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Study: Exchanging fees for carry bad deal for GPs

The average GP does not benefit from lowering their management fee in exchange for a greater share of carried interest, according to fresh research.

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GPs tend to lose money when lowering their management fee for a promise of higher carried interest, according to research soon to be published by Cyril Demaria of the University of Sankt-Gallen in Switzerland.

Pressure from investors on the industry standard ‘2-and-20’ model in management and performance fees has forced firms to think about different fee arrangements. Bain Capital and KPS are two notable examples of firms offering their investors a menu of options on carry and fees.

Demaria examined distributions from 626 leveraged buyout funds with vintages between 1984 and 2001 to tease out how various fee arrangements would impact GPs' total compensation.

When assuming a 1.5 percent management fee and 20 percent carry allocation, the research showed the average GP would receive $68.3 billion between 1984 and 2001. In comparison, GPs using the 1-and-30 structure would receive a lower $66.5 billion in total.

In an interview with sister publication *PE Manager*, Demaria stressed the numbers reflect averages, meaning top quartile GPs would likely benefit from exchanging fees for performance-based carried interest payments.

Demaria's study also explored the effect of paying less in management fees and giving away a greater carry percentage on LPs.

Demaria found LPs were better off reducing the management fee and giving GPs more carry, but only just. LPs would have received $77.5 billion using the 1-and-30 model, whereas they would have received $75.8 billion using the 1.5-and-20 between 1984 and 2011.

“The 1-and-30 is slightly, but very minimally, more interesting for LPs,” said Demaria. “But the increase of the variable compensation [carried interest] captures more or less what the LPs could have gained [in management fee savings].”