would be well advised to incorporate a “loss-to-clawback” analysis into their American-style waterfall calculations. Broadly speaking, a “loss-to-clawback” analysis calculates the negative dollar value - taking into account expense allocations and preferred return accruals - which would be required for a realized clawback event to be triggered.



Unlike the unrealized contemporaneous and zero proceeds scenario models – which run unrealized “proceeds” through a waterfall structure to determine if clawback would result should those liquidation assumptions hold true –, a “loss-to-clawback” analysis calculates the true “excess value” available to a fund before a clawback event would be triggered. This “excess value” can then be compared to the unrealized performance of investments in a fund’s portfolio, truly quantifying the risk of clawback at a specific point in time.

Unlike the unrealized contemporaneous and zero proceeds scenarios, which take as their starting point projected future liquidation values, the “loss-to-clawback” calculation provides a real-time data point which can be incorporated into capital management decisions. However, the “loss-to-clawback” concept could similarly be applied to the above scenarios, providing perhaps the most detailed metrics to gauge the risk of future clawback and assist with proactive mitigation strategies.

10. How Citco can support

While all of the above strategies are of great benefit to GPs and their LP stakeholders, the complex and bespoke nature of American-style waterfall calculations requires technology solutions to be employed to execute these strategies with the level of accuracy required for them to be of true benefit.

Citco's Waterfall™ tool offers all GPs – whether a fund admin client or not – the ability to customize and calculate forward looking investor distributions and carried interest scenarios, as well as be guided through various 'what if' scenarios, via a proprietary, built-to-purpose technology solution.

Enhancements to Citco Waterfall™ tool now allow clients direct access to the application, for the purpose of modelling and executing forward looking liquidation scenarios. Through this "self-service" add-on, clients have the ability to execute complex carried interest projections through an intuitive, step-by-step user interface, which is configurable to allow for multiple liquidation parameters within a single distribution event. Additional enhancements to Citco Waterfall allow for the administration of complex carry-plans, in which fund-level carried interest is allocated to the GP Partners based on bespoke ownership percentages, individual deal grants and vesting schedules.

Should you require any support, please do not hesitate to contact our Waterfall team directly on teberle@citco.com

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