Deal Syndication in Private Equity

- Educational Presentation #11 – Private Equity
- 17.03.25
- Property of the ESCP Alternative Investment Society (AIS)
- Sources: Moonfare, WallstreetPrep

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Section I: Introduction

What is Deal Syndication

The Role of Syndication in Private Equity Transactions

Deal syndication refers to the process where multiple private equity (PE) firms or financial institutions collaborate to funda leveraged buyout (LBO) or other investment. This approach helps distribute financial risk while enhancing deal execution capabilities

Purpose: balancing diversification and exposure

- Diversification of Risk: Reduces exposure for any single investor by spreading capital commitments across multiple firms
- Enhanced Capital Access: Allows firms to undertake larger deals without over-leveraging their own balance sheets

Risk Sharing	Larger Deal Execution	Regulatory and Structural Benefits
• Spreading financial and operational risk among multiple investors	• Enables access to bigger transactions that a single firm might not fund alone	• Can facilitate smoother regulatory approvals and better structuring for tax efficiency

Deal syndication enables PE firms to pool resources, share risks, and execute larger investments efficiently

Section II: LP-GP Structure & Liability Considerations

Liability Structures for LPs and GPs

- LPs have limited liability and act as passive investors, while GPs actively manage the fund and bear greater financial and legal risk
- The following slides cover the most common structures for liability in LP-GP relationships

Limited Partner (LP) Liability

- **Limited to Investment Amount**: LPs are only liable for the amount they commit to the fund
- **No Operational Control**: LPs do not participate in fund management, reducing exposure to legal or financial risks
- **Legal Protection**: Structured as passive investors, shielding them from fund debts or lawsuits beyond their committed capital

General Partner (GP) Liability

- **Unlimited Liability**: GPs are responsible for fund operations and can be held personally liable for fund debts if structured as individuals
- **Fiduciary Duty**: Must act in the best interest of LPs, including duty of care and loyalty
- **Mitigation via Entities**: Most GPs set up Limited Liability Companies (LLCs) or Limited Partnerships (LPs) to cap liability exposure

Carried Interest & Risk Exposure

- **Performance-Based Compensation**: GPs earn carried interest (typically 20% of profits) but must meet return hurdles (e.g., an 8% preferred return)
- **Skin in the Game**: GPs often commit their own capital, ensuring alignment with LPs.
- **Regulatory & Compliance Risks**: GPs face scrutiny from investors and regulators on fund governance, conflicts of interest, and transparency

GP-LP relationship and fund structures

Understanding how fund structures shape GP-LP dynamics

- The following fund structures are typical in a GP-LP relationship, shaping liquidity, control, and alignment while balancing flexibility with governance

Closed-End Fund

- Fixed lifespan (typically 10 years) with defined exit timelines
- Capital is committed upfront and called as needed
- LPs cannot withdraw funds before exits occur

Evergreen Fund

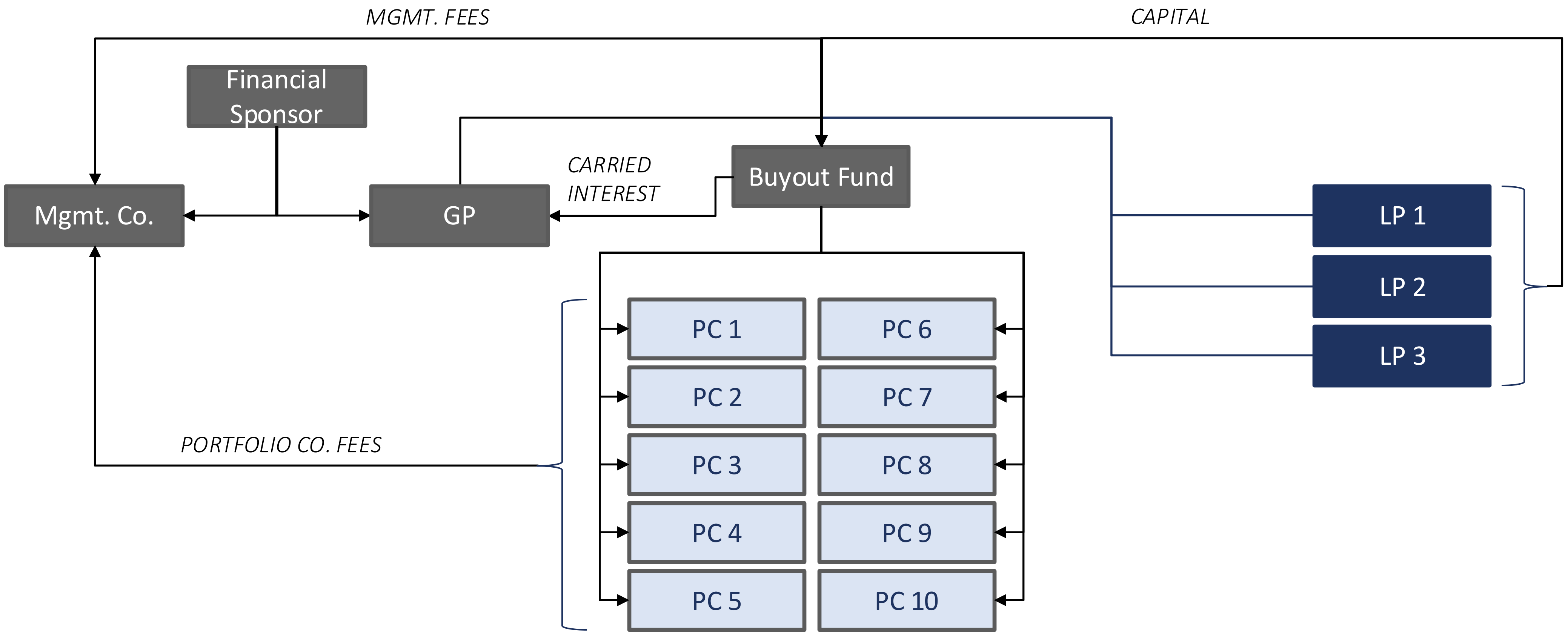
- No fixed end date; allows for continuous capital inflows
- Profits can be reinvested rather than distributed
- Offers more liquidity but requires strong governance

Continuation Fund

- Extends the life of selected assets from an existing fund
- Provides liquidity options for existing LPs
- Aligns long-term interests of GPs and investors

Fund structures balance risk, capital efficiency, and flexibility, shaping GP-LP alignment and optimizing deal execution

Chart on Fund Structure



Co-investments and their role in syndication

- Co-investments give LPs direct deal exposure, reducing diversification but enhancing return potential
- GPs use co-investments to scale deals, optimize capital, and strengthen LP alignment

Benefit to LPs	• Co-investments reduce fees as LPs invest directly, bypassing fund-level charges • Co-investments let LPs select deals, allowing targeted exposure and capital control
Benefit to GPs	• Co-investments let GPs raise deal-specific capital for larger transactions • Co-investments deepen LP engagement and align incentives with GPs
Liability Impact	• LPs take on direct investment risk rather than diversified fund exposure • GPs retain fiduciary duty but share financial risk with co-investors

How the Co-Investment Structure Works in Practice

How co-investments are layered into the broader fund structure, detailing capital flow, ownership, and role separation

- Co-investors commit directly to portfolio companies often via an SPV outside the fund
- GP allocates deal portions between fund and co-investors based on size and strategy
- Co-investors can also be LPs, but participation in the fund is not required
- Co-investments often bypass management fees and carried interest

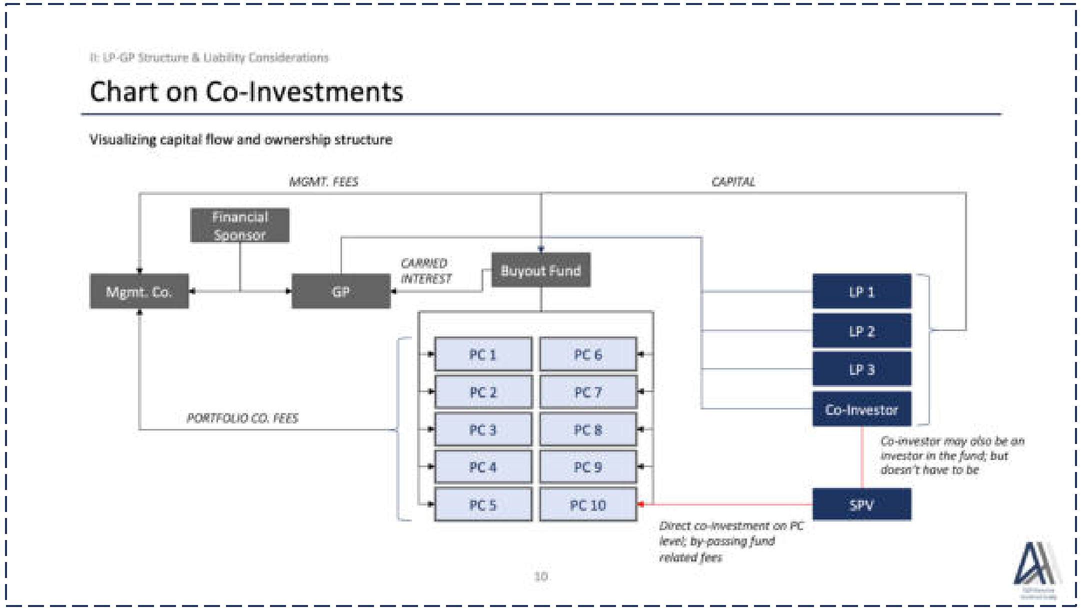
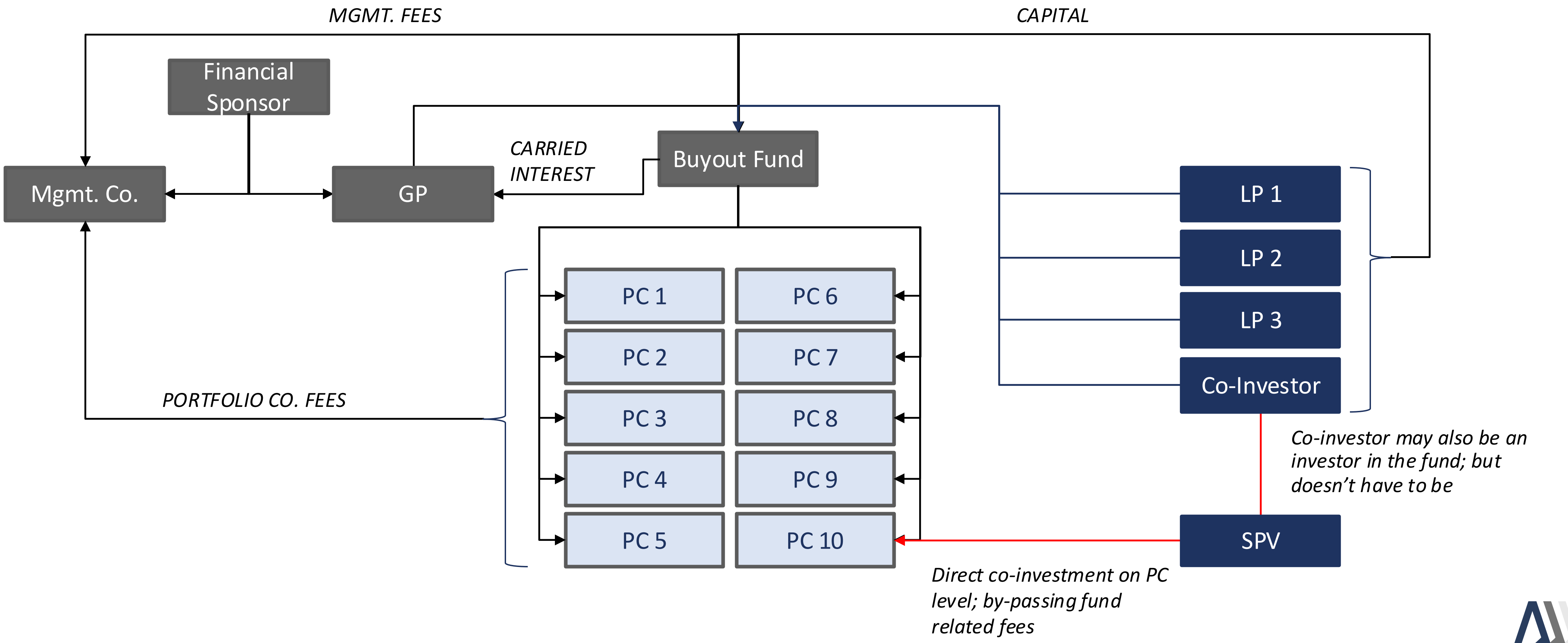


Chart on Co-Investments

Visualizing capital flow and ownership structure



Special Purpose Vehicles (SPVs)

A Structured Entity for Isolating Risk and Managing Investments

- SPVs are separate legal entities created to hold specific assets or liabilities, protecting the parent company from financial risks and regulatory constraints

Advantages

1. Risk Isolation: Shields the parent entity from financial and legal liabilities
2. Investment Flexibility: Enables tailored financing, tax efficiency, and asset management

Disadvantanges

1. Regulatory and Compliance Complexity: SPVs may face extensive reporting and legal scrutiny
2. High Administrative Costs: Requires ongoing legal, tax, and operational oversight

Private equity firms use SPVs to acquire and hold assets, keeping liabilities separate from the main fund. This is common in structured finance, securitization, and real estate transactions

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Section III: Distribution Structure in Deal Syndication

Importance of Distribution Structures in Deal Syndication

The establishment of a distribution structure is essential in syndicated deals involving investors and sponsors

- While LPs provide the capital, the expertise and management is provided by the GPs. A proper structured compensation model ensures that both parties have aligned interests

- With no structured compensation, GPs could simply earn fees for managing capital regardless of the investments made. Compensation models ensures GPs are rewarded for performance

- Distribution structures defines how profits are shared, ensuring compensation is fair and the risk incurred by LPs and GPs is proportionally recognized

Distribution Structure Overview | Hurdle Rates → Key Performance Metrics → Waterfall Frameworks

Hurdle Rates

Hurdle Rates help ensure fair returns in syndicated deals by recognizing the financial risk incurred by LPs

- A hurdle rate is the minimum return that investors must receive before the PE sponsor earns a share of the profits made
- Typical hurdle rates hover around 7-9% in the PE space, approximately 80% of PE firms setting the rate at 8%, and are usually set by the GPs alongside the offering documents
- Investments that surpass the hurdle rate unlock carried interest for PE investors, making it one of the most lucrative components of their compensation
- Although hurdle rates are very common some notable PE firms such as Thoma Bravo and TA Associates have operated without them in the past

Key Elements:

Investor Protection	It acts as first claim on profits for LPs, ensuring they earn a minimum return to compensate for the risk associated in investing in this type of vehicles
Incentive alignment	Encourages GPs to focus on tot tier, high potential investments instead of simply relying on collecting management fees
Prevents unfair overcompensation	If returns are weak, a hurdle rate, prevents GPs from benefitting from poor investments at the fund level

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Types of Hurdle Rates

Soft Hurdle Rates are the preferred distribution structure among GPs

Soft Hurdle Rate: GPs earn carry on all profits, but only after the LPs meet the established hurdle rate

- This structure is more common among PE firms and preferred by GPs as it enhances returns

Hard Hurdle Rate: GPs are only entitled to carry on profits above the hurdle rate

- Although less common in the PE space, some firms may still employ hard hurdle rates

Example

Investment	100M€
Hurdle Rate	8%
Return after Y5	140M€ (8.45% IRR)
Carried Interest	20€

Total Profits: $40M
Fund exceeds 8% hurdle rate; GPs earns carry on all $40M of profits
Carried interest (20%): $8M goes to GP, $32M to LPs

Total Profits: $40M
LPs receive hard hurdle return ($8M), GPs earns carry on profits above the hurdle; $32M
Carried interest (20%): $6.4M goes to GP, $33.6M to LPs

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Key Performance Metrics

Key financial indicators determine the success of investments and how profits are allocated in deal syndication

- Specific metrics are used at fund/deal level to evaluate investment success and establish distribution returns based on hurdle rates
- This performance metrics, along the hurdle rate and other components are essential in the creation of Waterfall structures

Internal Rate of Return (IRR)

- Annualized return of an investment
- Most important metric in return and hurdle rate analysis
- The IRR must surpass the hurdle rate for GPs to unlock carry

IRR (%) = (Future Value of CF / Present Value of CF) ^(1/periods) – 1

Multiple on Invested Capital (MOIC)

- Measures return multiple without factoring time value of money
- MOIC helps LPs find if capital was efficiently deployed to exceed the hurdle rate
- A high MOIC but a low IRR can reveal slow capital recycling

MOIC = Total Cash Inflows / Total Cash Outflows

Equity Multiple

- Measures how much LPs take after the hurdle rate and profit splits
- For example, in a profit split of 80% LPs and 20% GPs, the equity multiple will accurately reveal returns for LPs

Equity Multiple = (Distributions + Residual Value) / Capital Invested

General Waterfall Framework

Waterfall Structures | **No GP Catch-up** | **GP Catch-up**

Framework used to determine the capital gains from cash flows, refinancing, and sales are distributed among LPs and GPs. Set hurdles are thresholds, predefined by investors that must be met, before the next distribution may be allocated

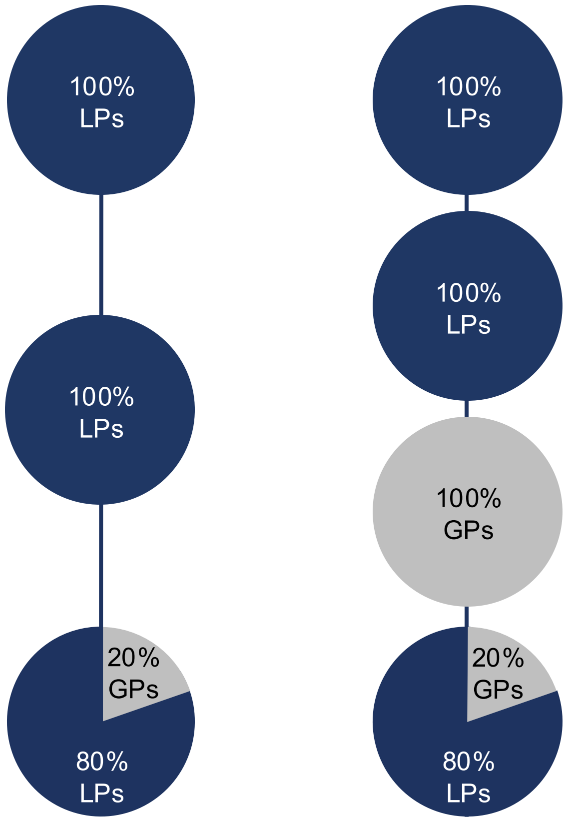
American Waterfalls
(deal-by-deal waterfall)

- Individual investment deals, allowing GPs to extract a share of the profits with every deal
- ‘clawback’ features allow LPs to bring GPs share back from old deals to LPs if the aggregate baseline is not met

European Waterfalls
(global-style waterfall)

- Higher priority to LPs, as the funds require 100% capital repayment before profit split with GPs

Shift from the European to the American Model, as most funds US-based



Waterfall Structures (with GP Catch-up)

Waterfall Structures (with GP Catch-up)	Visualization	Explanation
#1 Initial Capital Returned 100% LP	100% LP	LPs recover their initial equity investment
#2 Preferred Return Hurdle & GP Catch-up If first hurdle is met, catch-up on 20% of all distribution	80% LP / 20% GP	LPs recover until distributions equal the preferred return (e.g. 8%). If hurdle is met; GPs are entitled to 20% of all profit distributions. Therefore, significantly increasing the return of GPs (example on the next slide)
#3 Performance Hurdle 80/20 Split until 12% IRR (explanatory values)	80% LP / 20% GP	Profit Split are performance-based, allowing the GPs to receive a greater share of profits if the fund surpasses set IRR expectations
#3 Performance Hurdle 70/30 Split until 14% IRR (explanatory values)	70% LP / 30% GP	Profit Split are performance-based, allowing the GPs to receive a greater share of profits if the fund surpasses set IRR expectations
#3 Performance Hurdle 60/40 Split above 16% IRR (explanatory values)	60% LP / 40% GP	Profit Split are performance-based, allowing the GPs to receive a greater share of profits if the fund surpasses set IRR expectations

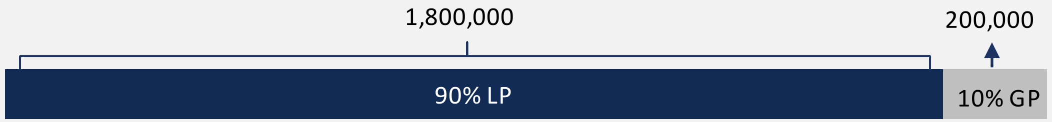
GP-Catch-up (case study)

Case

The Limited Partner initially contributed of 1,000,000€ in equity to the acquisition of an asset. During a given investment period, the assets increased in value. The GP is refinancing the existing loan on better terms. Resulting from the refinancing, 2,000,000€ are being distributed to the investors. The preferred return is 8%. After returning the initial capital and preferred return to the LPs and fulfilling the GP Catch-up, the remaining proceeds are distributed to the performance-based profit-sharing arrangement with an 80/20 split.

Distributions

At the time of distribution, the 2,000,000€ will be allocated as follows:



Description	GPs	LPs	Total
Return Capital	-	1,000,000	1,000,000
Preferred Return	-	80,000	80,000
GP Catch-up	20,000	-	20,000
Performace-based Return	180,000	720,000	900,000
Total Distribution	**200,000**	**1,800,000**	**2,000,000**

GP-Catch up

Common Mistake: do not calculate 80,000€, this amount only represent the share of LPs. One needs to "gross up" to ensure the distribution to GPs. Thus, the total distribution is 100,000€.

$$\frac{80{,}000€}{100\% - 20\%} \times 20\% = 20{,}000€$$

$$\frac{\text{Preferred Distribution}}{100\% - \text{GP Catch-up (\%)}} \times \text{GP Catch-up}$$

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Waterfall Structures (without GP Catch-up)

Waterfall Structures (without GP Catch-up)	Visualization	Explanation
#1 Common Equity Hurdle 100% LPs	100% LP	LPs recover their initial equity investment
#2 Preferred Return Hurdle 100% LPs	100% LP	LPs recover until distributions equal the preferred return (e.g. 8%)
#3 Performance Hurdle 80/20 Split until 12% IRR	80% LP / 20% GP	Profit Split are performance-based, allowing the GPs to receive a greater share of profits if the fund surpasses set IRR expectations
#3 Performance Hurdle 70/30 Split until 14% IRR	70% LP / 30% GP	Profit Split are performance-based, allowing the GPs to receive a greater share of profits if the fund surpasses set IRR expectations
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Types of Waterfall Structures

Cash-Flow Sources		Description	Example
Cash Flow	1	• Distribute periodic profits (ongoing) • Ensuring stable returns to LPs	• Real Estate asset generating stable rental income
Refinance	2	• Mid-hold strategy to recapitalise • Early returns for LPs, mitigating risk	• Replacing old loan or extract capital
Sales Promote	3	• Final profit distribution • LPs recover capital and pref. return • GPs can receive highest share of profit	• IPO, Asset Sale

However, standard waterfalls combine all three sources of cash flow into a single Levered Cash Flow (CF) line, which then serves as the starting point for the waterfall

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In-depth Excel Application

Summarized Distributions

Property level CF		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Levered Cash Flow		(2,500)	175	180	186	191	4,447
Levered IRR		17.3%					
Equity Multiple		2.07x					

Partnership Structure	%		Sponsor	LP	IRR
Sponsor Equity Share	10.0%	Preferred Return	10.0%	90.0%	8.0%
LP Equity share	90.0%	Hurdle 2	25.0%	75.0%	12.0%
Total Equity	**100.0%**	**Hurdle 3**	**40.0%**	**60.0%**	

Sponsor Cash flow		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Distributions	900	-	18	18	19	19	827
Contributions	250	250	-	-	-	-	-
Net Cash Flow	**650**	**(250)**	**18**	**18**	**19**	**19**	**827**
IRR	31%						
Equity Multiple	3.60X						

LP Cash Flow		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Distributions	4,279	-	158	162	167	172	3,620
Contributions	2,250	2,250	-	-	-	-	-
Net Cash Flow	**2,029**	**(2,250)**	**158**	**162**	**167**	**172**	**3,620**
IRR	15%						
Equity Multiple	1.90X						

- Use colour codes: Blue (hardcoded), Black (formulas), Purple (same-sheet refs), Green (cross-sheet refs); hardcodes have yellow fill + black border.
- Use =min and =max functions instead of =if functions to cap or floor distributions within each hurdle tier – avoiding nesting
- To show formulas in Excel, press Ctrl + ` (key above Tab)

How to Illustrate a Hurdle on Excel

Hurdle 1 - Pref Return and return of capital	%	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning Balance (LP Capital Account)		-	2,250	2,273	2,292	2,308	2,321
LP Required return to hit Hurdle 1	8.0%	-	180	182	183	185	186
Contributions from LP	90.0%	2,250	-	-	-	-	-
Distributions to LP (Hurdle 1)	90.0%	-	158	162	167	172	2,507
Ending Balance (LP Capital Account)		**2,250**	**2,273**	**2,292**	**2,308**	**2,321**	**-**
LP IRR Error Check	**8.0%**	**(2,250)**	**158**	**162**	**167**	**172**	**2,507**
Contributions from Sponsor	10.0%	250	-	-	-	-	-
Distribution to Sponsor	10.0%	-	18	18	19	19	279
Sponsor IRR Error Check	**8.0%**	**(250)**	**18**	**18**	**19**	**19**	**279**
Total Distributions		**-**	**175**	**180**	**186**	**191**	**2,785**
Cash Flow Remaining		**-**	**-**	**-**	**-**	**-**	**1,662**

Hurdle 2		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning Balance (LP Capital Account)		-	2,250	2,363	2,484	2,615	2,756
LP Required return to hit Hurdle 2	12.0%	-	270	284	298	314	331
Contributions from LP		2,250	-	-	-	-	-
Prior Distributions		**-**	**158**	**162**	**167**	**172**	**2,507**
Distributions to LP (Hurdle 2)	**75.0%**	**-**	**-**	**-**	**-**	**-**	**581**
Ending Balance (LP Capital Account)		**2,250**	**2,363**	**2,484**	**2,615**	**2,756**	**-**
LP IRR Error Check	**12.0%**	**(2,250)**	**158**	**162**	**167**	**172**	**3,087**
Contributions from Sponsor		250	-	-	-	-	-
Distribution to Sponsor	25.0%	-	-	-	-	-	194
Total Distributions		**-**	**-**	**-**	**-**	**-**	**774**
Cash Flow Remaining		**-**	**-**	**-**	**-**	**-**	**888**

Hurdle 3		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Distribution to LP	60.0%	-	-	-	-	-	533
Distribution to Sponsor	40.0%	-	-	-	-	-	355
Total Distributions		**-**	**-**	**-**	**-**	**-**	**888**

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