

Carried interest – an explanation

Private equity firms ensure alignment between the interests of management teams and investors through a variety of mechanisms. A key financial mechanism is “carried interest” or “carry” and this is explained below.

What is carried interest?

Carried interest refers to the profits generated in a successful private equity fund that are received by the carried interest holders, and which typically amount to 20% of the net profit in the fund.

Who is the carried interest holder?

This is often the senior management team of the fund manager but varies between private equity firms.

Where does the term carried interest come from?

The investor who receives the carried interest is said to be carried by the other investors since they are willing to allocate up to 20% of their profits to the carried interest holder.

How does carried interest ensure alignment of the parties in a private equity transaction?

The main parties in a private equity transaction are the management team of the underlying company in which the fund is investing, the investors in the fund, and those who manage the fund.

Management teams of companies backed with private equity are incentivised by the potential capital gain on their investment in the company. **Investors** in private equity funds benefit from the growth in value of these underlying companies.

Managers of the fund holding the carried interest benefit if the overall performance of the fund is successful.

When is carried interest paid and how is it calculated?

Carried interest is usually based on the performance of the fund as a whole, but in some funds is paid on an investment-by-investment basis. Usually investors receive their initial capital back plus a “hurdle” to ensure a minimum level of return before any carried interest is paid.

Typically, this hurdle is based on the Internal Rate of Return (“IRR”) of the fund since its inception – for more information on IRRs see page 108. An IRR-based hurdle is the most appropriate mechanism in the private equity industry due to the focus on cash-to-cash returns.

Once the hurdle has been met, most funds allocate cash flows above the hurdle disproportionately for a short period, known as the “catch up” phase, until the carried interest holder has received the right proportion of the overall profits in the fund.

Why are investors in a private equity fund willing to forego as much as 20% of profit in carried interest?

Generally investors value the alignment that carried interest provides.

Carried interest functions in a similar way to a performance fee. It is directly linked to the success of the investment fund and has the benefit to the investors of being measured on the cash returned to them rather than the value of the fund.

In return for paying carried interest, fund investors demand “active” management of their capital. Specifically, the fund manager will:

- invest fund investors’ capital in high quality companies;
- develop and implement a value creation strategy for each company in the portfolio;
- participate in the strategic and operational policy-making through board representation;
- earn an appropriate yield on the investment;
- and provide a profitable exit through a trade sale, IPO or refinancing.

What other return does the fund manager receive?

The fund will pay a priority profit share (often called the “management fee”) to cover the costs of the fund manager. This is typically 1% to 2% of the investors’ commitments to the fund annually.

Why does 3i have both carried interest receivable and carried interest payable?

3i’s **carried interest receivable** is due from the third-party funds that 3i manages. 3i calls these external funds “co-investment funds” since they invest alongside 3i’s balance sheet. A variety of funds are managed by 3i but in recent years 3i has only raised buyout funds to invest alongside its Buyouts business line. The most recent fund is 3i Eurofund V, investing primarily in mid-market European buyouts.

3i’s **carried interest payable** is due to investment executives employed by 3i. This is payable mainly in relation to 3i’s Buyout, Growth Capital and Venture Capital investments. Assets in a vintage are grouped together in pools (typically covering two years of investment), which are specific to a particular investment team. The executives in that team purchase the rights to the carried interest and, if the pool is profitable, they will receive an allocation of investment profits. 3i’s internal carry schemes are structured in the same way as external funds, with similar terms and conditions. Approximately 86% of 3i’s portfolio assets, measured by value at 31 March 2007, are within carried interest schemes.

Both carried interest receivable and payable are accrued in line with underlying realised and unrealised profits in the fund but cash payments are not made until the cash is returned to investors, as noted above.

As the level of carried interest receivable is related to the returns in 3i's co-investment funds, while the level of carried interest payable is related to the returns from 3i's own investments, carried interest receivable and payable are only indirectly related in 3i's accounts.

However in 3i's Buyout business line, there is a correlation between carried interest receivable and payable because investments in the same business are held both by the co-investment fund and held on 3i's own balance sheet.

How does 3i account for carried interest?

3i accounts for carried interest on an accruals basis. As realisations are made and valuations are adjusted, 3i reviews the impact on each carry scheme in place and amends its carried interest accruals accordingly.

However it should be noted that some private equity firms account for carried interest as it is paid and received (the so-called cash basis) and others account for carried interest at the time of making a new investment by employing option valuation techniques.

3i's accounting policy means that movements in gross portfolio return are fully reflected in the calculation of carried interest payable and receivable, ultimately reducing year-on-year volatility to 3i's total return.

Worked example

