

The Importance of Testing Term Sheet Math

GPs need to focus on the language of their waterfall calculations to avoid LPs coming knocking at their door years later.



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—Roy Schneiderman, Bard Consulting

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Investors and managers can spend dozens of hours negotiating a working waterfall profit distribution model. However, a failure to pay attention to specific term sheet language can cause trouble years down the line and impact the alignment between general partners and limited partners.

“A term sheet will often be in the range of several pages, with somewhere between a few lines and a few paragraphs on fees,” says Roy Schnei-

derman, a principal at Bard Consulting. “The problem is, once the term sheet is hammered out, people sometimes go on autopilot.”

Schneiderman points out that problems often occur at the point where term sheets are converted to full-fledged legal frameworks. It’s a problem that has put many LP-GP relationships out of alignment at the outset, but changes in process could help lessen the heartache.

Once term sheets are completed, the actual waterfall structuring is often passed on to legal advisers, with little oversight thereafter. “Missing the mark on fine print can lead to a great deal of friction,” says Schneiderman, referring to fund, venture, and operating documentation that, if too general, leaves remaining stakeholders open to interpret ambiguities.

One fund manager, commenting on the challenges of executing on loose documentation language, says, “The hardest thing to wrap our heads around is the nuances in our waterfalls. When you think of expenses...you have to wonder if your investor is interpreting them the same way. We’ve had a time when we were literally off by pennies, and we got a knock on the door.”

Among strategies for investors, Schneiderman recommends avoiding boilerplate language, as it can contrib-

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ute to an “autopilot mentality” across all relationships. “Specificity matters, and it’s important to focus on the definitions, models, and the precise math used,” he says. “As an example, a 10 percent preferred hurdle and a 10 percent IRR are not always the same, but some analysts will treat them as synonymous.” He underscores the need for investors to seek clarification

on asset management fee provisions that include definitions such as unreturned equity versus invested capital.

Testing is also critical at the outset. Stakeholders often do not test the math in their waterfall structures, nor do they test the various iterations of scenarios that can occur, especially those situations that can affect hurdles. Schneiderman recommends strong testing up front, along with a level-best effort to record the math, examples of its application, and situational examples in the documentation.

Of course, the biggest problems rear themselves after the fact. “When terms and calculation methodologies are not fully vetted, issues are discovered years down the line when the waterfall models are actually run,” says Dillon Lorda, principal at consultant PCA, highlighting the tail end of investment life cycles when profits are realized and distributed.

“Years after the terms were negotiated and language [was] drafted, the people who have to interpret the language are often not the same,” Lorda notes. “So the language might not be interpreted the way it was originally intended.” Instead, he recommends

the use of “blind-eye testing” to validate incentive fee language and structures, whereby an analyst or other third party not involved in the negotiations runs cash flow models based on the specific language used. “Without using examples, [this analyst/third party] helps ensure the language accurately reflects the intentions of the people negotiating the terms, based on documentation language alone.”

More than ever, investors are adding advisers to their talent pool to tackle the waterfall conundrum. Specialists are being employed to reduce the litany of loopholes that can occur in fees, structuring, and documentation. One prominent pension fund portfolio manager says that waterfalls have been the most difficult topic to educate their team on and agrees that consultants have offered a huge lift, though risks are always present.

Ultimately, Schneiderman says, “recognize you haven’t finished when completing the term sheet. It’s important to pay careful attention to the legal documentation and make sure to include one or more examples of how the waterfall will work.” ■



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