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GNDF: Private Equity Net Returns Simplified

A practical guide to calculating net returns to comply with the SEC's new Marketing Rule

The Problem: Net Returns

The SEC's new Marketing Rule requires a net return to be displayed every time a gross return is displayed.

The net return should be based on a "highest fee-paying investor."

This is a challenge because while management fees and expenses can be estimated, carried interest depends on the performance of the rest of the portfolio.

Three Key Principles: Compliance with Flexibility

Principle 1:

The rule requires net returns with any presentation of gross returns.

This cannot be avoided.

Principle 2:

The rule requires a highest fee-paying investor" net when model fees are used.

Principle 3:

The requirement to calculate a "highest fee-paying investor" is designed to give a potential investor a directional sense of actual performance.

The manager has flexibility in the method used as long as the method is clearly disclosed in footnotes.

Proposed Solution:
Gross-Net Discount Factor (GNDF)

Method: For any fund, GNDF is the highest fee-paying investor return divided by the highest fee-paying investor gross return.

$$\textit{Fund IRR GNDF} = \frac{\textit{Highest Fee-Paying Investor Unlevered Net IRR}}{\textit{Highest Fee-Paying Investor Unlevered Gross IRR}}$$

$$\textit{Fund MOIC GNDF} = \frac{\textit{Highest Fee-Paying Investor Unlevered Net MOIC}}{\textit{Highest Fee-Paying Investor Unlevered Gross MOIC}}$$

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Example Performance Table:
Application of Gross Net Discount Factor (GNDF)

Net MOIC = Gross MOIC × GNDF

Net IRR = Gross IRR × GNDF

Investment	Date Invested	Invested Capital	Realized Proceeds	Unrealized Proceeds	Total	Gross IRR	Gross MOIC	Net IRR	Net MOIC
1	Nov-17	$139	$67	$58	$125	N/M	0.9x	N/M	0.7x
2	Dec-17	$240	$58	$0	$58	N/M	0.2x	N/M	0.2x
3	Jul-18	$130	$108	$365	$473	41%	3.6x	31%	3.0x
4	Dec-18	$76	$0	$168	$168	27%	2.2x	20%	1.8x
5	Jan-19	$112	$0	$374	$374	60%	3.3x	45%	2.8x
6	Feb-19	$110	$0	$229	$229	32%	2.1x	24%	1.7x
7	Nov-19	$71	$223	$0	$223	41%	3.1x	31%	2.6x
8	Jan-20	$274	$0	$381	$381	30%	1.4x	23%	1.2x
9	Apr-20	$112	$34	$109	$143	8%	1.3x	6%	1.1x
10	Nov-21	$67	$0	$68	$68	N/M	1.0x	N/M	0.8x
Fund Gross		**$1,330**	**$490**	**$1,752**	**$2,242**	**15.8%**	**1.7x**		
Fund Net						**11.9%**	**1.4x**		

$$\text{IRR GNDF} = \frac{11.9\%}{15.8\%} \qquad \text{MOIC GNDF} = \frac{1.4x}{1.7x}$$

Other Considerations:
Suggestions for Overcoming Common Challenges

J-Curve, Pre-Fund Track Records, Deal by Deal: Utilize a "Reference Fund". Calculate the GNDF for the closest analogous fund assuming overall fees and carry terms for the Reference Fund are no less than the fund being marketed.

Hypothetical Portfolio Composed of Investments from Multiple Funds: Calculate a blended, invested capital weighted GNDF.

Distortions Due to Uneven Investment Sizes: For funds which contain very large or small investments, GNDF can be made more accurate by applying an invested capital or total investment value weighting.

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