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The evolution of direct lending fund fee structures

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Introduction

As competition within the private credit market intensifies, there is increasing fluidity in fee structures. This is being driven by both investor demand and manager innovation.

On the investor side, those with available capital can exercise their bargaining strength in a more challenging fundraising environment. On the manager side, megafunds, consolidation and increased competition are all signs of a mature market where, particularly in certain areas, differentiation is becoming difficult with the result that there is more emphasis on volume and cost.

In our practice, direct lending fund fee structures is a hot topic, with varying perspectives from both investors and managers. Our view is that there will not be a single answer, but rather a continuation of what feels like a proliferation of different terms, which in some cases will be provided to investors as optionality.

In this article we analyse how different bases for calculating manager remuneration and different combinations thereof create optionality for managers and their investors.¹

This article is mainly focused on drawdown, self-liquidating direct lending funds. We will consider the extra considerations that apply to evergreen funds in a second article, including the importance in terms of both manager and investor economics of those funds starting and remaining “ramped”.

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[Endnotes can be found on page 11](#)

Typical income sources for direct lending fund managers

Income source	Description/objective	Typical connection to manager profit
Management fee	<ul style="list-style-type: none">▪ The fee charged by the fund manager to the fund to cover the manager's operational costs, the largest item of which will be team compensation.▪ In direct lending funds, these are typically charged on an invested capital basis. <p>Lifecycle</p> <ul style="list-style-type: none">▪ As capital is deployed, management fees increase. However, with a self-liquidating fund in the harvest period, as loans mature and principal repayments occur, management fees begin to decline.	In theory, a private credit manager should not primarily rely on management fees to generate profits as this is intended to cover the manager's costs. However, management fees do generate profits for managers with significant AUM that benefit from economies of scale.
Performance fee	<ul style="list-style-type: none">▪ The portion of the fund's profits that the manager receives. In a closed ended direct lending fund, performance fees are usually paid after returning to investors their invested capital plus a preferred return. Unlike management fees, performance fees are dependent on the investment return of the investors. <p>Key components of performance fee calculations</p> <ul style="list-style-type: none">▪ Preferred return – the minimum profit investors need to receive in addition to the return of their capital before performance fees become payable.▪ Catch-up – as the performance fee usually shares in all of the profits of the fund, but only after the investors have received back their invested capital and preferred return, the manager needs to catch up on its “carry share” of the preferred return. A 100% catch up would see the manager receive all fund distributions after the preferred return until it has caught up although lower sharing ratios in favour of the manager are also agreed (for example 80:20). After the manager is caught up, fund distributions are split between the investors and the manager based on the agreed performance fee percentage. <p>Lifecycle</p> <ul style="list-style-type: none">▪ The point to note in relation to typical direct lending fund performance fees is how back ended they are and, accordingly, how important the catch-up rate is. Carry is normally satisfied out of the realisation proceeds of the last few investments of the fund and with a large proportion of the carry comprising the catch up, the catch-up rate can really matter.	In a performing fund, the performance fee should be a significant profit source for a direct lending fund manager.

Base case fee structure

In order to compare different potential approaches to fee structures, we first look at the typical fee structure of an unlevered² closed ended drawdown direct lending fund to establish a base case.

Base case assumptions and outputs³

Vehicle size	£800m ⁴
Management fee	1% on net invested capital ⁵
Performance fee	10%
Preferred return	5%
Catch-up	100%
Arrangement fees	3% (treated as part of fund return)
Lending spread	600 basis points above the market reference rate
Default rate	2% ⁶
Holding period of investments	3 years
Deployment rate schedule⁷	<ul style="list-style-type: none"> ▪ Year 1: 20% ▪ Year 2: 35% ▪ Year 3: 40% ▪ Year 4: 5%

Based on the base case assumptions we can see how, over the life of the fund, manager income is broadly split 50/50 between management fee and performance fee.

Scenario 1 – base case

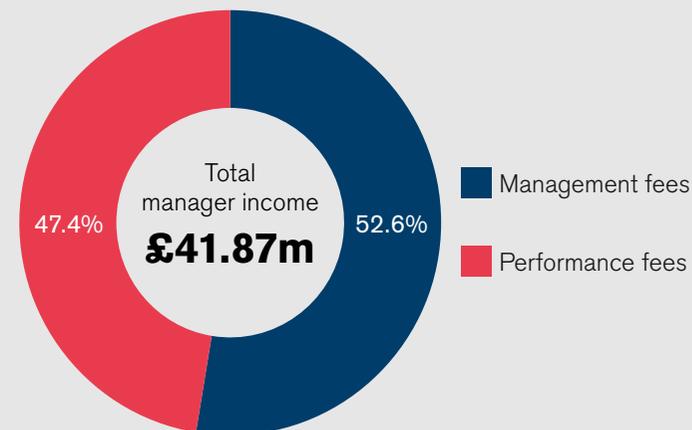
It can be seen in this base case how over half of the manager's income (and all of the performance fee) is received in the last two years of the fund life.

£41.87m Manager income⁸

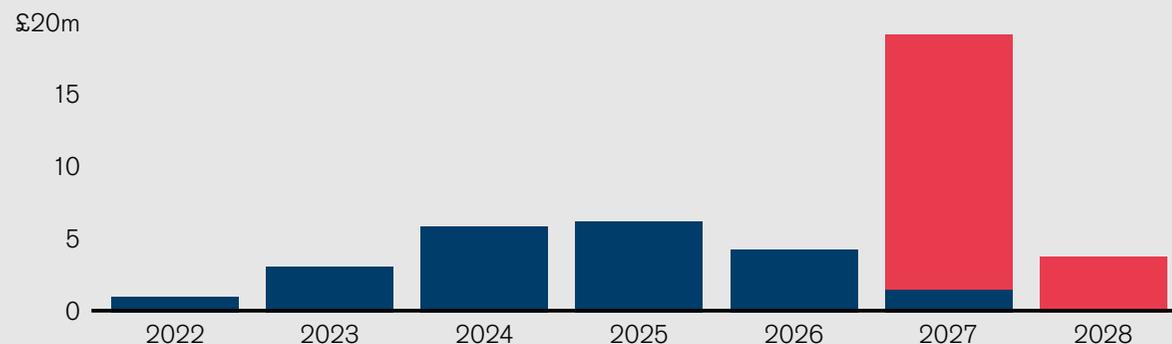
0.81% Average annual costs to investors as a % of committed capital⁹

8.79% Net IRR

10.88% Gross IRR



Yearly manager income



Growing pressure on management fees

Pressure on management fees is not a new topic across private capital asset classes. Power naturally shifts back and forth between investors and managers and the management fee is often the first commercial term that is tweaked to reflect this dynamic.

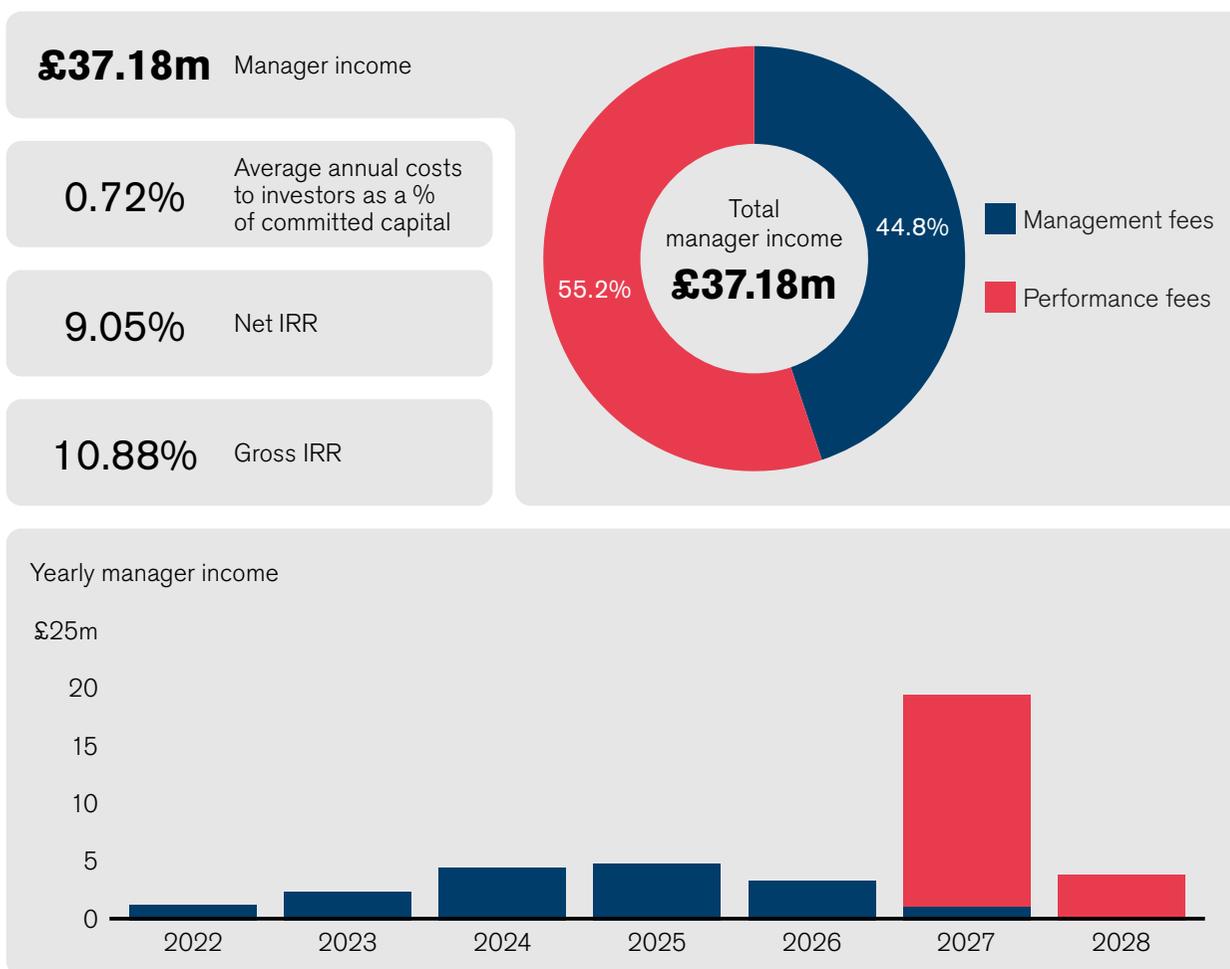
Although some of the reasons for current pressure on management fees are cyclical, such as the more difficult fundraising environment, others are more structural, such as consolidation and growth in fund sizes – average fund sizes across private debt have increased from approximately \$600m in 2019 to over \$1bn in 2024.¹⁰

Interestingly, only a slight downward trend in headline fees in the last 10 years can be identified meaning most of these negotiations are happening through side letters, making them more opaque. Discounts for early commitments, large commitments and loyalty to the manager are now widely used and we see both an increase in discount percentages and a decrease in the minimum commitments required to achieve such discounts. This is not limited to private credit; in private equity, discounts have also led negotiated management fees to be on average 25 basis points lower than the headline figures.

In our second scenario, we assume that increased pressure from investors leads to a lowering of the management fees by 25 basis points. Assuming the underlying fund performance is consistent with the base case scenario, this would generate an additional Net IRR of 0.26% bringing it to a total of 9.05%. The reduction in management fees implies that the manager income is now proportionately more dependent on performance fees when compared to management fees and the total payout to the manager would drop by c.11%. To maintain a similar total income to the base case, the fund would need to increase its performance from 10.88% gross IRR to 13.08% which would require an increase in lending spreads of approximately 200–250 basis points which would reflect a risk profile which is not typically seen within the direct lending space.

Scenario 2

Reducing management fees from 1% to 0.75%.



Lower management fees in return for a share of the arrangement fees

Some fund managers may be open to negotiating a reduction in their management fees for new funds in exchange for a share of the arrangement fees.

To illustrate this, we examine the impact on manager income when management fees are reduced from 1% to 0.75%. By securing approximately 15% of the arrangement fees, the manager can achieve a total income comparable to the base scenario as illustrated in in Scenario 3.

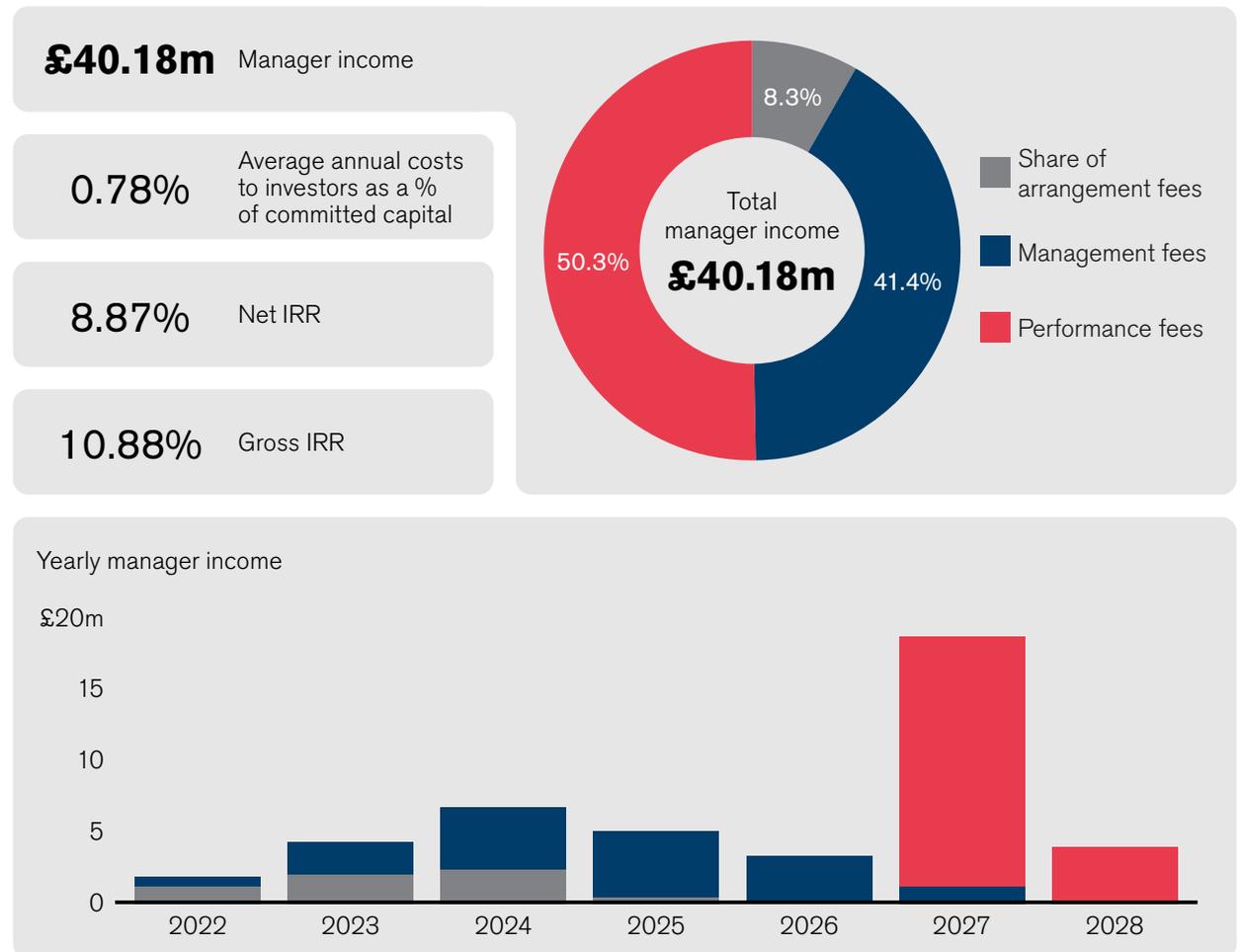
Scenario 3 results in the following fee split:

- performance fees make up 50.28% of the manager's income;
- management fees make up 41.43% of the manager's income; and
- arrangement fees make up 8.29% of the manager's income.

In many ways such a shift would be optical only, with a share of arrangement fees economically mirroring a management fee on invested capital in many ways. However, a share of arrangement fees can represent a cash flow boost for managers and a different ultimate amount depending on how long the loan remains unpaid.

Scenario 3

Management fee of 0.75% and 15% share of the arrangement fees.



No performance fees funds

Over the past year, some private credit fund managers have launched funds without performance fees.

This has mostly been seen in the context of evergreen funds which, unlike closed ended traditional funds, are not constrained by a finite lifespan.

There are reasons for removing performance fees from evergreen funds including:

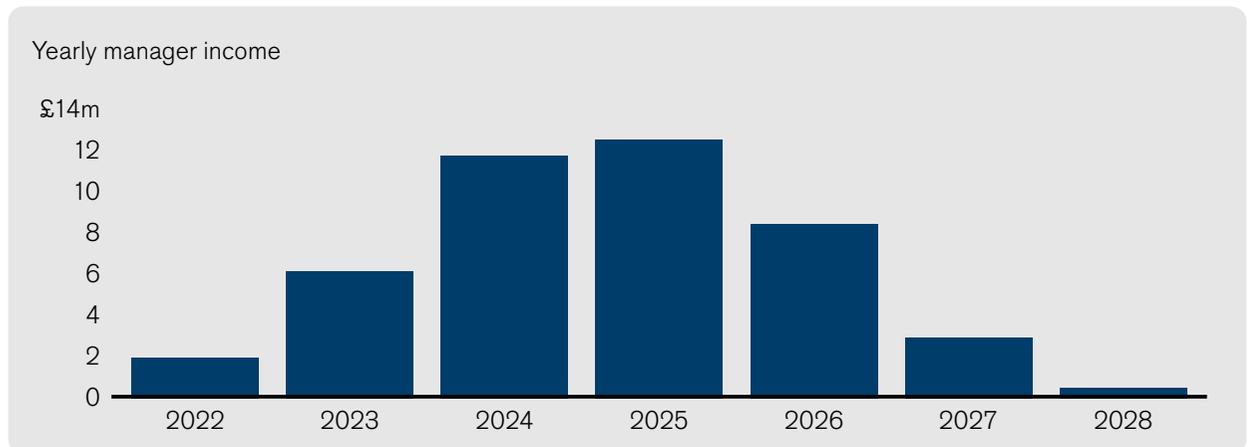
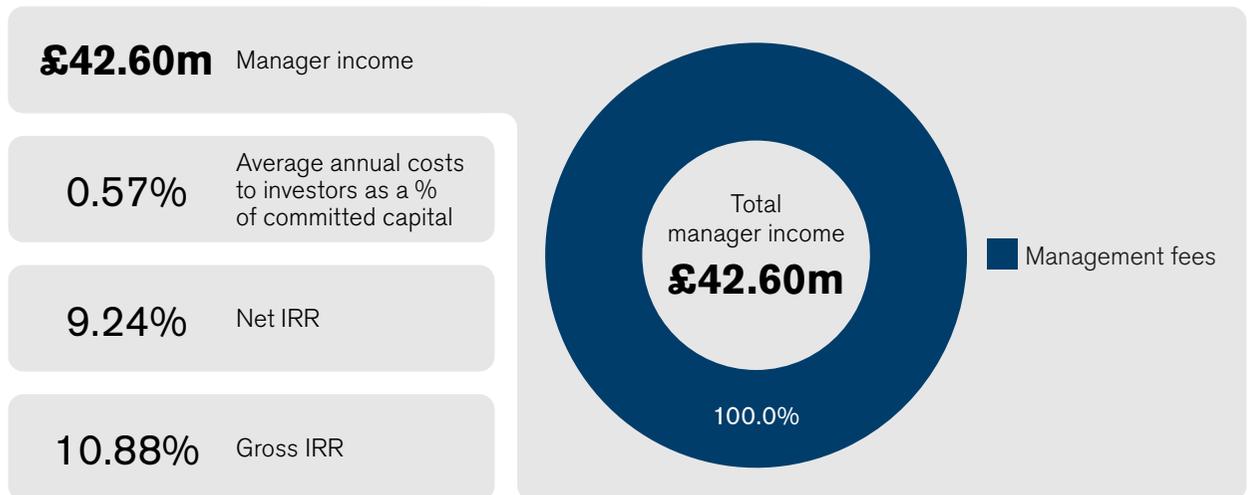
- from the manager perspective, evergreen funds are often a volume play from which they may be able to achieve sufficient profits from the management fee alone through economies of scale; and
- to the extent an evergreen fund can be fully ramped from inception, it should produce more management fee relative to AUM for a manager than a drawdown fund.

We will return to the economics of evergreen funds in our next article. For now, we will consider the impact of the removal of the performance fee on a drawdown/self-liquidating direct lending fund. Accordingly, in Scenario 4, the fund has a drawdown/self-liquidating structure. As can be seen, to return the same outcome for the manager, the management fee needs to increase from 1% to 1.3% and the fund size needs to increase from £800m to £1.2bn. With the manager relying on greater AUM to retain the same economics, the cost to the investors reduces.

In Scenario 4, if the fund size were to remain the same as the base case (i.e. £800m), management fees would be required to increase to approximately 2% to deliver a comparable total manager income in this scenario without performance fees. A 2% management fee would be seen as commercially unviable within direct lending. As such, in a drawdown/self-liquidating fund, a zero performance fee structure can only deliver equivalent economics through economies of scale.

Scenario 4

Increase in management fees from 1% to 1.3%, increase in fund size from £800m to £1.2bn and no performance fees.



Investor attitudes to performance fees

Investors views on performance fees can vary considerably with some investors stating they would prefer to pay higher performance fees and lower management fees and others saying the polar opposite. In the UK, for example, we see particular pressure on performance fees for managers trying to break into the defined contribution pension market, where NEST, the largest master trust in the UK, has publicly stated it is not paying any carry on its private market investments.

The removal of performance fees can be particularly attractive to investors that are more sensitive to headline fee levels or that struggle with performance/cost attribution, as is the case with defined contribution pension schemes. Fund managers looking to gain market share and appeal to new investors such as retail investors and private wealth management clients may find this approach effective.

Other investors see performance fees as critical for manager incentive and alignment of interests. While in private credit, the concept of outperformance does not apply in the same way as it does in private equity, the value that private credit managers bring is exactly the ability to source deals with superior risk adjusted returns and the robust underwriting and enforcement that allow them to take on additional risk. Being able to do so requires talented managers that are compensated, at the end of a fund's life, based on their performance.

Proliferation of terms

As private credit has grown so have product innovations, which encompass deployment strategies, structures and terms. We see a proliferation of commercial terms which, at an industry-level, are increasing pressure on managers to justify their proposed costs. Particularly in the less differentiated segments of private credit, differentiation on price or other commercial terms is becoming more relevant. Interestingly, it seems to be both the largest and the newest managers leading the way on fee innovation. For the largest managers, this is made possible through economies of scale and the prioritisation of acquiring market share and penetrating new investor bases. For new entrants, their advantage is that they are not encumbered by legacy funds and have an opportunity to stand out to investors.

Some private credit fund managers are moving away from performance fees, particularly in evergreen funds, due to their potential to generate sufficient profits through management fees, economies of scale, and flexibility for investors.

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Giving investors a selection of fee structures to choose from on new funds

Fund managers may decide to offer a selection of fee structures for their funds to appeal to different investor bases.

We have illustrated this in Scenario 5 where we include two extra options in addition to the base case with varying management and performance fees. The three options provide a comparable total manager income under the same performance assumptions, but the breakdown of the income into management fees and performance fees is greatly different.

For option 3, approximately 78% of manager income derives from management fees. Investors would benefit from selecting option 3 if the fund outperforms the expectations that have been assumed in this analysis as they would receive a significantly higher share of the profit. For example, if base rates fall more slowly than currently expected by market forecasts or if direct lending spreads widen then option 3 would be beneficial to the investors.

However, option 1 with lower management fees and a higher performance fee for managers would benefit investors compared to options 2 and 3 in the case of more adverse movements in base rates, lending spreads or default rates.

These options result in similar costs to investors but option 1 has a higher net IRR due to a greater portion of the cost to investors being incurred later in the fund life and therefore having a lower present value.

Scenario 5

Fee structure options for investors with varying management and performance fees.

	Option 1	Option 2	Option 3
Management fee	1% on net invested capital	1.25% on net invested capital	1.5% on net invested capital
Performance fee	10%	7.5%	5%
Manager income	£41.87m	£41.70m	£41.81m
Average annual costs to investors as % of committed capital	0.81%	0.80%	0.81%
Net IRR	8.79%	8.72%	8.64%
Gross IRR	10.88%	10.88%	10.88%
Management fee as a % of manager income	52.63%	65.58%	77.93%
Performance fee as a % of manager income	47.37%	34.42%	22.07%

Key takeaways

- Private credit fee structures are becoming more diverse as investors and managers respond to market dynamics, such as competition, consolidation, fundraising and differentiation.
- The typical fee structure of an unlevered direct lending fund consists of a management fee on net invested capital, a performance fee subject to a preferred return with catch-up, and no arrangement fee sharing.
- Management fees are under pressure from investors who seek discounts for early, large or loyal commitments, or who prefer lower headline fees for certain investor segments, such as defined contribution pensions. Lower management fees could reduce manager profits which in turn could increase manager reliance on performance fees.
- Some managers eliminate performance fees for evergreen funds. This appeals to fee-sensitive or attribution-challenged investors but may weaken manager incentive and alignment.
- As competition within the private credit market intensifies, we expect to see a rise in innovative fee structures where investors and managers could explore alternative fee arrangements using a blend of management fees, performance fees and arrangement fee sharing structures. A fundamental objective that such fee structures will need to achieve is to ensure that investors and managers remain aligned taking into account the risk/return profile of the direct lending investment strategy.

How we can help

This note was prepared by our Investor Intelligence team who provide holistic advice on how to shape products, terms, structures and marketing strategies to support fundraising efforts.

Learn more about our expertise

For more information, please contact one of the listed contacts, or your usual Macfarlanes contact.

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Endnotes

1. In this article we consider the income of the manager, not expenses of the fund, which of course also include establishment expenses and ongoing expenses. However, we note that, as investors look to reduce their cost leakage more generally, there is increasing investor scrutiny on these, especially establishment expense cap levels and ongoing expense definitions.
2. To simplify our analysis, in the context of assessing private credit fee structures, we focus on private credit structures for unlevered vehicles, but a similar analysis can also be performed for levered vehicles.
3. For simplicity, we assume realised proceeds are not reinvested.
4. For simplicity, we are assuming a GBP denominated fund. A similar analysis can be performed for a multi-currency direct lending fund.
5. The average management fee seen within direct lending will likely be slightly lower than 1% once factoring in negotiated discounts for early or large commitments. 1% has been used as a simplifying assumption for this analysis.
6. This default rate is broadly in line with the Proskauer's Private Credit Default Index. Overall default rates have fluctuated around 1.4–2.7% between Q3-22 and Q2-24.
7. Investments are spread evenly over the quarters for each year. Additional assumptions for a buffer and working capital have been made.
8. Manager income includes management fees, performance fees and arrangement fees (if applicable).
9. Costs include management fees, performance fees and expenses.
10. According to Private Debt Investor, October 2024 ([link](#)).

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