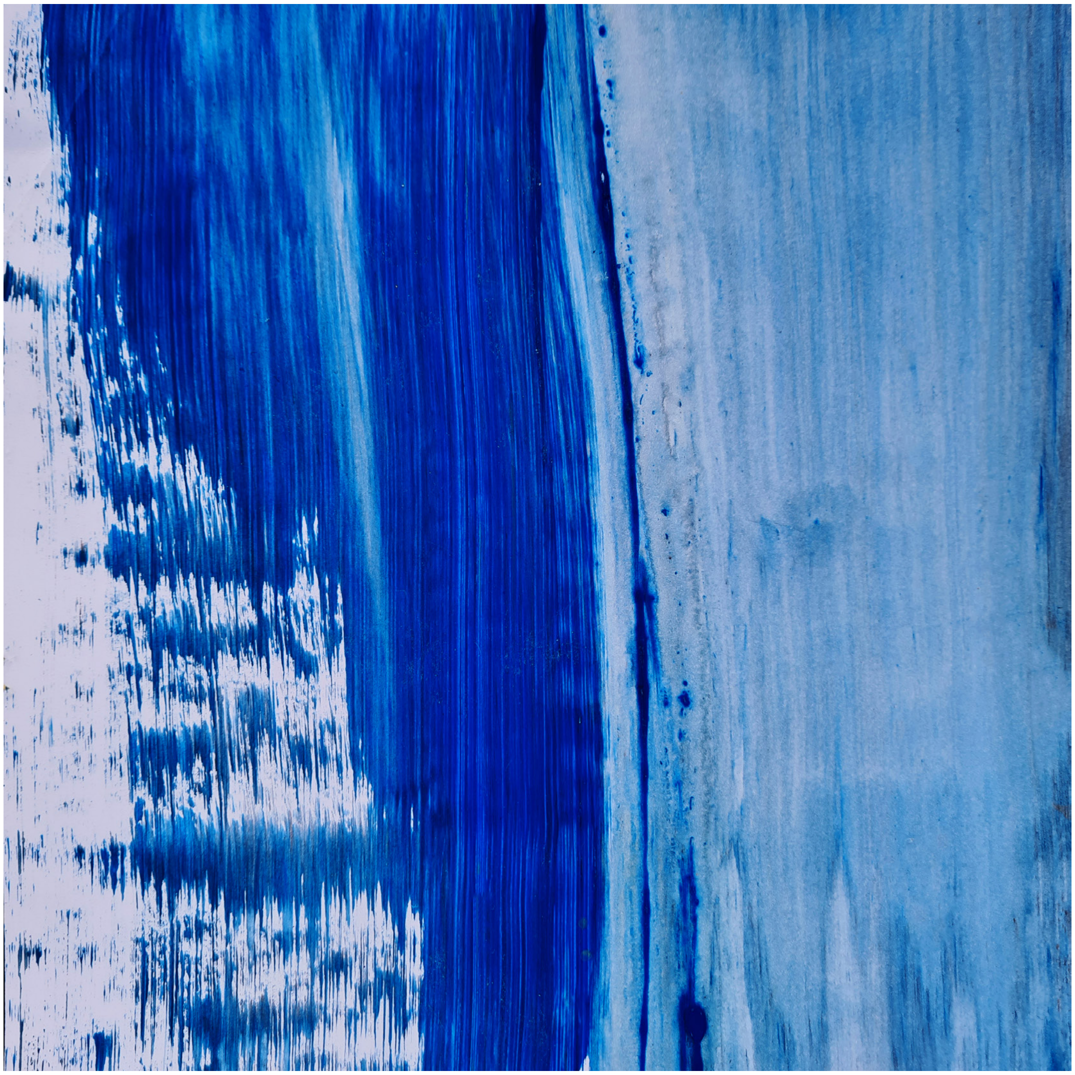
CITCO



CLAWBACK CONVERSATIONS

A look at GP attitudes and preferences when it comes to waterfall structures and clawback risk.

PRIVATE EQUITY WIRE

- A fifth of firms are experiencing higher clawback risk
- Firms are hesitant to push on clawback negotiations with LPs
- A mixed bag of strategies are at play to mitigate clawback risk

A persistently muted deal landscape, resulting from skyrocketing debt costs and widespread macro-economic uncertainty, have steadily upped the pressure on private equity GPs over the past two years.

Caught between demands to return LP capital and the need to realise the value of their investments, firms have leveraged short-term financing solutions, semi-liquid fund structures, secondaries deals and a host of other strategic pivots and mechanisms to generate much-needed liquidity.

Among the sources of pressure is the risk of clawbacks – LP claims on GPs' carried interest in the event of losses. Private Equity Wire and Citco's survey of around 140 GPs revealed that a quarter (26%) have either experienced an increase in clawback risk over the past 12 months, or plan to do so in the coming 12-month period.

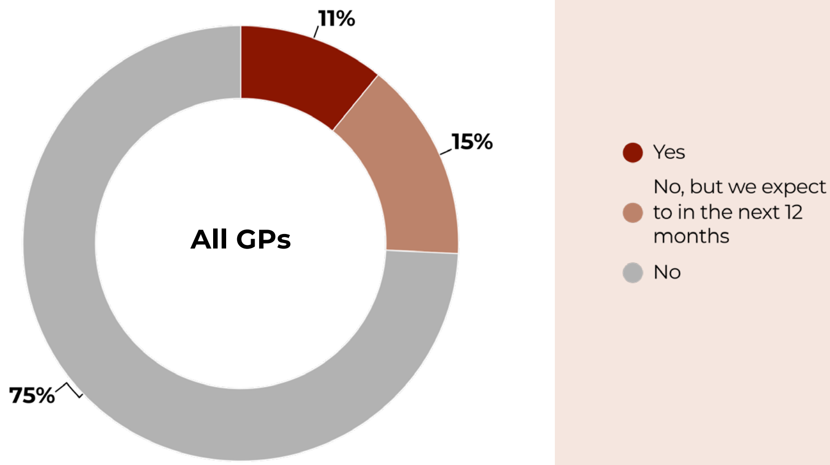
CONTINENTAL CHASMS

A core determinant of clawback risk is the model of waterfall adopted by a firm – American style or European style. "The risk of clawback is primarily associated with American-style waterfalls, in which the GP is able to collect carried interest on profitable realizations without the obligation of first returning aggregate LP capital contributions," says Tim Eberle, Managing Director, Waterfall Services at Citco.

There is a clear risk-reward calculation: American-style fee structures allow firms to compensate their investment teams earlier than European counterparts – not only providing a profit advantage for the firm as a whole, but also enabling a higher rate of talent attraction and retention.

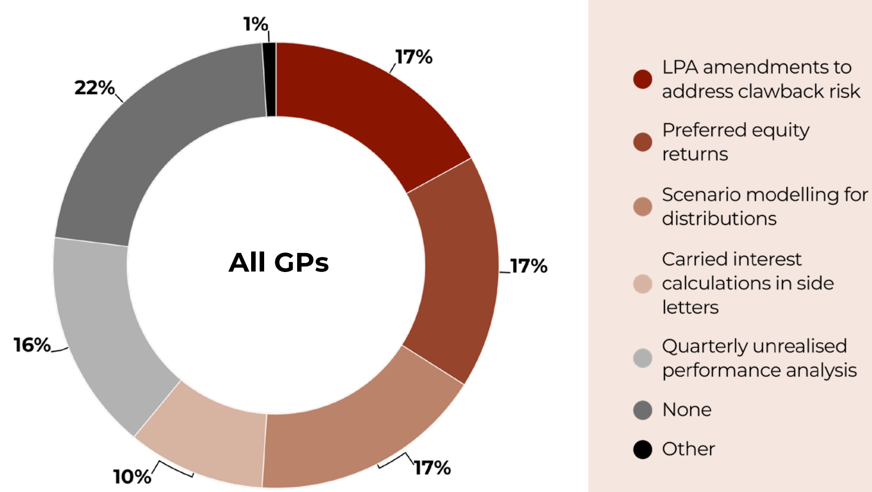
In a risk-off environment, it's no surprise that firms are opting to hedge against clawbacks.

Figure 1 Have you experienced an increase in clawback risk in the past 12 months?



Analysts note: Percentages are rounded up and may not add up to exactly 100%

Figure 2 Which of the following methods are you aware of to mitigate clawback risk? (Select all that apply)



Sources: *Private Equity Wire GP Survey Q3 2024*

Only 18% of our survey respondents say the return potential of American-style waterfalls outweighs the higher risk of clawbacks in their decision-making, while 40% say it doesn't. The rest remain undecided.

"The survey shows that back-office concerns have a tangible impact on front-office decision making, as the waterfall structure employed by a PE fund has a direct impact on IRRs and decisions around investment time horizons," says Eberle.

Overwhelmingly, it appears GPs would rather not have the conversation around clawbacks at all – a decisive 82% say clawback negotiations negatively impact the LP-GP relationship, of which 46% think they do so significantly.

STEMMING THE FLOW

So how can GPs mitigate the growing threat of clawbacks? Our research reveals a degree of ambiguity when it comes to the structural and operational strategies to mitigate risk. Between 25% and 30% are all aware of measures such as: LPA amendments, preferred equity returns, scenario modelling for distributions and quarterly unrealised performance analysis, while 35% weren't aware of any of the above.

According to Eberle, this is a gap that needs addressing upfront, to ensure a healthier foundation for collaboration. "A proper clawback mitigation strategy: whether through structural means such as multiple preferred return tiers, mandatory recoupment of unrealized losses), or others; or operations means such as detailed scenario analytics and downside analysis could allow for a GP-friendly compensation structure, while simultaneously avoiding the potential risks to the LP-GP relationship that the survey indicates as a primary concern." ■

Figure 3 To what extent do you believe clawback negotiations negatively impact GP-LP relationships?

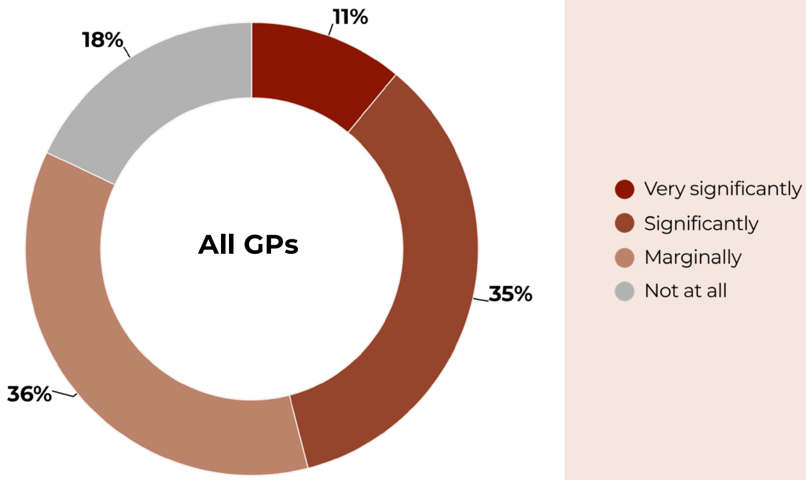
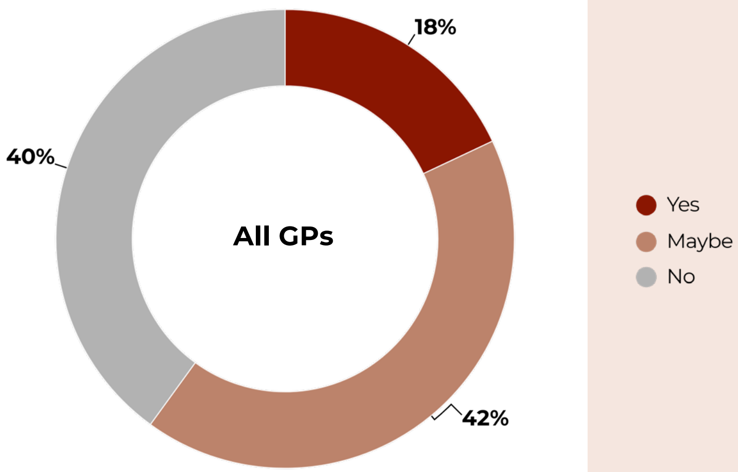


Figure 4 Does the increased return potential of American-style waterfalls outweigh the increased clawback risk in your decision-making?



Sources: *Private Equity Wire GP Survey Q3 2024*

KEY TAKEAWAY

Conversations around clawbacks can be beneficial for the GP-LP relationship, provided these are backed up with concrete analysis and a clear mitigation plan – a gap that remains in the market.