GOODWIN

INSIGHT · NOVEMBER 29, 2023

Half of private investment funds set hurdle rates at 8% but rates differ by asset class and strategy

Private equity funds show the least variation, with 80% of PE funds setting hurdle rates at 8%. Real estate funds are almost as likely to set rates at 7% or 9% as 8%.

BY Lauren C. Falkowitz Ben Yeoh Brian O'Neill Chris Ormond

Private investment funds distribute returns to investors and sponsors according to a predetermined plan, known as a "distribution waterfall," that is included in the fund's governing documents. Sponsors and managers typically do not participate in returns until investors receive an amount that is equal to their original investment plus a minimum return, known as the "preferred return" or "hurdle rate." Where funds set the hurdle rate affects when sponsors and managers get paid and can also impact how much they make overall.

According to the Goodwin Terms Database for Private Investment Funds, more than 50% of funds have a hurdle rate of 8%. The second-most-common hurdle rate, used by 16% of funds, is 7%. However, the picture can be quite different when you look at specific asset classes (as opposed to all funds considered in aggregate). For example, nearly 80% of private equity funds have a hurdle rate of 8%, but only 29% of real estate funds do (hurdle rates of 7% and 9% are almost as common in real estate). About half of infrastructure funds have a hurdle rate of 8%, with 7% and 7.5% being second and third most common. Credit funds typically set hurdle rates below 8%, with the majority being between 5% and 7%. The majority of US venture funds do not have a hurdle rate, but they are much more common outside the US.

Inflation could change the picture

Hurdle rates remained consistent during the recent period of historically low interest rates, although some managers have been able to get more favorable terms by setting hurdle rates lower or by switching to a fixed return of capital approach that requires managers to return 120% to 130% of invested capital to investors before they begin to receive carried interest. It remains to be seen whether hurdle rates will be consistent during the current period of higher inflation and interest rates.

Other factors

Hurdle rates should always be considered in the context of the distribution waterfall as a whole. Details related to carried interest and catch-up provisions, for example, can have a significant effect on profit sharing, and these factors may also vary by asset class and strategy. Private equity and venture funds usually have a 100% catch-up after payment of the preferred return, real estate funds are more likely to have a 50/50 catch-up, and infrastructure funds have catch-ups ranging from 50% to 100%.

CONTACTS

Lauren C. Falkowitz
Partner

lfalkowitz@goodwinlaw.com
Boston | +1 617 570 1157

Ben Yeoh
Partner

byeoh@goodwinlaw.com
London | +44 (0)20 7447 4820

Brian O'Neill
Knowledge Management Counsel

brianoneill@goodwinlaw.com
London | +44 (0)20 7447 4851

Chris Ormond
Knowledge Management Counsel

cormond@goodwinlaw.com
London | +44 (0) 20 7667 3640