

Revisiting Carry Valuation and Communication Approaches in Multi-Strategy Businesses

Introduction

Last year, Johnson Associates published an [article](#) discussing ways to value carried interest as firms expand into additional investment strategies with differing timelines and return expectations. While common approaches such as carry dollars-at-work were often sufficient for like-for-like funds, understanding values across multiple strategies is more nuanced.

This is important as firms provide economics across strategies to foster alignment, motivation, and collaboration. As an example, both carry awards and participation for support and sales professionals are increasing. These individuals often work across multiple areas and may receive carry in multiple products (i.e., a basket approach). This evolution requires an understanding of how carry values vary by strategy and how to form comparisons.

Goldman Sachs recently granted carried interest to senior executives to emphasize the importance of an expanding area for the firm. Other financial services firms with captive alternatives units may also provide carried interest to executives that are not directly involved in the alternatives business. Understanding relative values by strategy will be needed in crafting competitive senior executive awards.

As we discussed previously, carry can be valued similarly to stock options. Option valuation models, such as Black-Scholes, can approximate the present value of carry to recognize different timelines and return expectations. This is helpful in comparing values across strategies /

As compensation experts for the financial services industry, we are frequently asked about carried interest. Our clients increasingly need to value and aggregate awards and understand how they fit in the broader context of all-in economics.

We have found treating carried interest like stock options is helpful to compare values across multiple distinct investment strategies.

funds and allows carried interest to be better communicated alongside traditional annual compensation. Understanding present value helps determine and communicate compensation trade-offs. In other words, for employees that enter carry programs for the first time, what, if any, trade-offs should there be? In order to make proper comparisons, models should address the complexities of carried interest such as vesting, hurdles, and other factors.

It should be noted that some firms use a DCF (discounted cash flow) analysis to value carry. This can be helpful later in a fund's life when investments have already been made, and their projected value is easier to determine. However, for compensation communication purposes, where awards are made at the beginning of fund life and no investments have been made, using industry standard assumptions for Black-Scholes is a helpful tool to establish general "rules of thumb" to balance economics.

Exhibit A: Private Equity Illustration with 8% Hurdle

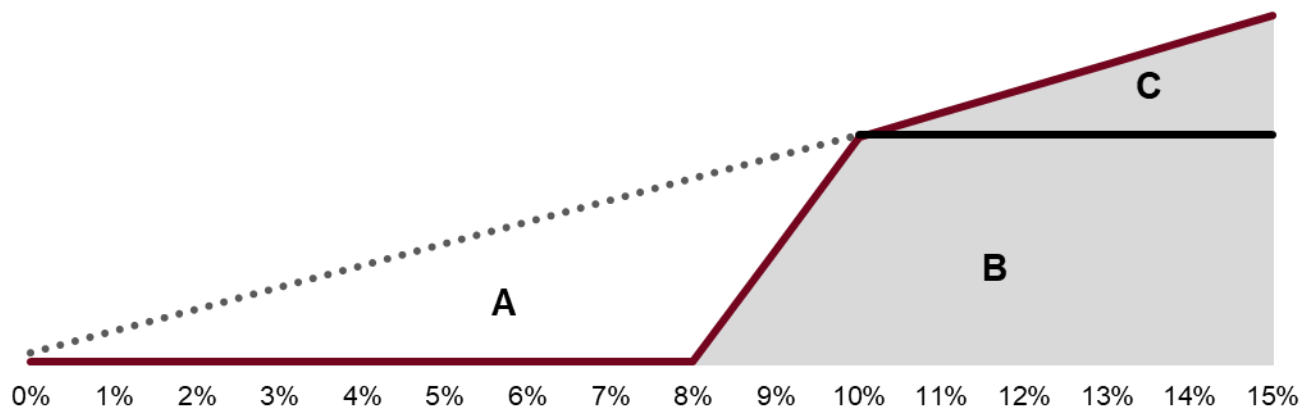


Exhibit Notes: Chart shows the difference in economics between standard options vs. carried interest at different IRRs. Areas A, B, and C reflect options economics, while areas B and C reflect carried interest economics.

Valuing Carry Dollars using Black-Scholes

The Black-Scholes inputs for valuing carry are the same as traditional options: current price, strike price, timeframe, volatility, dividend rate, and risk-free interest rate. However, to fairly value carry, the inputs need to be refined and will vary by fund and strategy. For instance, current price, dividend rate, and risk-free interest rate are easily adapted. However, volatility and time to expiration must be estimated. Volatility is difficult to calculate given the infrequency at which underlying investments are valued, but existing market resources on private investment volatility can help estimate this variable. Time to expiration is dependent on fund strategy and can vary with waterfall structure.

Accounting for strike price requires the most nuance. The stock option strike price is analogous to a hurdle rate in carried interest, but with one key difference - exercisable value increases at a linear rate for stock options, but carried interest often has hurdles and catch-up rates, leading to a non-linear band of outcomes to account for. This complicating factor requires a nuanced methodology on option pricing, but adjustments can be made to account for hurdles and catch-

up rates. Conceptually, hurdles and catch-up rates are similar to the strike price of an out-of-the-money option, except that carried interest increases quickly above the hurdle until full catch-up is achieved.

There are other factors to be considered – the concept of an illiquidity discount, which theoretically reduces the value of carry awards, and the often-different capital gains tax treatment of carry, which increases values. While the impact of each will vary on individual perceptions on value, award magnitudes, and geography, our research shows the net impact from both factors should roughly offset.

Illustrative Example

As an example, we illustrate a private equity fund with an 8% hurdle and a 100% catch-up rate over a 7-year perspective with 30% volatility. Private equity funds often require an 8% hurdle in which returns below this level do not generate carry gains. From 8% to 10% returns, private equity funds generate 5 times the normal economics, assuming a 100% catch up rate.

Exhibit B: Present Value Comparison by Investment Strategy

Relative carry values differ by investment strategy due to differences in investment profile

Lowest Value

Highest Value



Private Credit

Real Estate

Infrastructure

Private Equity



Factors influencing present value include:

- Time horizon
- Return expectations
- Investment volatility
- Hurdle rates

Above this 10% level, funds generate the typical 20% carried interest. This is different from a standard option that can be exercised for a gain any time the stock price is above the exercise price. The exercisable value of an option increases linearly with stock price increases, regardless of the return on investment (See Exhibit A).

The chart illustrates the difference between options economics (the areas denoted as A, B, and C) and private equity economics (the shaded grey areas denoted as B and C). Therefore, in order to calculate the value of a private equity interest through the Black-Scholes model, it is necessary to subtract the value of "A". To do this, it is helpful to solve for areas "B" and "C" separately.

To calculate area "B", in which value increases from 8% to 10% IRR and then stays constant, the easiest way to model this is to be "long" one option at the price equivalent of 8% IRR and "short" one option at the price equivalent of 10% IRR. In short, this means the value will increase from 8% to 10% and then stay constant thereafter. However, the economics in this IRR range are 5 times the standard 20% rate assuming a 100% catch-up rate, so the calculation should be long 5 options at 8% and short 5 options at 10%. The value of area "C" is a standard rate of

increase above 10% and can be denoted as long 1 option at 10% IRR. Therefore, the net value of areas "B" and "C" are 5 options long at 8% and 4 options short at 10%.

Applying these assumptions to Black-Scholes results in a carry NPV of $\cong 35\%$ for standard private equity products. This same logic can be applied to all fund types, but with slightly modified assumptions given the difference in investment profile. As a result, actual NPV for other products may be meaningfully different from traditional private equity (See Exhibit B).

At a simple glance, our calculations show that private equity carry is worth more than private credit carry. However, potential differences in fundraising cadences and grant frequency must be accounted for to truly understand relative values.

Comparison to Other Market Approaches

While our proposed methodology is not an industry standard, we have observed instances where firms have implemented a similar cash vs. carry trade. A common ratio is 3 dollars of carry-at-work for 1 dollar in current cash compensation. Assuming all else equal, this is simi-

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Exhibit C: Comparison of Carry / Equity Vehicles

	<u>Carry Basket</u>	<u>Single Fund Carry</u>	<u>Options</u>	<u>Stock</u>
Economic Value	Upside above hurdle only	Upside above hurdle only	Upside only; should account for hurdle	Downside protection w/ muted upside
Vesting	Typically longer	Typically longer	Typically shorter; should be adjusted	Typically shorter; should be adjusted
Tax Treatment	Often beneficial	Often beneficial	Standard treatment	Standard treatment
Applicability	All firms	All firms	Public alternatives only	Public alternatives only
Compensation Communication	Dollars-at-Work; NPV comparison helpful	Dollars-at-Work; NPV comparison helpful	Easily understood	Easily understood
Collaboration	Yes	No (in isolation)	Yes	Yes

lar to our internal analysis for traditional private equity products and would be considered a fair trade. However, this is potentially understating or overstating the values of other illiquid investment products. Values would vary for private credit, real estate, infrastructure, venture capital, etc.

As we discussed in our last publication, stock options are conceptually similar to carried interest. At grant / strike, they do not have exercisable value. Therefore, options can be structured to be economically similar to carry but with a firm-wide view rather than a single fund view. In fact, there are multiple examples of publicly-traded firms already taking advantage of options to provide a firm-wide link in place of a basket carry approach. However, the differences between options and carry should be noted. Options do not usually have tax advantages but have more frequent liquidity. While it is easy to account for hurdles with options, it is more complicated to adjust for catch-up rates. While carry vehicles offer 20% upside, it may be difficult for a public company to grant an equivalent number of options. Substantial options grants may also be met with resistance from groups such as ISS and Glass Lewis.

We have also observed publicly traded alterna-

tive investment firms granting stock to employees. While this full firm perspective shares a similar collaborative alignment as a basket of carried interest products or options, the economic proposition is entirely different. Whereas carry and options are similar in that performance conditions must be met in order to receive economic gains, stock awards have value under all performance conditions but with more muted upside and downside. This may be perceived as a positive for some recipients as a more conservative vehicle, but if the goal is to provide similar economics but at a broad-based scale, it is worth considering attaching performance vesting conditions to these shares.

For both stock and options, vesting schedules should be designed in line with carried interest products that typically have longer vesting timeframes than standard public company equity. Firms should also understand the limitations of public company equity grants. While this approach may be effective at alternatives firms, it is less useful for major banks, insurance companies, and asset management firms that are building out alternatives platforms, since the alignment to illiquid investments may be significantly diluted (See Exhibit C).

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Conclusion

The alternative investment industry continues to evolve in complexity and expand across products. Given attractive economics, additional firms throughout financial services are expanding their alternative investment capabilities to a meaningful degree. Different firms have different perspectives on who should receive carried interest, what products should be included, and what other vehicles should be used to reward contributions. Now more than ever, it is important to consider the different value propositions and “all in” economic packages in the industry. Understanding relative value of carried interest by product and versus traditional compensation provides a more comprehensive and explainable view of total economics.

If you would like to discuss this topic further, please contact us at info@jaiconsulting.com.