First-time Funds Series – Video #8: Distribution Waterfall

SPEAKERS

 Cameron D. Koziskie

 Lauren Hulme

06:03

In the eighth video of our first-time funds series, Cameron Koziskie and Lauren Hulme of our Private Equity practice unpack the basics of distribution waterfalls—the set of rules that establish the economic sharing of profits and losses in a private fund.

Our team discusses key considerations, including:

- dynamics of distribution waterfalls in current market practice; and
- navigating the four tiers that waterfalls typically include: return of capital; preferred return; catch-up; and carried interest.

Stay tuned for the next episode of our first-time funds series on remedies.

Click here to visit the main First-time Funds Series page.

Video Transcript

Cameron Koziskie (00:05): Hi, everyone. I'm Cameron Koziskie, a partner in the Private Equity Group here at Torys. I'm delighted to be here today to discuss the basics of distribution waterfalls with my colleague, Lauren Hulme.

Lauren Hulme (00:17): Hi, everyone. I'm Lauren Hulme, a Senior Associate in our Private Equity Group. I'm really looking forward to discussing this important topic with Cameron today, as waterfalls are one of the trickier topics in private funds and one where there is often the most amount of questions from our clients. As of course, waterfalls relate to the economics and the economics are what everyone cares about at the end of the day. Perhaps, Cameron, we could start with you giving us an overview as to what a waterfall is actually all about?

Cameron Koziskie (00:49): Absolutely. Thanks, Lauren. When people talk about a "waterfall", that's really jargon for the set of rules that establishes the economic sharing of profits and losses in a private fund. Funds are typically structured as limited partnerships. Investors, as limited partners, put up the capital that's invested. The sponsor and the team put up a little bit of capital—we call that "skin in the game". But the sponsor's main role is to be the group doing the work. To reward that work, and to incentivize the sponsor to do a good job and earn a strong return, the sponsor typically gets a share of the profits, which is what we refer to as the carried interest. There's a delicate balance of rewarding investors fairly for putting their capital at risk, and rewarding the sponsor for doing a good job investing and managing that capital, and the waterfall tries to strike that balance. What we typically see in the market is a four-tier cascading waterfall, with each tier serving a particular function and the tiers in totality working to achieve that balance of rewards to investors, and rewards to the sponsor. Lauren, I'll turn it over to you to discuss the first tier in the waterfall.

Lauren Hulme (02:10): For sure. Thanks, Cameron. So the first tier of the waterfall is called the "return of capital." This tier reflects the fact that investors put up hard cash before the sponsor has done any work to generate returns. As a result, investors expect to get their dollars back before the sponsor sees any carried interest. Now, the scope of the return capital in this first tier depends on the type of waterfall that the fund is using. Generally, being either a return of capital waterfall or a deal-by-deal waterfall. However, most commonly for first-time funds in Canada, the first step of the waterfall provides that 100% of distributions go to investors until they have recovered all of their capital contributions to the fund.

Cameron Koziskie (02:57): Thanks, Lauren. That's helpful. Moving on now to the second tier. This second tier is called the "preferred return," and it serves a slightly different function. Investors generally have a view that their capital has an "opportunity cost", in that investors could have put their money to work elsewhere. As a result, investors want to receive some profit first beyond just the return of their capital, as Lauren described in tier one, before money is paid out to the sponsor as carried interest. People also call this the hurdle. So after investors have received their capital back through tier one, the second tier generally provides that 100% of further distributions go to investors until they've received a preferred return on their investment. Market has historically calculated that preferred return at a rate of 8% per annum. However, we do see some variation from time to time, and the rate would certainly be in the range between 6% per annum and 9% per annum.

Lauren Hulme (04:06): Completely agree, Cameron. Now let's move on to the next tier of the waterfall, which is the third tier called the "catch-up". I would say this is the most complicated tier to understand in this tier. After investors have received their capital contributions back in the first tier and earned a preferred return on their investment in the second tier, most typically here, 100% of distributions will go to the sponsor until it receives 20% of the profits distributed to date. This effectively allows the sponsor to catch up in respect of getting a return, as to date the dollars have just gone to investors that have put in capital. This tier reflects the principle that if the sponsor has done a good job, the sponsor really should share in the profits earned since that first dollar distributed.

Cameron Koziskie (04:57): Thanks, Lauren. I'll now describe the fourth and final tier, which is called the "carried interest" tier. It's actually a relatively simple tier, in that after distributing cash through the first three tiers, whatever cash is left over, the remaining profits get shared by the partners, generally 80% to investors and 20% to the sponsor and the sponsor team. Again, the principle here is that the sponsor did a lot of work to generate profits, and therefore the sponsor should be rewarded accordingly.

Lauren Hulme (05:33): Thanks, Cameron. So that concludes this little video on the basics of waterfalls. Hopefully it was a helpful primer and either Cameron or I would be happy to discuss any questions you may have.

Cameron Koziskie (05:46): Terrific. Thanks again. In the next video, our colleagues Aaron and Batya will discuss LP Remedies. Thanks so much, and we hope you're enjoying the series!

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