Terms and Conditions Governing Brazilian Private-Equity and Venture-Capital Partnerships

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EXECUTIVE SUMMARY

When investors commit capital to private equity funds, they sign a blank check, delegating responsibility to the fund manager over the selection of portfolio companies, the structuring and monitoring of investments, sale and return of capital. It is a long-term relationship, characterized by information asymmetry, with fund managers knowing substantially more about investments than their limited partners (LPs), who have little to no chance of interfering with fund management. Therefore, it is paramount to understand what should be included in a fund's Limited Partnership Agreement (LPA) in order to promote alignment between manager and investor and mitigate conflicts of interest. As a parameter of best practices, we adopt the recommendations set forth by the Institutional Limited Partner Association (ILPA), a private-equity institutional investor association based in Washington, D.C. In Brazil, funds are regulated by Instruction 578 (I-578) of the Brazilian Securities and Exchange Commission, which is in line with international best practices in terms of defining the role of fund administrators and managers, framing the type of investments in active management, establishing accountability for LPs and governance rules between managers and investors. While there are minimum requirements that must be adopted in all LPAs, there is freedom for customization in several matters. This whitepaper analyzes 148 LPAs registered with Brazil's Securities and Exchange Commission (CVM) as Investment Funds in Participations (FIPs) between 1996 and 2019 and discusses the main aspects that govern the relationship between general managers and LPs in Brazil.

Brazilian LPAs are converging towards best international practices. The percentage of funds with investment committees with shareholder participation has decreased over the years; the spread of preferred return has also dropped, increasing the value of carried interest that can potentially be distributed to the manager, and consequently bring about greater alignment. More funds have started to declare a key-person provision in their by-laws. Other highlights of the analysis are commented herein.

Fund-operation

Funds registered in Brazil as FIPs have an average lifespan of 10 years, with an extension option subject to approval by the LPs' General Meeting (LPGM).

The average investment period is 5 years (median is 4 years), also with an extension option subject to approval by the LPGM.

Almost half (47%) of the FIPs allow reinvesting the proceeds of the sale of a fund's interests. ILPA recommends that reinvestment be restricted to the investment period. However, in 24% of the LPAs this restriction is not explicit.

Share structure and penalties for default

According to I-578, only qualified investors are eligible to invest in FIPs.

27% of FIPs provide for the existence of more than one share class, with different economic and financial rights.

It is not common to charge entry fees in Brazilian LPAs (only 9% of LPAs do).

I-578 provides for sanction in the event of LP default, and 85% of FIPs charge a fine at an average rate of 9.2% (median of 10%) on the amount due adjusted by the CPI (IPCA) or other inflation-related indicators in Brazil.

Governance

I-578 requires that FIPs have an administrator and a manager, establishing the obligations of each party. The administrator has responsibility over the inflows and outflows of funds, disclosure of financial statements and accountability of the fund. In turn, the manager is responsible for investing, monitoring and divesting fund interests. In 75% of LPAs, fund management and administration are performed by different legal entities. Regulations in Brazil assign to the LPGM the role of reviewing financial statements and judging situations that constitute conflicts of interest. The existence of a fund administrator combined with the role of the LPGM

deliberating on conflict situations probably fulfills a large part of the role of supervisory and fiscal committees. This is a possible explanation why these figures are uncommon in Brazilian LPAs. On one hand, this model is more democratic than the more-common model found in international LPAs, where a supervisory committee is responsible for judging conflicts of interest. However, there is a loss of specialization, since the decision is not made by industry experts, who are usually members of supervisory committees.

I-578 establishes that the LPGM deliberates on the removal of a fund's manager and administrator. LPAs have the flexibility to stipulate a minimum quorum and penalties for destitution in the event of a cause and no-fault event. The funds stipulate a median quorum of 66% for both forms of removal. This is more than the minimum quorum and sanctions that ILPA recommends.

Most FIPs establish arbitration chambers to resolve conflicts between managers, administrators and LPs, the most used ones being the Brazil-Canada Chamber of Commerce and the Market Arbitration Chamber - B3.

Most of the LPAs analyzed have investment committees with members appointed by LPs. This diverges from the international model and has generated conflicts between managers and LPs. In the last two years, there has been a decline in registered LPAs that adopt this model, which could mean that the market has learned that an LP's involvement in the managing of a fund's investments is inadequate.

Investment Strategy

Although diversification is expected to mitigate a fund's risk, less than half (41%) of FIPs specify limits for maximum exposure to a single company on the portfolio.

Roughly 75% of LPAs explicitly allow for fund co-investment with LPs, and most fund managers are free to offer co-investment without approval by the LPs' meeting.

Most funds are generalist, with no specification regarding preferred sector or region. Only 8% of funds specify that acquisition of a controlling stake is the main way to participate and influence the management of investee companies.

I-578 requires managers to implement various governance practices in investees. However, it does not specify rules regarding socioenvironmental issues, giving LPAs flexibility when defining these aspects. The few LPAs committed to socioenvironmental practices mostly limit restricting investments in specific sectors or companies with socioenvironmental problems.

Fund manager compensation

The average management fee paid to managers and administrators together is 1.8%, with a median of 2% p.a. Most of this fee is applied to committed capital during the investment period and to equity at cost after the investment period. This is in line with ILPA's recommendation that the amount paid as management fee drop over time.

Carry (performance fee) paid to managers corresponds on average to 19% (median of 20%) of the profit above the committed capital corrected by a hurdle rate, and due only if the fund outperforms the preferred return. The preferred return is calculated on average as 7.6% (median of 8%) above an inflation indicator, with IPCA (CPI) being the most used.

Preferred return with a very high spread can discourage managers from seeking carry. There has been a downward trend in spread, which went from 9.5% in 2006 to 6.5% in 2019, possibly indicating better alignment between managers and LPs.

Restrictions and requirements for fund managers

Most LPAs have key-person provisions and provide for approval at the LPGM for replacement in the event of departure of one of these persons. The percentage of LPAs with key-person provisions has increased over the years. However, few LPAs provide for liquidation of the fund in case of non-approval of a new key-person.

Although one of the main alignment factors between managers and LPs is that the manager contributes a significant portion of the fund's capital, few LPAs contain this clause.

Few LPAs restrict raising new funds until a stipulated portion of the committed capital has been invested.

I. INTRODUCTION

Private Equity funds operating in Brazil and registered with the CVM are regulated by Instruction 578 (I-578) introduced in 2016 to replace Instructions 209/94 and 391/03, and amended four times until 2020 by Instructions 589, 604, 609 and 615. I-578 consolidated the existing old rules for Investment Funds in Participations (FIPs) and Mutual Funds for Investment in Emerging Companies (FMIEEs), and imposed on all LPAs several rules that give security to the LP, such as clear definition of the fund manager and administrator's role, definition of relevant information and accountability that must be disclosed and how often, definition of frequency and meeting convention rules, necessary quorum and matters that the LPs' meeting can vote on to mitigate conflicts of interest, and an FIP's investment framework. LPAs are free to customize the rules on a variety of topics.

This report analyzes 148 FIPs and FMIEEs registered between 1996 and 2019 and aims to depict the main aspects that regulate the relationship between LPs and fund managers in Brazil, discussing whether they are aligned and mitigate relevant conflicts of interest, in addition to trying to identify whether there has been an evolution in LPAs over time, signaling the learning and maturation of Brazil's private-equity industry.

II. METHODOLOGY AND DATA

We selected all funds listed as FIPs and FMIEEs on Brazil's Securities and Exchange Commission (CVM) and classified as Private Equity (PE) or Venture Capital (VC) by the Brazilian Private-Equity and Venture-Capital Association (ABVCAP). We excluded investment vehicles from offshore funds, co-investment, and feeders from the sample, as they do not represent the relationship between investors and LPs. The sample includes 148 vehicles registered between 1996 and 2019.

Exhibit 1 – **Panel A** shows the number of funds registered over the years, and **Panel B** the average committed capital over time. In **Panel A**, we observed funding peaks in 2007, 2012 and between 2017 and 2019. The sample is representative of different vintages and allows us to analyze the evolution of LPAs over time: 25% of the funds are more than ten years old and are in their liquidation phase or extension period (before 2010), 37% of the funds are between 10 and 5 years old, being in their divestment phase (2011-2016), and 38% were raised less than 5 years ago, and are probably in their investment period (funds raised after 2017).

The most recent vintages have a higher number of funds, but there has been a drop in average committed capital: after 2013 the average committed capital had a range of $86 and $211 million, while from 2007-2012 the range was between $219 and $750 million (**Exhibit 1 - Panel B**). Years 2005 and 2011 have outliers that distort the average value. When removing these outliers, the average value is R$392 and R$280 million, respectively. This change may indicate two movements: an increase in funding by smaller managers and a focus on seed and emerging capital, or a dispersion in sources of funding from managers - feeders. FIPs can represent only a portion of what has been raised with local investors, while offshore vehicles are used to raise capital with foreign investors.

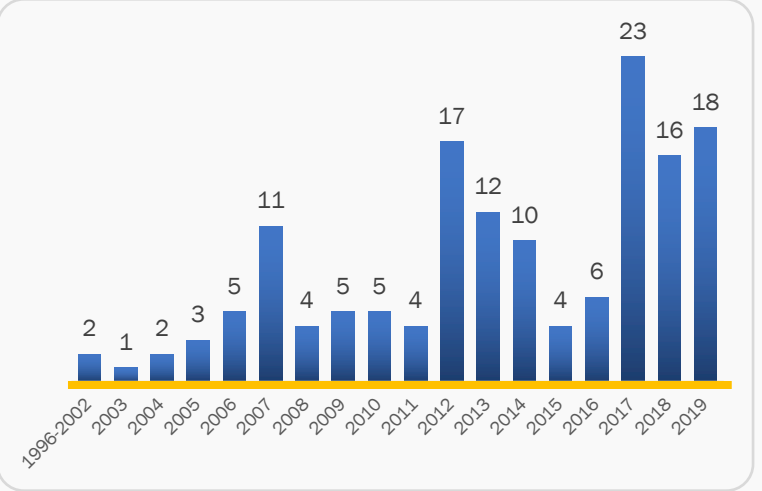
II. METHODOLOGY AND DATA

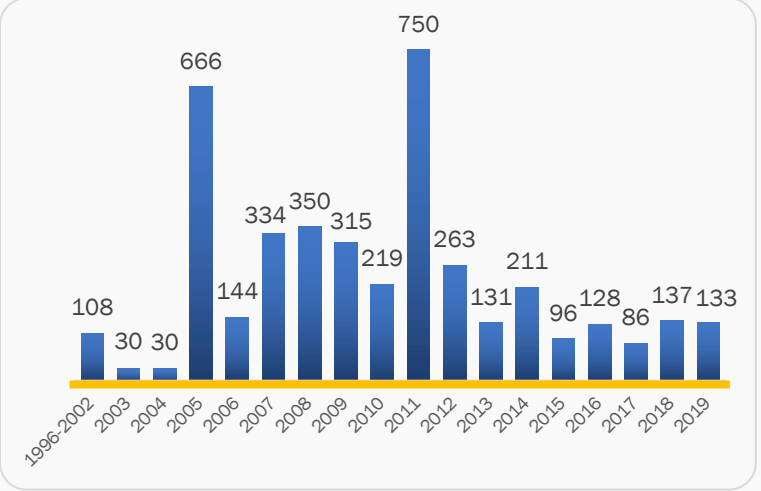
Exhibit 1

Evolution in number of funds raised and average committed capital per vintage

Panel A

NUMBER OF PE AND VC FUNDS RAISED PER YEAR





Panel B

AVERAGE COMMITTED CAPITAL (BRL MILLION) PER YEAR

III. FUND OPERATION: LIFETIME AND INVESTMENT PERIOD

Private Equity and Venture Capital funds differ from other asset classes. An LP commits capital but does not disburse and subscribe the entire capital at once, as is common with liquid funds. Disbursement and subscription is done through capital calls that occur in the years following commitment. The fund is closed and of finite duration.

The most common lifespan of Brazilian LPAs is 10 years (36% of funds), and 81% of the sample's LPAs have a lifespan ranging between 7 and 13 years (**Exhibit 2 - Panel A**). The average life is 9.8 years, with a standard deviation of 3 years.

LPAs provide for fund extensions, if they are approved by the LPs' meeting - only 3 LPAs do not require this approval. In 65% of the FIPs (97 cases), the extension period is explicit, and with 55% of the entire sample this period lasts around 1 and 2 years (**Exhibit 2 - Panel B**). In 29 funds, an extension is foreseen: 1 additional year (19 cases), 2 additional years (8 cases) and 3 years (2 cases).

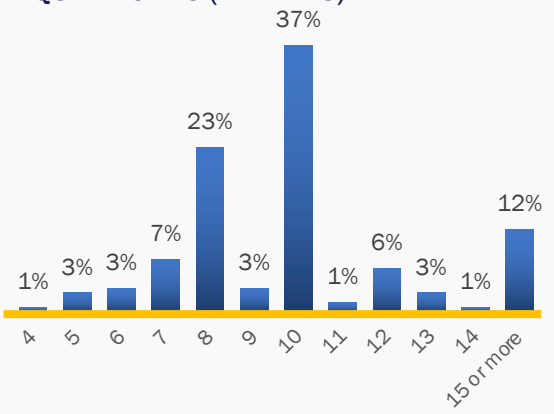
III. FUND OPERATION: LIFETIME AND INVESTMENT PERIOD

Exhibit 2

Duration and Extension of Private-Equity Funds

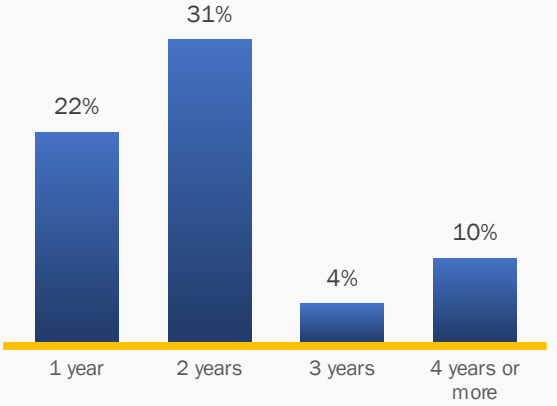
Panel A

LIFESPAN OF PRIVATE-EQUITY FUNDS (IN YEARS)



Panel B

DURATION OF INVESTMENT FUND EXTENSIONS (IN YEARS)



The extension option gives managers the flexibility to manage exits according to best market timing, avoiding the sale of assets when the market is bearish and paying low prices. Fund extensions are addressed by ILPA, which recommends that extensions be carried out in increments of one year and limited to a maximum of two requests and be approved by the majority of LPs. Brazilian LPAs appear to be in line with this recommendation.

In accordance with international practices, LPAs provide for a maximum number of years in which committed capital can be called up and allocated to companies - the investment period. If the committed capital is not fully called up during the investment period, LPs are released from honoring the unsubscribed capital. Some funds may allocate committed capital to investment theses and effectively make investments after the end of the investment period. 66% of the sample has an investment period between 3 and 5 years (**Exhibit 3 - Panel A**), with an average investment period of 5 years (median of 4 years) and a standard deviation of 2.6 years. In 91% of the LPAs analyzed, there is an extension provision for the investment period, provided it is approved by the investment committee or LPs' meeting. **Exhibit 3 - Panel B** provides a descriptive analysis of investment-period extensions.

47% of the LPAs provide for the possibility of recycling capital, that is, instead of distributing the proceeds from the sale of a company to LPs, the fund uses them for new investments. ILPA recommends that the possibility of recycling be restricted to the investment period, and that managers and investors agree on a maximum limit of capital that can be recycled. Of the FIPs expected to recycle, less than half (48%) establish a maximum period for reinvestment (average of 4 years), generally coinciding with the investment period, and only 3% of the funds restrict the percentage of capital that can be recycled (average of 60% of committed capital), indicating that not all Brazilian LPAs strictly follow ILPA's recommendation in this regard.

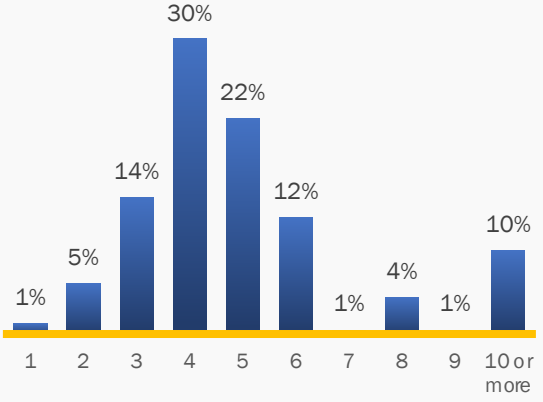
III. FUND OPERATION: LIFETIME AND INVESTMENT PERIOD

Exhibit 3

Duration and Extension of Investment Period

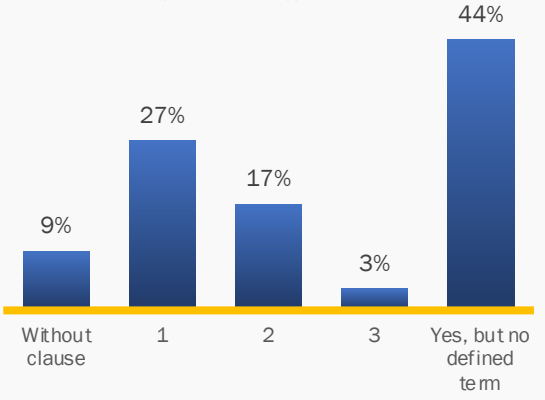
Panel A

INVESTMENT PERIOD OF PRIVATE-EQUITY FUNDS (IN YEARS)



Panel B

INVESTMENT-PERIOD EXTENSION DURATION (IN YEARS))



IV. SHARE STRUCTURE AND LIMITED PARTNER DEFAULT PENALTY

I-578 restricts investment in FIPs to qualified investors (those with more than R$1 million in financial investments), and allows for one or more share classes, with distinct economic and financial rights regarding administration and management fees, and preference in the payment of earnings, amortizations, and the fund's remaining balance. The existence of more than one share class is the case with 27% of the FIPs analyzed: 16% of the sample with two types of shares and 11% with three types of shares or more. Entry fees are not common in Brazil and only 9% of the funds analyzed charge this fee.

When there is a capital call, LPs have an established period to transfer capital to the fund. LPAs provide for penalties in the event of default. Of the FIPs analyzed, 85% foresee a fine of around 10% of the amount due adjusted by the IPCA index. The average rate charged was 9.2% (median of 10%) plus an inflation index, the most used being the IPCA (64% of funds that charge a fine). Other intoxicators observed were IGPM (14%), CDI (3%), INPC (2%) and IPC (2%). Other penalties noted were loss of political rights, retention of future distributions and the possibility of liquidation of shares.

V. GOVERNANCE

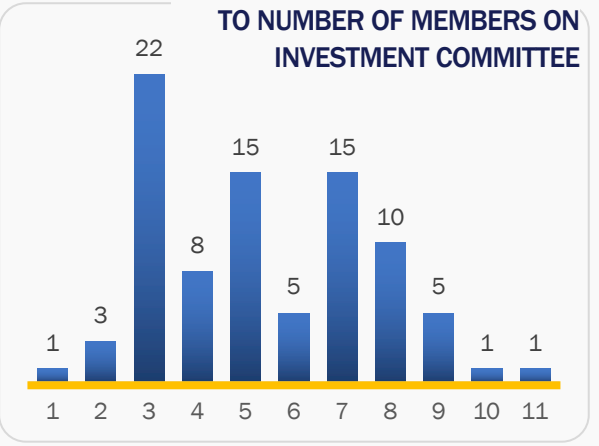
Brazil's financial and capital markets have undergone reforms in the last thirty years to protect minority shareholders and increase the quality and volume of information available to investors. Initiatives include the creation of B3's New Market, the revision of public offer regulation, the revision of norms ruling investment funds in general, and the revision of private equity funds' regulation in 2016, with the edition of I-578. The improvement in the business environment impacted Brazil's private-equity industry, affecting the investment decisions and divestment options of investees. ABVCAP and ANBIMA launched the Regulation and Best Practices Code in 2011 with the goal of increasing transparency, promoting standardization and making Brazilian market rules compatible with international private-equity standards. Adherence to the code is mandatory for ABVCAP members and associates: 75% of private-equity funds that operate in Brazil according to the association. The regulation code divides PE funds into three segments: Type 1, Type 2 and Type 3. Funds classified as Type 1 have an Investment Committee with LPs as members, Type 2 funds have an Investment Committee composed only of members of the fund management team and provide for the installation of a Supervisory Board, and Type 3 funds are not required to have an Investment Committee.

The Investment Committee has the function of monitoring and authorizing decisions made by managers, mainly regarding the acquisition and sale of assets, and is usual among international managers. In Brazil, however, there exists the peculiarity of LPs being able to appoint members to the Investment Committee, and thus interfere in fund-management decisions, which conflicts with the limited liability of investors, and diverges from the international model. In the sample of funds analyzed, 58% (86 cases) have an investment committee, with 53% (79) of the sample having members appointed by LPs, and 45% (67) with committees composed mainly of LPs. **Exhibit 4** provides a breakdown of the number of members (**Panel A**), as well as the percentage of members indicated by LPs (**Panel B**). A typical committee has 5 members (average 5.4), ranging from 3 to 8. LPAs can determine the number of years of a member's term - between one and two years in 55% of cases or leave it undetermined - 45% of the sample. Although members appointed by LPs are required to be approved at the LPGM, it is common for pension funds and development agencies to make nominations without the need for approval. This direct indication occurred in 22 cases

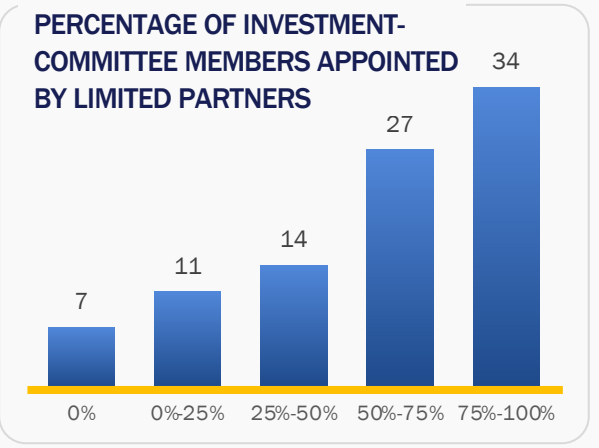
Exhibit 4

Number of members on the Investment Committee, LP participation and evolution of types of governance over time

Panel A



Panel B



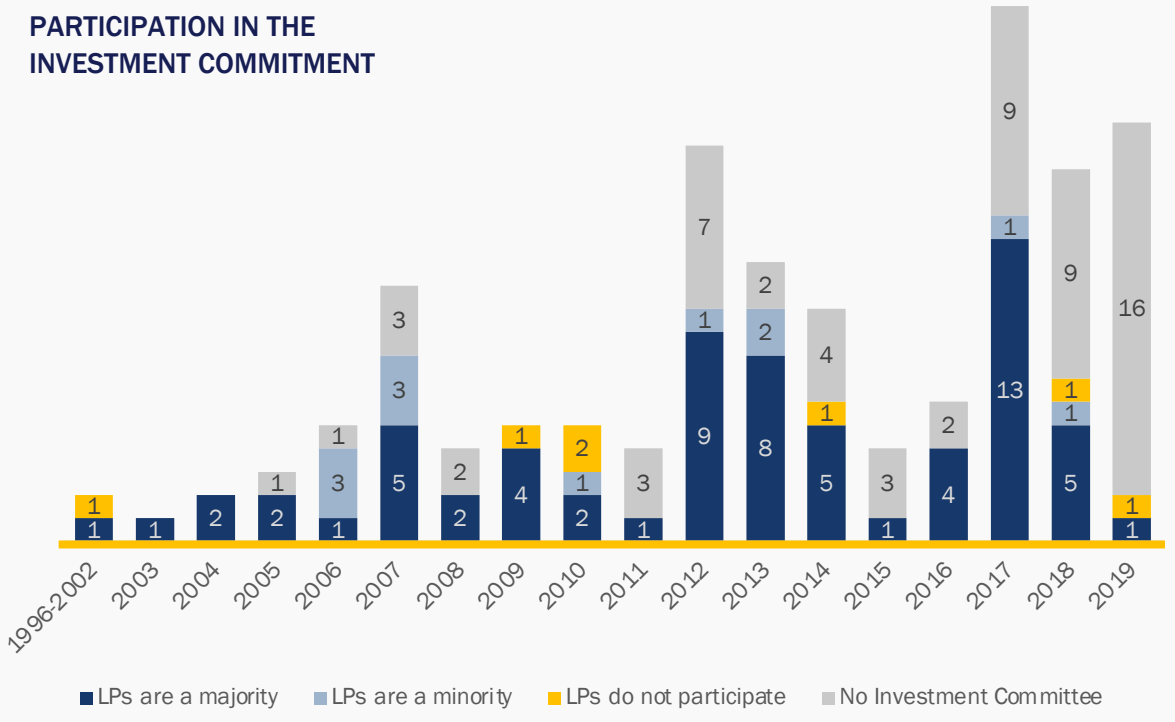
V. GOVERNANCE

An LP's interference in fund management creates several conflicts. The members that represent the LPs need internal vote approval before expressing it and can reverse decisions made by the managers, making the decision-making process time consuming, whereas managers can lose their timing of negotiations and hinder fund performance. Funds that adopt this model also find it more difficult to raise funds from international investors, who refuse to participate in committees because they do not want to jeopardize their limited liability, as occurs with members representing national LPs, and do not want to be subject to interference from other LPs. However, there seems to be a learning curve and the understanding that LP interference in fund management is not adequate. The percentage of funds registered with an investment committee with LPs as members fell to 37.5% in 2018 and 5.56% in 2019 (**Exhibit 4 - Panel C**).

Type 2 governance model, which is common in offshore structures and contemplates the existence of an Investment Committee without a member representing the LP and delegating to the Supervisory Committee the mitigation of conflicts of interest, is ~~a minority in Brazilian LPAs~~ uncommon in Brazil- only 4.73% of the sample. What is growing in Brazil is Type 3 governance, which does not require an Investment Committee (**Exhibit 4 - Panel C**).

Panel C

EVOLUTION OF THE NUMBER OF FUNDS ACCORDING TO LIMITED-PARTNER PARTICIPATION IN THE INVESTMENT COMMITMENT



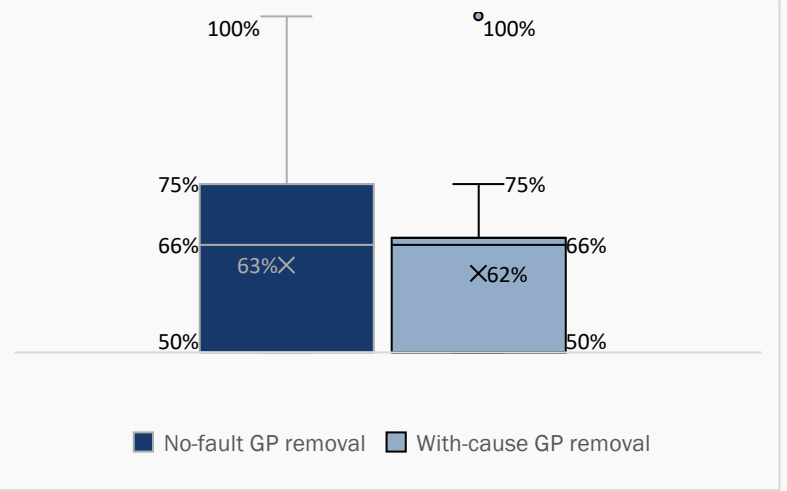
V. GOVERNANCE

I-578 empowers the LPGM to approve financial statements presented by the administrator, approve modifications in the LPAs, install and dissolve committees, and various other matters that mitigate conflicts of interest. The CVM also requires FIPs to hire a fund administrator, who may or may not be the same as the one appointed by the manager. In most cases (75%), the administrator and the manager are different individuals. The main obligations of the administrator are to comply with LPGM resolutions, supervise the services provided and enforce the provisions of the fund's LPAs.

The LPGM and the fund administrator comprise part of the functions that could be performed by the supervisory committee and fiscal committee. This fact probably explains the low percentage of LPAs with supervisory committees - only 15%, and even lower with fiscal committees - just 7%. If, on one hand, the LPGM democratizes fund governance to several LPs, on the other hand, there is a loss of specialization in this model. In the international model, it is common to invite industry professionals with recognized knowledge on the subject to be part of the Supervisory Committee.

A highly sensitive topic that can be resolved in the LPs' Meeting is the possibility of removing the fund manager. Such removal can take place with cause or with no-fault. ILPA recommends that in no-fault removals, the minimum quorum be 67%, while in the event of a with-cause event, a majority would already be sufficient to remove the manager. **Exhibit 5** presents the distribution of quorums for the two possibilities of removal in Brazil. The median quorum for the two events in Brazil is the same: 66%, when compared to ILPA recommendations, Brazilian LPAs have greater resistance with removal for cause.

EXHIBIT 5
MINIMUM LPGM QUORUM TO REMOVE MANAGER

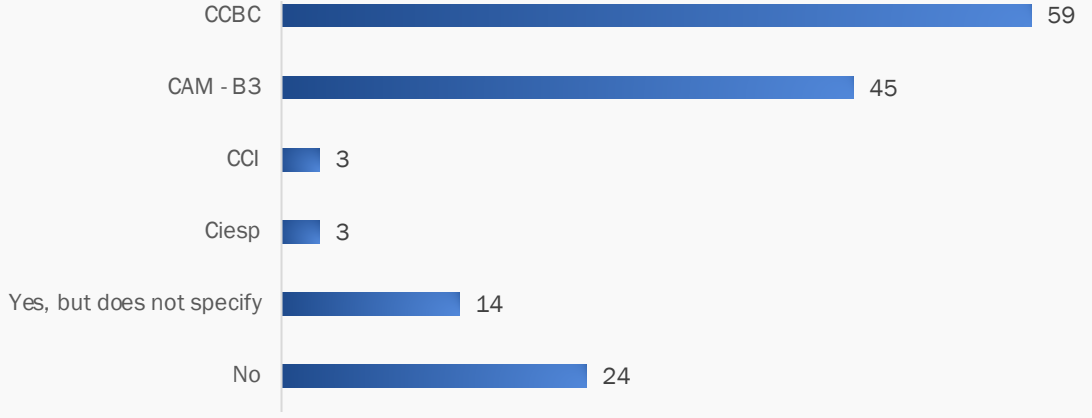


Manager removal has an impact on the compensation of managers. In the case of a no-fault removal, managers receive the management fee proportional to the management period, and if there is no penalty provision, they also receive the carried interest proportional to the management period. Only 4% of the sample (6 funds) have a carried interest penalty for no-fault removal. When it comes to removal with cause, 31% of the funds have no penalties foreseen in the LPAs, 63% have additional penalties for the carried interest due to the manager and 6% of the LPAs apply additional penalties on the caried interest and the management fee due to the manager. ILPA suggests that in cases of manager removal there should be at least a reduction in carried interest (even in cases of no-fault), increasing the percentage of carry that will be received by the new team, thus preserving the incentives of the new manager.

V. GOVERNANCE

Arbitration Chambers are a common artifice for solving conflicts and 84% of the LPAs provide for arbitration to solve disputes between managers and LPs. Conflicts are judged by specialized arbitrators, and resolution tends to be much faster than in traditional courts. **Exhibit 6** shows that the Brazil-Canada Chamber of Commerce (CCBC) and the B3 Market Arbitration Chamber (CAM - B3) are the two most cited in the LPAs with 59 and 45 observations, respectively.

EXHIBIT 6
ARBITRATION CHAMBERS ACCORDING TO THE NUMBER OF LPA ADHERENCE



VI. INVESTMENT STRATEGY

I-578 classifies FIPs according to type of target investment in five modalities: (i) Seed Capital, (ii) Emerging Companies, (iii) Infrastructure (FIP-IE), (iv) Intensive Economic Production in Research, Development and Innovation (FIP-PD&I) and (v) Multi-strategy. Companies invested by Seed Capital FIP must have up to R$16 million in annual gross revenue in the year prior to the fund's investment, in addition to being exempt from following more-stringent governance practices. Emerging Companies FIPs invest in companies with annual gross revenue of R$300 million in the year prior to the investment and are exempt from some governance rules, such as the ban on issuing participation certificates, a unified mandate of the board of directors and availability of contracts with related parties to LPs.

Infrastructure and Economic Production Intensive in Research, Development and Innovation FIPs have tax benefits and invest in companies in the following sectors: energy, transportation, water and basic sanitation, irrigation and other priority areas. Lastly, funds that do not fall under any other definition are classified as Multi-strategy FIPs and can invest up to 100% of the capital abroad.

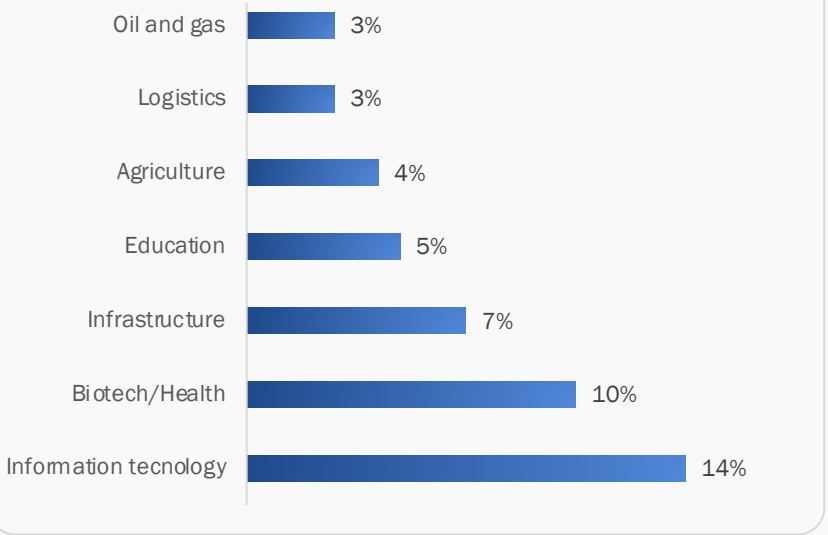
Diversification is a desired feature for private-equity fund investors, and 41% of LPAs specify a maximum-exposure limit in a single company on the portfolio, which on average amounts to 23% of the fund's maximum committed capital.

VI. INVESTMENT STRATEGY

Co-investments between LPs and the fund are covered in 73% of the LPAs, provided that the fund has already been fully committed or has a very-high concentration on the asset - exceeding the maximum concentration in an asset or sector. According to ILPA, the Limited Partnership Agreement (LPA) or PPM must contain clear rules for co-investments and how opportunities will be allocated. Among the LPAs that have a co-investment clause, 21% of the funds must approve the co-investment in the investment committee meeting or at the LPGM, which can lead to conflicts between LPs and managers. In the other 79%, the manager has more freedom to offer co-investments, which is not in line with ILPA recommendations.

EXHIBIT 7

SECTORS PLANNED FOR INVESTMENT IN LPAS



Most private-equity funds are generalist, with no preference over sector or region. The information technology sector is the one with the highest preference (14%), while health (10%), infrastructure (7%) and education (5%) are the other most-cited sectors (**Exhibit 7**). The most popular regions for LPAs are states in the Southeast (4%) and Northeast (2%).

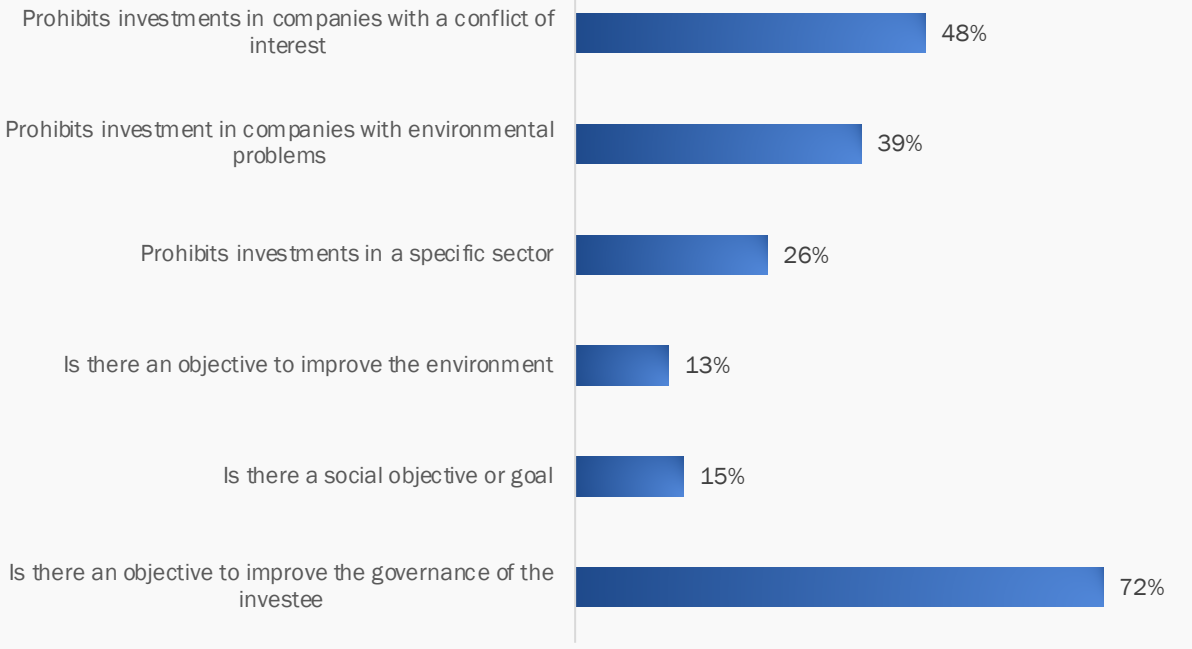
The acquisition of a company's controlling stake is the main form of acquisition in just 8% of the funds, while in the USA and Europe most funds are buyouts. The other funds seek to participate in management through mechanisms provided for in I-578: by holding shares in the controlling block, LPs' agreement, participation on the board, covenants in the main decisions of the company or a procedure that ensures the fund's effective influence on the company's strategic policy.

ILPA recommends that funds present an ESG (environmental, social and governance) report at the LPGM, in addition to periodically reviewing the risks and incidents in investee companies. I-578 presents the governance practices that investees must follow, the main points being the ban on issuing participation certificates, unified mandates of up to two years for the entire board of directors, transparency of contracts with related parties, adherence to arbitration chambers and, if the company obtains registration as a publicly-held company, it must have the same practices as the differentiated level of governance from B3. However, I-578 does not provide any recommendations on social and environmental practices. **Exhibit 8** shows ESG objectives and seals found in Brazilian LPAs. The presence of governance-related items is perceptible; however, environment and social aspects are only present in a few LPAs, mainly in the form of investment prohibitions.

VI. INVESTMENT STRATEGY

EXHIBIT 8

FUND PROHIBITIONS AND ESG GOALS



VII. FUND MANAGER COMPENSATION

The fund-manager compensation scheme is a key factor for alignment between manager and investor. The management fee is intended to finance the fund's operation and day-to-day expenses, while carried interest is the premium that managers receive for the fund's performance, encouraging them to seek high returns.

The management fee can be broken down between management and administration, but only 30% of LPAs do this separation. For this reason, in our analysis, the term 'management fee' consolidates fixed compensation for administrators and managers. The management fee consists of a percentage rate per year calculated in relation to a base, and paid at a given frequency (monthly, quarterly, biannually, annually). ILPA recommends that the management fee be reduced after the investment period, since the fund will incur less expenses because it has already invested all the committed capital and the manager will raise new funds, accumulating management fees for different vehicles. This drop can be done either through a reduction in the rate or a change in the base.

VII. FUND MANAGER COMPENSATION

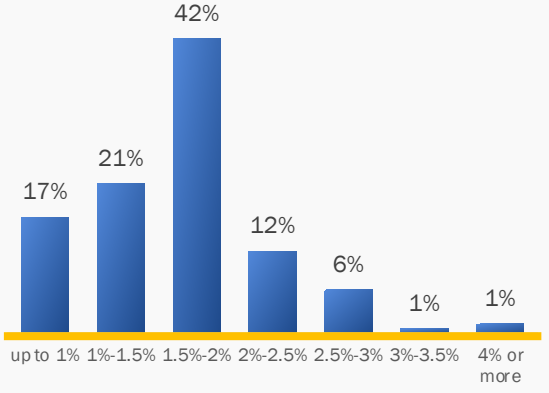
In 81% of Brazilian LPAs, management fees range between 1% and 3%, with an average rate of 1.8% (median of 2%), a standard deviation of 0.9%, and a maximum fee of 7.7% (**Exhibit 9 - Panel A**). Three funds charge a fixed management fee in Reais (BRL). Most of the LPAs (63%) have committed capital (drawn down plus unpaid) as the basis during the investment period, while the remaining LPAs (37%) adopt net equity. After the investment period, 65% of the funds that use committed capital as a base start to use equity (**Exhibit 9 - Panel B**). CVM I-579 establishes that the assets and liabilities of FIPs must be recognized at their fair value, so changing the management fee basis from committed capital to equity can increase the amount received by the fund if investments appreciate. A portion of the funds uses equity at cost, where the amount consists of the sum of the acquisition value of companies in the portfolio, avoiding this kind of distortion. In addition, 13% of the funds change the management fee after the investment period, with an average decrease of 0.3% per year. The collection of fees is monthly in 90% of the funds and quarterly in 10% of the funds.

Exhibit 9

Management Fee Calculation in Brazilian LPAs

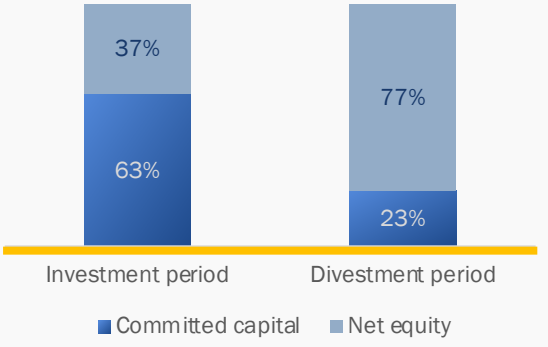
Panel A

MANAGEMENT FEE LEVEL (IN PERCENT PER YEAR)



Panel B

BASIS FOR CALCULATING MANAGEMENT FEES



The fund manager is only eligible to receive carried interest if it performs above the preferred return (hurdle rate), which is the opportunity cost of the investor. In Brazil, the most common is to calculate carried interest as a percentage of the profit above the paid-in capital adjusted by the preferred return. In international contracts, it is usual to charge carried interest on profit above committed capital without correction.

VII. FUND MANAGER COMPENSATION

Of 76% of the FIPs analyzed, the percentage of profit charged as carried interest ranges between 15% and 20% (**Exhibit 10 - Panel A**). The average carried interest is 19% (median of 20%), with a standard deviation of 5.4% and a maximum of 50%.

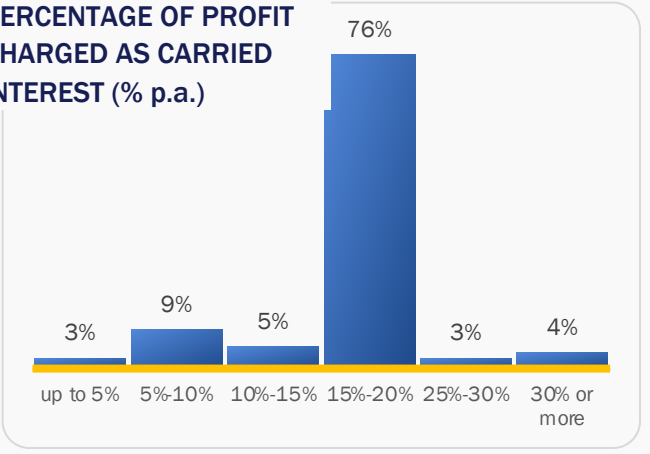
The most common hurdle rate in international contracts is 8% p.a.. In Brazil, priority return is usually calculated as a spread above an inflation index. In 82% of the LPAs, the index used is the IPCA (**Exhibit 10 – Panel B**), with IGP-M being the second most popular, seen in 10% of the agreements. In 66% of regulations, the spread varies between 5% p.a. and 8% p.a., with an average spread of 7.6% p.a. and median of 8% p.a. (**Exhibit 10 – Panel C**).

Exhibit 10

Calculation of carried interest in Brazilian LPAs

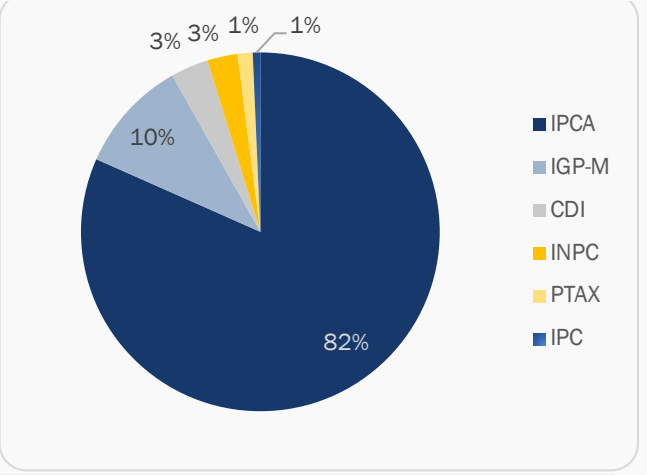
Panel A

PERCENTAGE OF PROFIT CHARGED AS CARRIED INTEREST (% p.a.)



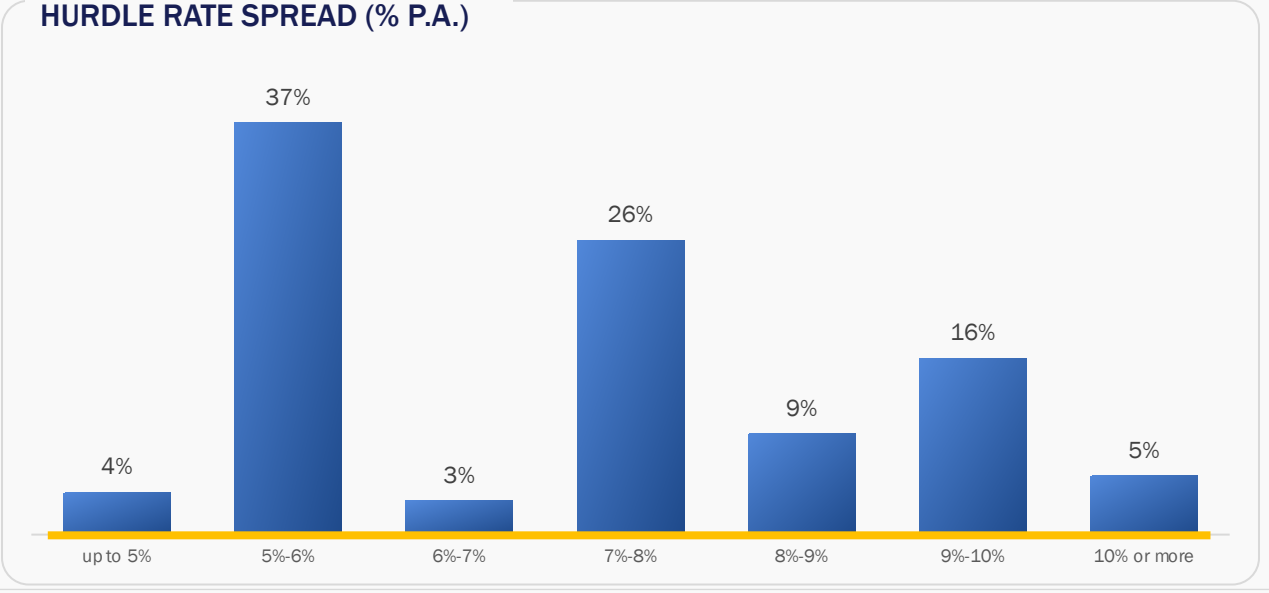
Panel B

HURDLE RATE INDEX



Panel C

HURDLE RATE SPREAD (% P.A.)

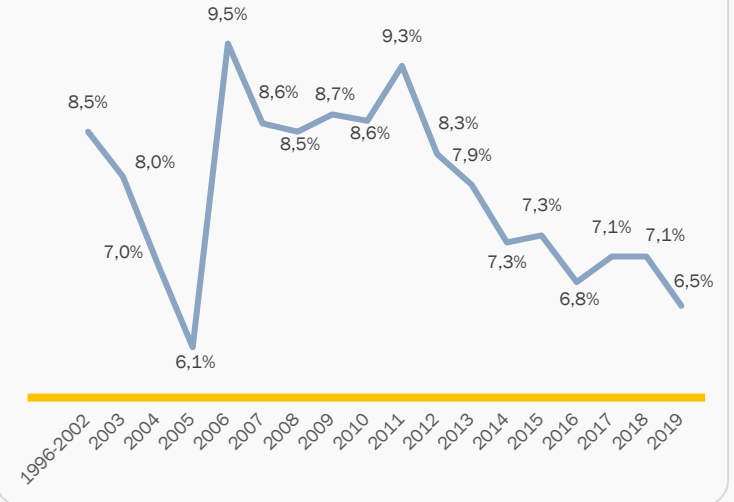


VII. FUND MANAGER COMPENSATION

Hurdle rate is a point of attention because, if it is too high, it can discourage the manager from pursuing an unrealistic goal, mainly because if reached, there will be little carry left, as the most usual in Brazil is to calculate carry based on profit that exceeds paid-in capital adjusted by the preferred return. Exhibit 10 - Panel D shows the evolution over time in hurdle rate spread. A downward trend is perceived over the years - from 9.5% in 2006 to 6.5% in 2019, which could signal a learning curve in Brazil's PE industry.

Panel D

AVERAGE HURDLE RATE SPREAD BY VINTAGE



The timing of collection of carried interest is reflected in two different forms of collection: fund as a whole, where carried interest is only paid after the shareholder receives all paid-in capital adjusted by the preferred return; and deal-by-deal, where the shareholder receives carried interest after each exit that is profitable above the preferred return, anticipating carried interest, but with the risk that the shareholder might pay more than the due fee. In this case, the by-laws should have a claw-back clause, which entitles the shareholder to call back the manager fee unduly paid. In Brazil, 94% of the funds receive carried interest for the fund as a whole and only nine funds are deal-by-deal. Another form of alignment with the manager is the catch-up clause, where after reaching a pre-established performance goal, the manager starts to receive carry between the committed capital and the preferred return. However, only twelve funds have a catch-up clause.

Lastly, only five funds state that managers can receive other forms of compensation from investees, such as consulting fees, premium per transaction or co-investments. ILPA suggests caution with other forms of compensation, recommending that these fees be received by the fund, and be divided among shareholders and managers proportionally to the carried interest, and that there be transparency in the form of collection.

VIII. RESTRICTION AND REQUIREMENTS FOR MANAGERS

The management team is an important aspect for investors, who are concerned with the permanence of people they deem important for the fund to be able to implement the investment thesis it is selling. It is also important for the managers that are listed in the LPAs, as it proves their prestige to raise the fund. In our sample, 63% of funds disclose the names of their key-persons. According to ILPA, any significant change in management should allow investors to reconsider the decision to commit capital and in order to guarantee the long-term success of the GP-LP partnership, there must be a programmed and transparent process for succession. Of the funds analyzed, 94% present the replacement process for key-persons, and 26% of the funds that disclose a key-person foresee liquidation if managers are unable to approve a substitute (12% of all funds).

VIII. RESTRICTIONS AND REQUIREMENTS FOR MANAGERS

Exhibit 11

Evolution in the percentage of funds with key-person specification provisions over the years

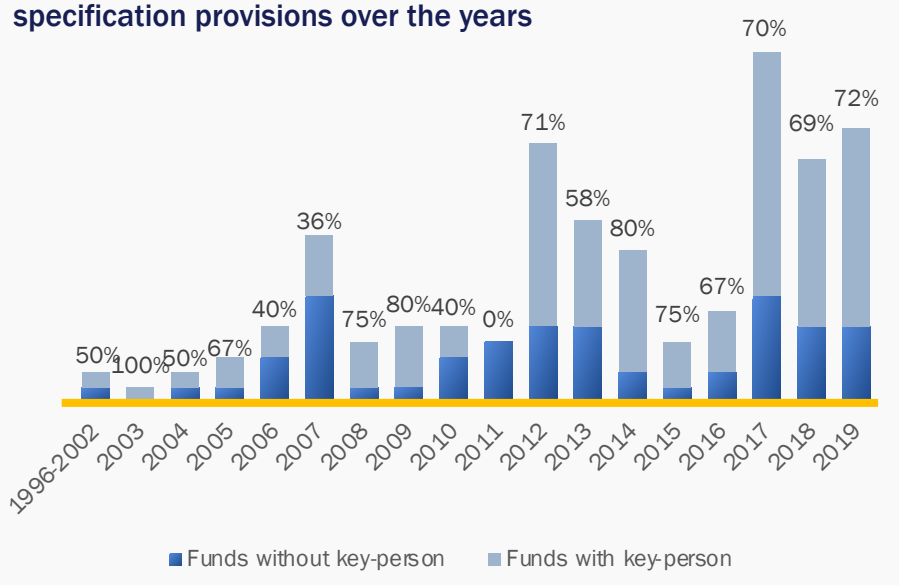


Exhibit 11 presents the evolution in the percentage of funds with a key-person clause over the years. We observed an increase in the importance of divulging the names of key-people: between 1996 and 2010, 53% of the funds specified the key-team and after 2010 this percentage increased to 68%.

Pension funds can be an important factor in institutionalizing key-person clauses. In funds that have pension funds with a seat on the investment committee, 87% have this clause. Funds with a key-person clause have become the dominant structure over the past decade.

According to ILPA, the manager should contribute a substantial portion of the fund's capital and this contribution should be in equity and not by waiver of management fees. This would be one of the main forms of alignment between manager and investor, in addition to carried interest. Only 10% of funds have this type of policy in the LPAs and the average commitment of managers is 9.65%, with 5% being the most common commitment. Most funds are likely to have this commitment, but do not mention it in their LPAs.

It is common in international LPAs to prohibit managers from raising new funds before they have drawn down a significant percentage of the committed capital to acquire companies for the portfolio. This is because the manager's time is limited, and during the investment period the manager should be mainly concentrated on sourcing and monitoring potential companies, and not focus on activities that also consume a lot of time, such as fundraising efforts. In our sample, only 15% of the LPAs are concerned with this practice, in which case they stipulate that the manager can only raise a new fund after 80% of the committed capital has been invested.

IX. CONCLUSION

This paper presented a description and evolution in FIP-fund LPAs between 1996 and 2019. These funds comply with CVM I-578, which is in accordance with ILPA best practices and provides for instruction guides on transparency and disclosure of information, definition of manager and administrator roles, function of the LPs' meeting, description of investment thesis, management compensation and sanctions.

In a static analysis, it is observed that the median fund has an expected lifespan of 10 years, with an investment period of 4 years. The management fee is 2% p.a. charged on the committed capital during the investment period and on equity at cost (sum of the acquisition value of companies in the portfolio) after the investment period. Carry is 20% of the profit that exceeds the paid-in capital adjusted by the preferred return: IPCA + 8% p.a., paid only after the LP has received the committed capital adjusted by the preferred return (whole of fund) and without a catch-up clause. The fund manager and fund administrator are different entities, and there is no supervisory or fiscal committee. There is an investment committee with LP participation, which approves investments and divestments. Conflicts are decided by an arbitration chamber. The investment strategy is generalist, without specifying a region or sector, nor stating preference for control or minority stakes. Few funds declare socioenvironmental objectives.

Governance of Brazilian funds differs from international LPAs, where funds that have an investment committee without members elected by LPs and with a supervisory committee are rare. The existence of a fund manager combined with the deliberative power of the LPs' meeting probably fulfills a large part of the role of supervisory and fiscal committees. Another point relates to the manager removal process and sanctions applied: on average, minimum quorums in Brazil are higher and sanctions are milder than those recommended by ILPA.

On the other hand, the fact that the management fee decreases during the life of the fund (change in the base of committed capital to equity at cost after the investment period) as well as carried interest being paid on the fund as a whole, lending greater security to the LP, are in accordance with ILPA recommendations.

In a dynamic analysis, the evolution of LPAs towards convergence with best international practices is noticed, indicating a learning curve in Brazil's PE and VC industry. The percentage of funds with investment committees with LP participation has decreased over the years; the spread of preferred return has also decreased, increasing the value of carried interest that can potentially be distributed to the manager, and consequently bringing greater alignment. A higher number of funds started to declare a key-person provision in their LPAs.

There is still room for improvement, particularly in terms of: (i) milder sanctions for the removal of managers and a minimum quorum for removal higher than that suggested by ILPA; (ii) few LPAs restrict managers from raising new funds; (iii) more than half of the funds do not impose a limit on the maximum that can be invested in a single company; (iv) few LPAs provide for the liquidation of the fund if a key-person is not replaced.

Lastly, guidelines on integrating ESG practices still focus solely on Governance (G), with few LPAs addressing Social (S) or Environmental (E) aspects. The few LPAs that address S or E are limited to restricting investments in sectors or companies with bad practices, without a commitment to positive practices. This reflects the novelty of the theme, which needs to follow international standards and increasingly integrate S and E, in addition to G, in the investment process of the funds.

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