The drawback to clawbacks — how funds can mitigate risk

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1) There has been an increasing concern around clawback risks in the private markets sector – what is driving that?

The primary reasons that clawback is of such a recent concern to Private Equity (PE) funds are the macroeconomic and geo-political conditions forcing fund managers to delay liquidation events past their initially estimated timeframes.

As rising interest rates are eating into portfolio company valuations, PE funds are shifting their focus away from liquidation and towards value creating, holding investments longer in an attempt to increase a prolonged exit model.

However, due to the nature of PE-style waterfall calculations – in which the return on investment required for the General Partner (GP) to receive an allocation of carried interest increases exponentially with every day a portfolio company remains unrealized –, even an increased exit value may not be sufficient to compensate the Limited Partner (LP) for the time-weighted value of their capital.

If the GP has been allocated carried interest based on early fund realizations but then notes their returns have dropped below the Preferred Return threshold based on longer hold-times, there is a significant risk of clawback.

2) How can funds best mitigate clawback risk, and what role can technology play in this?

The primary way that PE fund managers can mitigate their risk of clawback is through a robust process of downside scenario modeling, performed not only at the time of a distribution but periodically as part of standard front and back-office analysis.

These scenarios can involve projected downside valuations, “zero proceeds” analysis in which unrealized portfolio investments are projected to be sold at a 100% loss, or post-carry Fair Market Value (FMV) tests – for the latter, this is where the current value of an unrealized investment portfolio is required to have achieved a pre-defined Multiple on Invested Capital (MOIC) or Internal Rate of Return (IRR) before the GP is able to take carry on a profitable realization.

These analyses are key components to the decision of whether to realise or defer carried interest, and thus mitigate the risk of a potentially damaging clawback event. Due to all of the various factors inherent to downside scenario modeling –as well as the complexity inherent within waterfall calculations themselves – the need for fit-for-purpose technology becomes almost a requirement for mitigation.

3) For Real Asset funds which may have joint ventures that have an array of potential calculation – such as Real Estate –, how can utilising tech streamline operations for LP?

Joint venture structures add an additional level of complexity to what is already a very detailed and nuanced calculation. By utilizing technology which has functionalities to cover unrealized/hypothetical distributions, realized cash distributions and scenario/projection calculations, and provides for the allocation of deal specific carried interest calculations, users can take control and test partners’ projections, rather than having to wait for an actual sale before getting an up-to-date calculation.

This can be of particular benefit to deal teams as the hypothetical distribution can be recorded in the financial statements so the actual cash distribution determined upon each asset sale can be projected, allowing users to view the impact of alternative sale prices on carried interest.

Indeed, the Waterfall calculation complexity is especially exacerbated for Real Estate fund managers, where the confluence of post-Covid migration patterns, changing hybrid work arrangements, and a challenging interest rate environment require very specific scenario analysis calculations within a wide range of input parameters – so for these funds, technology is key for streamlining operations.

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