Harvard Business School

9-296-042

Rev. October 6, 2000

Acme Investment Trust

In early 1994, officials at Acme Investment Trust were considering investments in the sixth partnership organized by E.M. Warburg, Pincus & Co. The Trust, the employee pension fund of Acme Corporation, a major manufacturer, had recently raised the private equity allocation of its $10 billion pension fund from 3% to 6%.

Warburg intended to raise a $2 billion "mega-fund." This fund, about 15% larger than the organization's 1989 fund (in which Acme had also invested), would be one of the largest funds ever raised by a private equity organization. What concerned Acme's managers the most was not the size of the fund, but rather the way in which their profits would be split.

Warburg, Pincus proposed that investors would receive 85% of the profits from the fund, with the remaining 15% going to the firm's partners. This differed from the 80%-20% split standard within the industry: a division that the *Private Equity Analyst* termed "sacrosanct."[1] Warburg, Pincus also proposed to raise its annual management fee from 1% of capital, as in its previous fund, to 1.5%. Interpretations of these proposed terms differed. While the *New York Times* termed it a "fat discount to investors,"[2] other observers argued that it was an appropriate response to the changing mixture of Warburg, Pincus' investments. Others wondered how this move would affect the compensation terms in less established venture and buyout partnerships.

E.M. Warburg, Pincus & Co.[3]

E.M. Warburg & Co. was established in New York in 1938 by Eric Warburg. Warburg was a member of one of the most illustrious German Jewish families, which had played an integral role in Germany's financial life for several centuries. Eric's father, Max, had been an advisor to Kaiser Wilhelm, a participant in the Versailles peace conference at the end of the first World War, and the head of the powerful Hamburg bank, M.M. Warburg & Co. Nonetheless, the Warburg family was forced to flee Germany in 1938 in the face of Nazi persecution.

---

[1]Steven Galante, "Warburg Points the Way to a Lower Carry," *Private Equity Analyst*, 4, July 1994, 7.

[2]Barry Rehfeld, "Even in Hard Times, He's Still the Top Player in Town," *New York Times*, October 23, 1994, 3:9.

[3]This section is based on Ron Chernow, *The Warburgs* (New York: Vintage Books, 1993); "The Mantle of Warburg," *Forbes*, August 12, 1985, 61; Udayan Gupta, "Megafund Chief Pincus Speaks Softly, Carries a $1.17 Billion Venture Stake," *Wall Street Journa*l, March 9, 1987, 1:15; and Rehfeld, *op. cit.*

Professor Josh Lerner prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

E.M. Warburg & Co. had initially focused on providing investment services to its German-American clientele. After Eric Warburg returned from service as an intelligence officer in the Army Air Force during World War II, the firm expanded into investment banking activities, participating in underwriting syndicates. Its prominence in the post-war years, however, was eclipsed by that achieved by S.G. Warburg & Co., the London bank founded by Eric's cousin Siegmund.

In 1956, Eric Warburg returned to Germany to reclaim the management of M.M. Warburg & Co. from his father's partners. In the ensuing years, as Eric devoted most of attention to German affairs, E.M. Warburg & Co. found it difficult to broaden its base of clients and its investment banking activities. In 1966, these concerns led Eric Warburg to sell a half-interest in the New York firm to 34-year-old Lionel Pincus.

Pincus, the grandson of Polish and Russian immigrants, had received an M.B.A. from Columbia University. Instead of entering his family's Philadelphia apparel retailing and real estate business, he had joined the small investment bank Ladenburg, Thalmann & Co. Much of his activity there involved investing wealthy families' money–typically about $1 million in each deal–in small private firms. At age 29, Pincus was made partner and head of the bank's corporate finance activities. In 1964, he had left Ladenburg to found Lionel I. Pincus & Co.

Pincus' experiences persuaded him of the opportunities presented by investing in private firms. At the same time, he realized that far greater returns could be realized if the activity was pursued in a more systematic and professional manner. Shortly after joining E.M. Warburg, he recruited John Vogelstein from Lazard Freres, who shared this vision.

These two men–in conjunction with a team of long-standing managing directors–developed a distinctive approach to private equity investing, which they termed "venture banking." The firm made a diverse array of investments, including traditional start-ups, leveraged buyouts, and purchases of major blocks in publicly traded firms. While the firm initially invested only its own money, in 1971 it raised its first formal fund. Like other private equity firms, Warburg organized this and subsequent funds as limited partnerships with a life-span of approximately ten years. (Warburg's funds are summarized in **Exhibit 1**.) The firm served as the general partner of each fund, and the various investors as limited partners. At about the same time, the firm assumed its current name.

Investors in the five Warburg funds had enjoyed substantial success over the years, earning an average annual return between 1971 and 1990 of over 25%. This was substantially better than the returns of private equity as a whole, summarized in **Exhibit 2**. The funds had enjoyed very attractive returns from quite different classes of investments. These included buyouts, including Mattel, investments to finance industry consolidations (e.g., Waste Management), and start-ups such as U.S. Health Care Systems. (Major investments that had led to initial public offerings by the end of 1992 are summarized in **Exhibit 3**.)

Several distinct themes characterized Warburg, Pincus' approach over these years. The first was a willingness to go against the trends in the industry. During the mid-1980s, for instance, the firm had shunned the computer hardware and software investments then in favor at many venture organizations, focusing instead on buyouts and health care. During the 1990s, when many private equity organizations marketed themselves as having a distinctive specialty, Warburg, Pincus retained its eclectic approach. Second, the firm had been willing to build a core group of managers. While many venture and buyout funds were run with very lean staffs, Warburg, Pincus had 28 managing directors by 1994, many of whom had been with the firm for a decade or longer. Third, the firm had been aggressive in raising capital. The 1980 and 1989 funds had been the largest ever raised to that date by private equity organizations. The firm had successfully attracted investments from some of the most sophisticated investors, including pension funds of AT&T, General Electric, IBM, and New York State, as well as the Harvard University Endowment.

By early 1994, the firm had nearly entirely invested its 1989 fund. Its decision to raise a sixth fund had been widely anticipated. It was the proposed terms of the contract that would govern the fund (outlined in the private placement memorandum) that generated widespread discussion within the Acme pension and elsewhere.

Compensation in Private Equity Partnerships[4]

Private equity investors are typically compensated in two ways: a share of the profits and annual fee. These two elements, however, display many variations. For instance, the way in which the fee is calculated and the timing of the profit-sharing often varies tremendously.

The percentage of profits retained by the private equity investors is known as the carried interest. This share, as noted above, is typically about 20%. **Exhibit 4** presents the percentage of capital gains retained after any provision for the return of invested capital, or invested capital plus a premium, for 441 funds established between 1978 and 1993 to make venture or both venture and buyout investments. The carried interest varied from 1.01% to 45%, but the value in 81% of the funds was between 20% and 21%.

Exhibit 4 shows how the average carried interest varied over this period. Funds are divided by their date of formation, as well as by two measures of the experience of the private equity organization. The first measures the relative size of the organization's previous funds (their "market share").[5] The second is the time from the establishment of the organization's first partnership to this fund. Older and larger private equity organizations command a slightly larger carried interest, with about a 1% higher share than the less experienced funds.

The second element of compensation is management fees. These fees are typically paid quarterly, and finance day-to-day operations. In many funds, the fees change over time. For instance, the fees will often be reduced in later years, reflecting the expectation that the partnership's costs will be lower during the "harvesting period." The fees may also contain provisions for inflation adjustments. As **Exhibit 6** indicates, the base used to calculate the fee varies. While most agreements compute the annual fee as a percentage of invested capital, in some cases the value of the partnership's assets is used. Funds which use asset value as the base often will also often limit the maximum and/or minimum fee. A number of firms charge fees not only on the funds raised by the partnership, but also on the indebtedness of the companies in which they invest. This fee structure was commonplace during the 1960s, when Small Business Investment Companies (many of which were affiliates of commercial banks) made equity investments in firms and arranged for their credit lines.

Exhibit 6 also summarizes the level of the fees in the partnerships' fourth year. (As noted above, in some cases the fee will be based on different measures.) The typical fee is 2.5% of fees under management. The table also shows the level of fees for the fifteen largest partnerships. Here the percentages are lower, with an average and median fee of about 2.0%.

Fees based on net asset value have virtually disappeared in recent years. While 21% of funds formed between 1978 and 1983 had fees based on asset value, this fell to 2% in the period between 1990 and 1993. Some practitioners attribute this decline to opportunistic behavior on the part of private equity partnerships. As investment manager Harold Bigler relates:

---

[4]This section and **Exhibits 4** through **7** are based on Paul Gompers and Josh Lerner, "An Analysis of Compensation in the U.S. Venture Capital Partnership," *Journal of Financial Economics*, 51 (1999), 3-44.

[5]The invested capital in all of the organization's funds established in the ten years previous to the year that this fund closed is totaled. This sum is divided by the total amount raised by independent venture organizations in this period.

> In the 1970s specific partnerships were referred to as a "West Coast Deal" or an "East Coast Deal." The East Coast deal had its fee generally based on committed capital.... The West Coast partnerships had a tradition of management fees related to assets. The general [partner] participated in appreciation both through the management fee and the carried interest, thus having the element of "double-dipping."[6]

More specifically, accounts by Venture Economics[7] suggest that asset value-based fees led private equity partnerships to be very aggressive in valuing firms and to delay exiting investments.

There are also many differences in the timing of compensation. **Exhibit 7** provides an overview of the restrictions on the receipt of capital gains by general partners. Over 90% of the funds contain some provision which insures that the private equity investors do not unconditionally receive distributions. This table does not include the exceptions which allow small payments to cover tax obligations.

Most restrictions are of two types. The standard partnership agreement of the 1960s and 1970s called for the private equity investors to only receive distributions after their limited partners had received their invested capital back. Any subsequent distributions were then split according to the carried interest. This arrangement, however, was perceived to have a negative effect on the choice of securities distributed.[8] This is because private equity investors frequently distribute securities of firms that they have taken public, rather than selling the shares and distributing cash.[9] Before the committed capital had been returned, some private equity investors were perceived to distribute overvalued securities. Undervalued securities were retained until after committed capital was returned and the investor was eligible to receive distributions.

During the 1980s, a new contractual form appeared, which allowed private equity investors to receive capital gains as long as the value of the portfolio exceeded 100%, 125% or some other multiple of the invested capital. (The multiple is referred to as hurdle rate.) Under these arrangements, the cost basis of each investment was first returned to the limited partners. The remainder–the capital gain on this particular investment–was then divided between the limited and general partners according to the agreed-upon formula. Consider the distribution of 1000 shares of a company which the private equity investors had purchased for $2/share and currently trading at $12/share, under a contract where the proceeds were divided 80%-20%. The limited partners would receive shares with a value of $10000 [1000*($2+.8*($12-$2))] and the general partners shares worth $2000 [1000*(.2*($12-$2))].[10]

---

[6]Harold E. Bigler, "Am I Really So Bad?: A 'Gatekeeper' Replies to a Recent Challenge," *Venture Capital Journal*, 31 (February 1991), 22-39.

[7]See, for example, Venture Economics, "Venture Partnership–Conventions and Customs," *Venture Capital Journal*, 20 (July 1980), 9-11.

[8]Venture Economics, *Venture Capital Performance–1989*, Needham, Venture Economics, 1989.

[9]Private equity investors have at least two reasons for distributing securities rather than cash. First, the limited partners usually include both tax-paying and tax-exempt investors, who may have different preferences concerning the timing of security sales. Second, distributions of securities are valued (both in the partnerships' internal accounting and in the records of gatekeepers and other monitors) using the share price prior to the distribution. The actual price that a private equity investor might realize if he sold a large block of a thinly traded security might be considerably lower. See Venture Economics, "A Perspective on Venture Capital Management Fees," *Venture Capital Journal*, 27, December 1987, 10-14.

[10]Some recent funds have gone to the other extreme: they do not allow the private equity investors to receive capital gains until *more* than 100% of invested capital has been returned to investors. These tend to have been raised by smaller and younger organizations.

Private equity organizations who have persuaded their investors to allow them to receive accelerated profit-sharing are significantly older and larger. Industry observers argue that the ability of larger partnerships to accelerate their compensation through a hurdle rate reflects their market power. For instance, a Venture Economics report noted, "although there are some limited partners which believe they should receive their original capital back before the general [partners] begin to share in the profits, most of the limited [partners] . . . were aware that it was difficult to demand, particularly with more experienced groups."[11]

Warburg, Pincus Ventures, L.P.[12]

The fundraising document that Warburg, Pincus circulated in the spring of 1994 proposed to raise $2 billion for a fund that would last for twelve years. Warburg, Pincus would receive an annual management fee of 1.5% on the capital that it had actually drawn down from investors. The fund anticipated drawing down these funds fairly evenly over the fund's first six years. Warburg, Pincus would not begin receiving any profits until it had returned the invested capital to investors.

The offering document attracted considerable attention in the private equity community. The Acme pension's managers discounted the suggestion that the Warburg, Pincus's fee structure was a manifestation of anxiety about reaching the $2 billion fundraising target. The flow of funds into private equity had been accelerating in the past several years, and 1994 was anticipated to be a record year for fundraising. Instead, the reduced carry might reflect the changing mixture of Warburg, Pincus' investments. In particular, a substantial share of its portfolio was publicly traded firms. Public equity managers typically received an annual fee of about 0.5% of assets under management, without any performance-linked compensation. Alternatively, Warburg, Pincus might be anticipating that the recent flow of institutional money into private equity would lead to lower returns, and that the lower carried interest represented a way of "in effect sharing the downside of the market."[13]

Another area of discussion within Acme was the implications of the shift for other private equity organizations. One observer noted that "with their action, Warburg, Pincus has given us all an opportunity to reconsider pricing." Others speculated that the move was especially likely to lead to pressure on less established private equity organizations to reduce their share of the profits.[14]

---

[11]Venture Economics, "Stock Distributions–Fact, Opinion and Comment," *Venture Capital Journal*, 27, August 1987, 8-14.

[12]This section is drawn from "Warburg Pincus Preps Huge Fund Launch," *Buyouts*, 7, April 4, 1994; Jennifer L. Reed, "Warburg, Pincus Seeks Only 15% Carry," *Venture Capital Journal*, 34, May 1994, 6; and Galante, *op. cit.*

[13]Reed, *op. cit.*

[14]Galante, *op. cit.*

Exhibit 1 Funds Raised by Warburg, Pincus & Co.

	Year	Fund Size ($ millions)
EMW Ventures	1971	28
Warburg, Pincus Associates	1980	100
Warburg, Pincus Capital Partners	1983	341
Warburg, Pincus Capital Company	1986	1,175
Warburg, Pincus Investors	1989	1,780

Source: Compiled from public reports.

Exhibit 2 Returns of Private Equity Organizations, as Compiled by Venture Economics. The table indicates the average and median return for private equity funds begun in various years through the end of 1993.

	Return Through 12/31/93	
Year Fund Began	Mean	Median
1969-1975	23.4	20.6
1976-1979	30.6	24.2
1980	17.4	13.6
1981	6.8	5.0
1982	2.9	2.2
1983	5.5	5.5
1984	4.7	5.1
1985	7.7	9.9
1986	6.6	6.6
1987	5.2	6.2
1988	10.7	8.4
1989	7.4	5.1
1990	3.4	2.1

Source: Compiled from Venture Economics, 1995 Investment Benchmark Report, Boston, Venture Economics, 1995.

Exhibit 3 Major Investments by Warburg, Pincus & Co. in Private Firms that Went Public between 1976 and 1992

Company	Market Value at Time of IPO ($ millions)	IPO Underwriter[a]	Offering Date	Size of Offering ($ millions)
ADVO-SYSTEMS	N/A	None	9/15/86	N/A
AGRIDYNE TECHNOLOGIES	64.9	Piper, Jaffray & Hopwood	2/14/92	17.5
AI CORP	73.0	Alex. Brown & Sons	6/25/90	21.4
ALLIED CLINICAL LABORATORIES	87.1	Alex. Brown & Sons	7/31/90	22.1
ALLSTAR INNS	145.4	Drexel Burnham Lambert	3/27/87	72.9
ALTA HEALTH STRATEGIES	78.6	Alex. Brown & Sons	1/22/91	14.3
BABBAGE'S	65.3	Alex. Brown & Sons	7/14/88	19.5
BRIDGE COMMUNICATIONS	96.7	Morgan Stanley	4/18/85	24.0
CAMBRIDGE NEUROSCIENCE	82.8	Montgomery Securities	6/06/91	18.0
CENTRA FARM GROUP NV	30.5	L.F. Rothschild Unterberg	1/14/85	6.8
CERTIFIED COLLATERAL	18.3	Blunt	12/08/83	4.0
CHIPSOFT	177.4	Robertson, Stephens & Co.	4/03/92	41.2
FOUR-PHASE SYSTEMS	24.6	Lehman Brothers	6/08/76	14.4
GARTNER GROUP	33.7	Shearson Lehman Brothers	7/17/86	11.6
KOLFF MEDICAL	84.9	L.F. Rothschild Unterberg	7/15/83	18.8
MARINE DRILLING CO.	77.8	Dillon, Read	7/28/89	29.8
STARTEL	19.5	Rooney	11/22/83	4.5
SYNERGEN	86.2	Alex. Brown & Sons	3/07/86	17.6
US HEALTHCARE SYSTEMS	71.3	Merrill Lynch	2/09/83	20.0
VALUE HEALTH	146.3	Alex. Brown & Sons	4/04/91	36.0
VESTAR	42.6	Alex. Brown & Sons	11/05/86	10.6
ZILOG	98.3	Alex. Brown & Sons	2/27/91	22.0

Source: Compiled from initial public offering prospectuses.

[a]If there were multiple underwriters co-managing the offer, the table reports the one responsible for managing the order book.

Exhibit 4 The Share of Profits Retained by Private Equity Organizations. The figure indicates the carried interest (the share of capital gains retained by the organization after any initial return of investment to the limited partners).

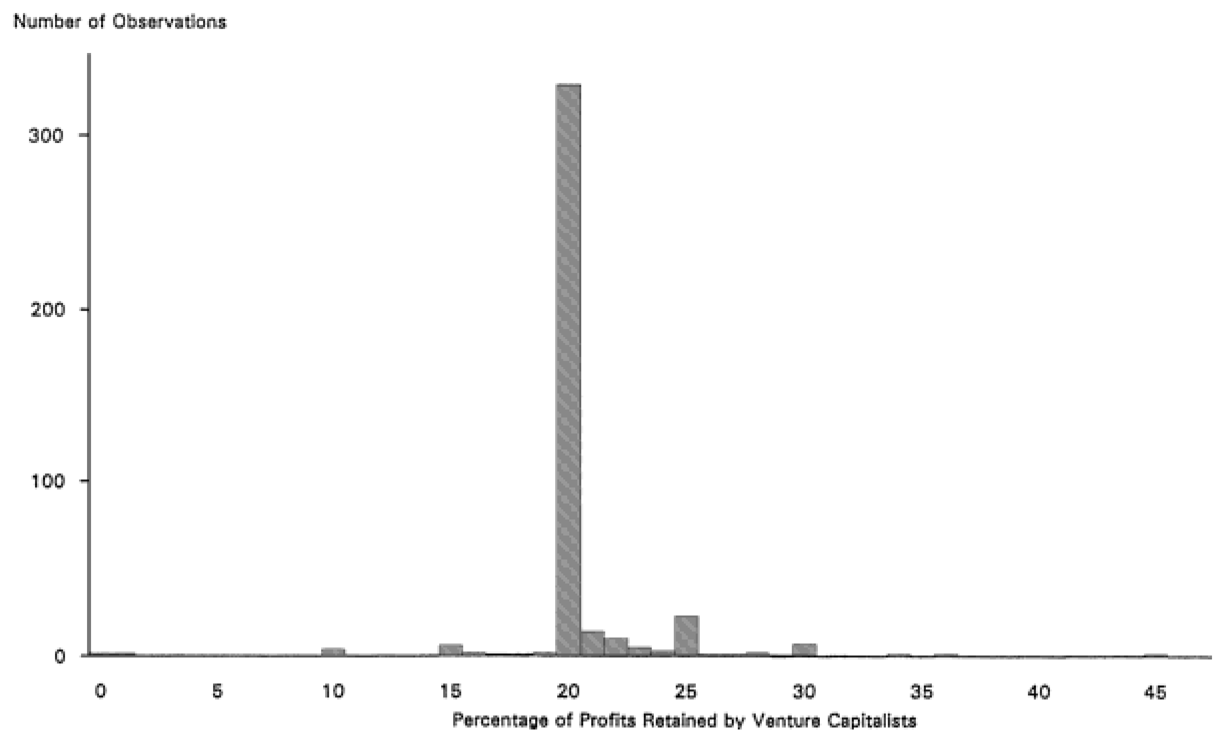

Exhibit 5 The Share of Profits Retained by Private Equity Organizations. The average share of capital gains retained by the organization after any initial return of the original investment to the limited partners is indicated. The second panel indicates the correlation coefficient between the percentage and the other variables.

Panel A: Percentage of Profits

	Average	*# of Observations*
Date Fund Established:		
January 1978–December 1984	20.5	100
January 1985–June 1986	20.9	111
June 1986–December 1988	20.7	120
January 1989–December 1992	20.9	85
Size of Private Equity Organization		
No Earlier Funds or Cannot Determine	20.4	170
Between 0.0% and 0.2%	20.9	83
Between 0.2% and 0.7%	20.5	87
Greater than 0.7%	21.6	76
Age of Private Equity Organization:		
No Earlier Funds	20.5	146
Four Years or Less	20.7	87
Between Four and Eight Years	20.6	93
More than Eight Years	21.4	90
Objective of Fund		
Focus on high-technology firms	21.2	198
Other industry focus (or no focus)	20.3	218
Focus on early-stage investments	21.1	172
Other stage focus (or no focus)	20.5	244

Panel B: Correlation Coefficients

Variables	*correlation*
Date of Closing and Percentage of Profits	0.027
Size of Organization and Percentage of Profits	0.109
Age of Organization and Percentage of Profits	0.104

Exhibit 6 The Table First Summarizes How the Annual Management Fee Is Determined. The table then summarizes the distribution of fee percentages, for all funds and the 15 largest funds.

Panel A: How Management Fee is Determined

Percent of capital under management	69.7%
Percent of capital under management, less cost basis of distributions and write-offs	1.3
Percent of net asset value	11.6
Percent of net asset value, but subject to a minimum and/or maximum	7.6
Percent of sometimes capital under management; sometimes capital less distributions	1.9
Percent of sometimes capital under management; sometimes, net asset value	4.6
Percent of debt of portfolio companies, as well as capital or asset value	2.2
Negotiated annually	1.0

Panel B: Fee Percentage

	All Funds	15 Largest
3.5% or higher	4.3%	0.0%
3% to 3.49%	10.1	6.7
2.5% to 2.99%	63.0	13.3
2% to 2.49%	16.2	46.7
1.5% to 1.99%	4.3	20.0
1.49% or lower	2.1	13.3

Exhibit 7 Timing of Compensation for Private Equity Organizations. The table summarizes the restrictions on the receipt of capital gains.

Restrictions based on return of committed capital	
No distributions until return of 100% of committed capital	43.8%
No distributions until return of 101-25% of committed capital	1.4
No distributions until return of 126-50% of committed capital	0.5
No distributions until return of more than 150% of committed capital	0.2
No distributions until return of 100% of committed capital plus an annual return of 1-10%	0.7
No distributions until return of 100% of committed capital plus an annual return of 11-20%	0.2
No distributions until return of 100% of committed capital plus four times salaries	0.2
No distributions until return of 100% of committed capital plus four times tax distributions	0.5
Restrictions based on return of net asset value	
No distributions until adjusted net asset value exceeds 100% of committed capital	6.2
No distributions until adjusted net asset value exceeds 101-25% of committed capital	15.8
No distributions until adjusted net asset value exceeds 126-50% of committed capital	1.0
No distributions until adjusted net asset value exceeds 150% or more of committed capital	0.5
No distributions until increase in adjusted net asset value exceeds 125% of the S&P 500	0.2
Hybrid restrictions	
No distributions until 100% capital return and adjusted NAV exceeds 100% of capital	0.2
No distributions until 100% capital return and adjusted NAV exceeds 101-25% of capital	1.4
No distributions until 100% capital return and adjusted NAV exceeds 126-50% of capital	1.4
No distributions until 100% capital return and adjusted NAV exceeds 150% or more of capital	0.2
No distributions until 100% capital return or adjusted NAV exceeds 100% of capital	0.5
No distributions until 100% capital return or adjusted NAV exceeds 101-25% of capital	1.2
No distributions until 100% capital return or adjusted NAV exceeds 126-50% of capital	0.2
Requirements to hold distributions in an escrow account	
Distributions held until return of 100% of committed capital	3.4
Distributions held until return of 101-25% of committed capital	1.2
Distributions held until adjusted asset value exceeds 100% of committed capital	0.2
Distributions held until adjusted asset value exceeds 101-26% of committed capital	0.7
Distributions held until 100% capital return and adjusted NAV exceeds 100% of capital	0.2
Distributions held until 100% capital return and adjusted NAV exceeds 126-50% of capital	0.2
Distributions held until 100% capital return or adjusted NAV exceeds 126-50% of capital	0.2
Distributions held set dollar amount reached	0.5
No restriction specified or other restriction	13.9