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PRIVATE EQUITY PERFORMANCE

An Overview of “Carry”

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What is Carried Interest?

Carried interest, often referred to as “carry,” is a **share of the profits** that the general partners (GPs) of private equity and venture capital funds earn as compensation.

This performance fee is **typically around 20% of the fund's profits**, but it can vary. Carried interest incentivizes GPs to maximize returns for their investors, aligning their interests with those of the limited partners (LPs) who provide the capital.

How does it actually work?

In private equity, carried interest is **calculated after the fund has returned the initial capital investment** and a predefined preferred return (or hurdle rate) to the LPs. Once these benchmarks are met, the GPs begin to receive their share of the profits.

For example, if a private equity fund achieves a significant exit on an investment, the **profits are first used to pay back the LPs** their invested capital plus the preferred return, central to the partnership agreement.

Any **remaining profits are then split according to the carried interest agreement**, typically 80% to the LPs and 20% to the GPs.

Tax Implications of Carried Interest

Capital Gains Tax (I).

- The taxation of carried interest has been a topic of extensive debate. Carried interest is often taxed as a capital gain rather than ordinary income, which generally results in a lower tax rate for GPs. This tax treatment has sparked discussions on fairness and the need for potential reforms.

Capital Gains Tax (II).

- When “carry” is treated as a capital gain, it is subject to the long-term capital gains tax rate, which is usually lower than the ordinary income tax rate, reflecting its role as an alternative investment. This favorable tax treatment is based on the notion that GPs are investing their time and expertise, similar to how investors commit their assets and capital

Differences Between “Carry” and Other Income

- The key distinction between carried interest and other types of income lies in the tax rates. Ordinary income, such as wages or salaries, is taxed at higher rates compared to capital gains.

Performance Fees – How to calculate?

The performance fee, represented by carried interest, is calculated based on the fund's profits after meeting certain benchmarks. These benchmarks typically include returning the initial capital and achieving a preferred return. **This fee structure is designed to motivate GPs to maximize the fund's returns.**

For example, if a fund generates \$100 million in profits, and the LPs have already received their initial investment and preferred return, the remaining profits might be split with \$80 million going to the LPs and \$20 million to the GPs as carried interest.

Performance Fees – Valuation methods

Accurate valuation is crucial in determining carried interest. Private equity funds use various valuation methods, such as **discounted cash flow (DCF)**, **comparable company analysis (CCA)**, and **precedent transactions**, to assess the value of their investments.

These methods help ensure that carried interest is calculated based on realistic and reliable valuations, reflecting the true economic value generated by the fund's investments.

Why is Carry so relevant in PE?

1 Alignment of interest

Carry encourages long-term success since it is often only paid after the fund achieves a minimum return for investors, managers are motivated to focus on long-term growth rather than short-term gains.

2 Significant Upside for GPs

Carry can form a large part of a fund manager's compensation. While management fees (often around 2%) cover operational costs, carried interest (typically around 20% of profits) can strongly enhance the earnings of managers, especially when the investments are success.

3 Tax Advantages

In many jurisdictions, carried interest is taxed at capital gains rates rather than ordinary income tax rates, which are often higher. This tax treatment has been controversial, but it makes carried interest more attractive for managers.

4 Impact on Fundraising

Investors often look at the carried interest structure when deciding where to allocate their capital. If structured properly, carried interest can signal that a fund manager is confident in their ability to generate returns.

5 Competitive Differentiation

Carried interest can differentiate investment firms. Highly skilled managers may negotiate higher carried interest percentages, while newer or less established firms might offer lower rates to attract investors.

6 Wealth Creation

For fund managers, carried interest can lead to significant wealth accumulation if their investments succeed, contributing to the high earnings seen in the private equity and hedge fund industries.

To Wrap up...

Carried interest is a pivotal element in private equity and venture capital, influencing the dynamics between general partners and limited partners within a limited partnership.

By offering a performance-based incentive, carried interest aligns the interests of both parties, promoting successful investment outcomes.

However, the tax implications and regulatory landscape surrounding carried interest continue to evolve, prompting ongoing debates and potential reforms.

Understanding the complexities of this performance fee, from its calculation to its impact on stakeholders, is essential for anyone involved in the world of private equity or venture capital.

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