

Fix the denominators first

Chapters 1 and 18. Every multiple is a fraction. Write the four figures down before reading anything else; then say which question each headline number answers.

Fund		Manager	
Vintage		Date	

Figure	This fund	Where it comes from	Kelvinside
Commitment			
Capital called (investment plus fee)			
Capital invested in companies			
Gross proceeds (distributions before carried)			
Fees over the life (called less invested)			
Carried interest			

Multiple	Numerator / denominator	The question it answers	This fund
Initial cheques	initial proceeds / initial cheques	Can this manager price a first round?	
Gross on invested	proceeds / invested	What did the money that reached companies do?	
Gross on commitment	proceeds / commitment	What did the fund do with the money promised?	
Net TVPI	(proceeds - carried) / commitment	What arrived, after the manager's share of the upside?	
Net on called	(proceeds - carried) / called	What the treasurer reconciles to the bank	

Test	Answer
Spread from highest to lowest, in turns (Kelvinside: 1.5764)	
Ratio highest to lowest (Kelvinside: 1.7648)	
Which figure is on the cover of the deck, and what is its denominator?	
Is the net figure net of fees, of carried, or of both? (Fees are called: they belong in the denominator, not deducted again)	

The practical habit costs fifteen seconds: when a multiple arrives, ask what is on the bottom of the fraction. If the number is high and the denominator unstated, the denominator is usually small.

The fee schedule, reduced to two numbers

Chapter 2. A fee table is a statement about how much of the commitment reaches a company, and what that capital must return before the investor is level.

Fund		Manager	
Vintage		Date	

Year	Fee basis (commitment / cost of holdings)	Basis	Rate	Fee	Cumulative

The line to add to the fund summary	This fund	Kelvinside
Commitment		
Fees over the life		
Investable capital (commitment less fees)		
Break-even multiple on invested capital (commitment / investable)		
Fees as a share of commitment (the flattering one)		
Fees as a share of investable capital (the hurdle the portfolio must clear)		
Maximum call: commitment plus the recycling cap		

The variant to price	Fees	Investable	Break-even
As drafted (step-down after the investment period)			
Full rate on commitment for the whole life			
Difference: what the step-down clause is worth			

Kelvinside: 21,470,000 of fees, 128,530,000 investable, 1.1670x to break even; 14.3133 per cent of commitment is 16.7043 per cent of the capital at work. Without the step-down: 30,000,000, 120,000,000, 1.2500x. The clause is worth 8,530,000 and 0.0830 turn, in the direction of the manager if it is lost.

The recycling clause

Chapter 3. Recycling is ordinary and legitimate. It is defined in the partnership agreement and disclosed nowhere else, so its effects arrive in the accounts as anomalies.

Fund		Manager	
Vintage		Date	

Item	Answer	Evidence / note
The clause		
Cap: the maximum that may be recycled (% of commitment, absolute amount, or limit on total calls)		
Window: the period in which proceeds may be recycled (investment period only, extended, whole life)		
Gains: may only the return of cost be recycled, or gains as well?		
Threshold of the carried interest: "Commitments" or "Capital Contributions"? The difference is whatever may be recycled		
The record		
Called against commitment in each of the last two funds (%)		
Recycled amount, and share of the proceeds available when it was recycled		
Which lines received recycled capital, and what they returned		
Year the last distribution was made against the stated fund life		

Reconciliation	Amount
Called less commitment (the recycled capital)	
Invested less investable capital (must be the same number)	
Committee shortcut: gross multiple x investable / commitment	
Actual multiple on commitment less the shortcut (the recycling, visible)	
Carried paid on the recycled capital because the threshold is the commitment	

Kelvinside recycled 1,970,000 (1.3133 per cent of commitment), 44.7727 per cent of the 4,400,000 available by year six; the shortcut is 0.0351 turn light; the drafting is worth 394,000 to the manager. At a thirty per cent right the same drafting is worth 9,000,000.

The realised table, requested

Chapters 4 and 18. Twenty-eight rows fit on a page. Sorted by proceeds, it makes the count visible; no other presentation of a fund does.

Fund		Manager	
Vintage		Date	

[illegible]

Ask for it on every closed fund, with the split between the initial cheque and the follow-on and the entry valuation of each tranche. If it will not be provided, ask why: the fund is realised and the figures are in the audited accounts.

Concentration, measured

Chapters 4 to 7. Four statistics that read straight off the realised table and off nothing else.

Fund		Manager	
Vintage		Date	

Statistic	This fund	Kelvinside
Share of proceeds: the first line / three / five / ten		
Fund multiple without the first line		
Fund multiple without the first three		
The best three alone		
Lines that returned nothing: count, and share of capital		
Lines that returned less than cost: count, and share of capital		
Median line (state the convention: upper central value, or average of the two)		
Unweighted mean of the multiples (compute it only to discard it)		
Median pound: rank by multiple, walk the cost column to the halfway mark		

Kelvinside	Value
First line / three / five / ten	56.7376 / 80.0487 / 88.8387 / 98.2592 per cent
Without the first line; without the first three	1.3071x; 0.7447x
Zeros; below cost	13 of 28, 18.7739 per cent of capital; 21 of 28, 47.8927 per cent
Median (upper, midpoint); mean; median pound	0.1600x, 0.1242x; 1.0895x; 1.2071x

Verdict: how many decisions carry the result, and would the manager have raised the next fund on the figure without the first line?

The follow-on memo

Chapter 12. Five clauses, each testable against a piece of paper. Read the memo backwards: the price first, the story last.

Fund		Manager	
Vintage		Date	

Clause	This memo
1. Underwritten as a new investment: its own entry price, its own target, no credit for already owning the position	
2. Target multiple from THIS round's price, the one the firm would apply to a new company at this stage	
3. Per-company reserve cap set at the initial investment (as a multiple of the first cheque); any breach recorded with the reason	
4. The alternative use of the same money, written by someone who does not own the position (including holding it)	
5. The track record split annually: initial cheques against follow-ons, by fund and vintage	

Read in this order	Figure
Entry valuation of this round, and step-up from the last round	
Exit value the company must reach for this cheque to clear the target	
Base rate: follow-ons that returned more than cost in the firm's own record (Kelvinside: 3 of 16)	
Amount, and remaining reserve pool after it	
Only now: how the company has performed since the last round	

A rule of this kind is a presumption a partner can rebut in writing, not a gate: it declines the recoveries too, and Kelvinside contains none.

The committee agenda, weighted by money

Chapter 8. Follow-ons carried 52.1073 per cent of Kelvinside's capital and got ten minutes under any other business. Give them the new deal's format.

Fund		Manager	
Vintage		Date	

Item	Answer	Evidence / note
A follow-on gets		
A written memo, circulated with the papers		
A sponsor who is not the board member who has lived with the company		
The entry price of the new round, and what must be true at that price for the cheque to matter		
A stated alternative use of the money, including holding it		
A minute that says this was the best home for the amount, not "pro rata"		
An initial cheque gets		
A shorter standard memo and a hard filter applied early		
The cheque size below which the committee is buying an option, not underwriting an outcome (stated)		
The question: if it works, can it return the fund?		
Once a year		
The reserve pool and its remaining balance on one page		
The follow-ons not taken, and why		
Pages of memo per million deployed: initial cheques against reserves (the ratio should be at least even)		

Decision	Type	Amount	Memo pages	Minutes	Sponsor independent?

The track record, split

Chapters 9 to 11. Two businesses in one partnership. Compute the return on each half from the same table, and what each was charged.

Fund		Manager	
Vintage		Date	

	Initial cheques (Seed)	Follow-ons (Growth)	Total
Capital invested			
Share of invested capital			
Proceeds			
Gross multiple			
Management fee, pro rata to capital			
Carried interest, each half on its own paid-in			
Net multiple to the investor			
Manager's take, share of the half's proceeds			
Companies / cheques; returned nothing; returned less than cost			

Kelvinside	Seed	Growth
Capital; proceeds	62,500,000; 227,350,000	68,000,000; 121,625,000
Gross; net multiple	3.6376x; 2.6990x	1.7886x; 1.4287x
Fee; carried	10,282,567; 30,913,487	11,187,433; 8,487,513
Take, share of proceeds	18.1201 per cent	16.1767 per cent

Ask, in order	Response
1. The split on every prior fund, by company, with the entry valuation of each tranche	
2. A reserve budget in the agreement, reported annually	
3. Economics on follow-on capital: co-investment right above a threshold, or a lower fee after the investment period	
Do not ask for a separate carry pool on the reserve half: whole-of-fund netting is the investor's protection	

What the manager takes, at four outcomes

Chapter 13. Ask the manager to compute it on their own fee schedule, step-down, recycling clause and carried convention.

Fund		Manager	
Vintage		Date	

Gross multiple on commitment	Proceeds	Fees	Carried	Manager total	LP gain	Manager's share of the gain
1.0x						
1.5x						
2.0x						
3.0x						
The outcome you actually expect						

The same total, on four bases	This fund	Kelvinside
Share of gross proceeds		
Share of the capital called		
Share of the gain on invested capital (proceeds less invested)		
Share of the gain over calls (counts the fee on both sides)		
Share of the limited partner's net gain		

Invariant	Called	Invested	Mixed (wrong)
Capital base	151,970,000	130,500,000	151,970,000
LP receives	309,180,000	287,710,000	287,710,000
Net gain	157,210,000	157,210,000	135,740,000: the fee counted twice

Kelvinside at 1.0x, 1.5x, 2.0x, 3.0x: 110.1026, 38.5926, 30.3658 and 25.4992 per cent of the gain; as it happened, 28.0421. "Two and twenty" priced out at twenty-eight.

The carried interest clause

Chapter 14. The rate is not the price. Get three answers in writing before the rate is discussed.

Fund		Manager	
Vintage		Date	

Question	Answer from the agreement	Worth on Kelvinside
1. Threshold: "Commitments" or "Capital Contributions"? What does the recycling clause permit?		
2. When is the test applied? If not once, at liquidation, on the whole fund: what secures the clawback (escrow, gross or net of tax, firm or individuals)?		
3. Is there a preferred return, and a catch-up? At what rate?		

Convention, same 28 companies	Carried	Against actual
Deal by deal, no clawback	52,195,000	+12,400,000
Whole-of-fund, commitment threshold (actual)	39,795,000	-
Whole-of-fund, contributions threshold	39,401,000	-394,000
8 per cent preferred, full catch-up	39,401,000	-394,000
8 per cent preferred, hard hurdle	about 25,349,000	about -14,446,000

Convention in this agreement	Carried at the expected outcome	Year collected	Clawback security

A limited partner who negotiates the hurdle from 6 to 8 per cent and leaves a 100 per cent catch-up standing has won an argument and no money.

Four numbers, on stated denominators

Chapter 15. Any report that gives one multiple and one rate has already chosen which gap you see.

Fund		Manager	
Vintage		Date	

Stage	Capital base	Multiple	IRR
Before fee and carried			
After fee, before carried			
After fee and carried			

Question	Answer
Gross multiple: which capital base?	
Net multiple: which capital base?	
Gross IRR: gross of what, exactly? (fee in the called column or the distribution column)	
Net IRR: on the dates of the limited partner's wires, or of a credit line's drawdowns?	
In which year was the carried interest collected?	
What would the net IRR be if the same carried were collected in year one?	

Kelvinside	Multiple	IRR
Before fee and carried, on 130,500,000	2.6741x	21.7217 per cent
After fee, on 151,970,000	2.2963x	18.3357 per cent
After fee and carried, on 151,970,000	2.0345x	15.7734 per cent
Same carried taken in year 1 / year 10	cost 11.4034 per cent either way	11.5069 / 16.1264 per cent

The J-curve, written down in advance

Chapter 16. Written at the outset, the plan turns year six from a crisis into a checkpoint.

Fund		Manager	
Vintage		Date	

Expectation, before signing	Planned	Observed	Inside the range?
Trough, as a share of commitment			
Year of the trough			
Year the annual net flow turns positive			
Year the cumulative position crosses zero			
Share of proceeds in the single largest year			
Cash sleeve or facility held to meet calls through year seven			

Year	Called	Distributed	Net	Cumulative	DPI

Kelvinside: trough 129,856,666.67 at the end of year six, 86.5711 per cent of commitment; annual flow positive in year seven; cumulative position positive inside year nine; 66.5950 per cent of all proceeds in year nine; at the trough, 98.7392 per cent of the proceeds still to come.

Re-underwriting from the manager's own numbers

Chapters 17 and 18. Eight steps, each ending in a verdict. Then score the report against the seven tables.

Fund		Manager	
Vintage		Date	

Step	Verdict
1. Fix the denominators: committed, called, invested, distributed	
2. Rebuild the initial-cheque multiple apart from the reserves	
3. Measure the concentration: first line, first three, zeros, below cost, median	
4. Remake the fund without its best line and its best three, to the bank statement	
5. Identify the carried convention from the numbers (test the base)	
6. Establish what the published rate is net of (fee: called column or distributions?)	
7. The year the distributions, and the carried, fall	
8. Price the fee before the pitch	

Table in the report	Present?	Denominator stated?
1. The four multiples, with the question each answers		
2. The same fund on one denominator (multiple and IRR)		
3. The lines, ranked by proceeds, with exit years		
4. Where the proceeds came from (and the fund without its best lines)		
5. Initial cheques and reserves, kept apart		
6. The flows, year by year, calls and distributions separate		
7. What the manager took, and out of which pocket		

Which part of this record do you believe will happen again?