Opportunistic Investing and Real Estate Private Equity Funds

A recent survey of real estate private equity funds reveals current issues and concerns.

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OVER THE LAST decade, the real estate private equity funds sector has flourished. Real estate value-added and opportunity funds are perhaps the most prominent vehicles in this sector. The first of these opportunistic real estate private equity funds were raised in the late 1980s and early 1990s to capitalize on the opportunities resulting from the sudden unavailability of debt capital and the abundance of available product offered by motivated sellers, most notably the Resolution Trust Company. Since that time, the number of funds has grown and their underlying investments have become increasingly more complex and global in address.

Originally perceived as finite-life investment vehicles, these funds have arguably become viable, infinite-life businesses able to support the operating organizations built to manage them.

One factor supporting the proliferation of funds is the closer alignment of investor and general partner interests. Historically, advisors/managers were hired to invest money on behalf of institutional investors, and were compensated based on the appraised value of the investments; they had no equity of their own in the investments. This misalignment of interests between the investors and the advisors became glaring as real estate values decreased in the late 1980s. Today's real estate private equity fund structure provides better alignment of general and limited partner interests because the general partners have equity, sometimes significant equity, invested in the funds, and participate in realized gains as opposed to paper gains.

Other factors helping to fuel this rapidly growing sector include the success of most of the early vintage year funds, the continuing availability of equity coupled with a skyrocketing stock market, and expanding global opportunities. These factors have enhanced the growth of the sector, not only in terms of the huge amount of money raised, but also in terms of the number of funds now operating globally. There are now probably more than 100 fund general partners throughout the world.

Opportunistic real estate private equity funds are flush with capital as we enter 2002. If the sentiments voiced by fund general partners in our recent survey are on target, they are poised to capitalize on new opportunities in the ever-changing world. In fact, based on our survey results, a minimum of $20 billion of equity remains to be deployed. Further, according to our estimates based on survey responses and information available publicly, in excess of $90 billion in equity has been raised for opportunistic investing in real estate since 1991. Impute leverage of 60 percent to these amounts and one can appreciate the significance of this sector of the industry.

More recently, the trend among these funds has been to raise larger funds and to refinance existing assets to repatriate capital. In addition, a substantial period of real estate market equilibrium has slowed the pace of transactions domestically, increased the bid/ask spreads on properties, and driven funds to deploy capital outside the United States. At this point in their evolution, opportunistic real estate private equity funds are under increased scrutiny from investors seeking greater transparency and standardization in reporting information. We believe 2002 will be a watershed year in which great strides are made in these areas. The recent changes to the AICPA Audit and

Accounting Guide for Audits of Investment Companies with respect to the disclosure of financial highlights should help in this regard. Through our survey we tested the general partners' pulse on the subjects of financial reporting and performance reporting. We considered the various and complex tax issues that general partners must navigate to achieve targeted yields. We also surveyed the use of technology throughout the funds' value chain as a tool to facilitate global communication, reduce costs, and create better efficiencies.

Of course, it remains to be seen what impact the global recession, rising security and insurance costs, and the ability to secure terrorist coverage will have on the industry and on fund returns. The events of September 11 will certainly have profound effects on the real estate industry and, in the process, will create new opportunities as well as new challenges.

THE SURVEY RESULTS

The Ernst & Young survey of opportunistic real estate private equity funds, which included approximately 150 questions covering many subjects, including financial and performance reporting, taxes, and infrastructure and technology, was sent to more than 100 fund general partners, managing members, and managers (referred to here as the general partners). We received 48 responses. Not all respondents answered every question, and certain responses were supplemented with information gathered in personal interviews with the general partners. In total, our participants represent $72.3 billion of equity, raised in 145 separate funds, between 1988 and 2001.

Opportunistic real estate private equity funds are also known as "value-added" funds and "opportunity" funds. Their success stems from the ability of savvy general partners to locate and capitalize on over-discounted risk or overlooked value enhancement opportunities. Similar to more traditional private equity funds (i.e., venture capital and buyout funds), these real estate funds target higher yielding (15 percent-plus leveraged) private investments. In addition, they typically have an average life of from seven to ten years, often with two one-year extensions. Generally, they provide for a 1 percent to 2 percent annual management fee, a 20 percent carried interest to the general partner after achievement of a preferred return hurdle (typically 9 percent to 10 percent) and have a significant individual, pension fund, and endowment investor base. The general partners (and their affiliates) typically commit 1 percent to 5 percent of the fund capital, but commitments of those general partners (and their affiliates) associated with investment banks often range between 2 percent and 40 percent. Modern day opportunistic real estate private equity funds originated in the early 1990s with a proliferation in the number of general partner sponsors beginning in 1997.

For this reason, and given the 10-year-plus all-in potential life of these funds, the track record for this sector remains a work in progress. According to the survey, individual funds have raised capital in varying amounts, ranging from $22 million to in excess of $3 billion. However, only 11 general partners commanded equity in excess of $1 billion for a single fund.

The survey revealed that a relatively small percentage of general partners control a large percentage of the capital. An estimated 13 fund general partners represent 70 percent of the estimated equity raised. The average individual fund size for these 13 large fund general partners is $957 million of equity, or almost four times the average size of the other 35 respondents ($242 million of equity). The majority of the larger fund general partners are real estate investing arms of larger private equity groups, whether the merchant banking arms of investment banks or stand-alone private equity firms.

Since the early 1990s, the amount of capital earmarked or eligible for investment outside the United States has gradually increased, with in excess of 60 percent of the current outstanding and committed capital available for non-U.S. investment. Individual investments run a broad gamut and take many forms, as general partners structure transactions in response to the often-unique conditions of each opportunity. Average investment holding periods were generally reported to be four years, a period that could be reflective of the complexity of investments and the slowing economy. Our survey respondents reported raising an aggregate amount in excess of $17 billion of new equity during 2001, with $20 billion of total equity available for investment.

Considering that the typical leverage applied to their investments is between 60 percent and 70 percent, funds are currently holding more than $50 billion in investment potential. Based on our discussions with general partners, recent capital raising efforts are taking two to three times longer than anticipated. General partners also report a slowing pace of equity deployment in 2000 and 2001, as the pricing available in the market generally did not support targeted fund yields.

The growth in opportunistic real estate private equity funds and the changes that accompany a decade of history have led to a greater focus by the general partners on some of the management and operating basics. Discussions with general partners and survey responses identified a number of non-transactional issues that are receiving a great deal of attention. One issue that is of great importance to the respondents is financial and performance reporting. As this sector of the industry has grown, interest has heightened regarding the varied reporting practices and methodologies employed by real estate private equity funds. Our survey identified three distinct methods of financial statement reporting (i.e., historical cost, income tax, and fair value), with the overwhelming majority reporting in accordance with fair value.

Our respondents also reported using many different methods to determine fair value. Another area of focus is the efficiency of the funds' tax structure. Many funds indicated that they are using special tax structures (i.e., blockers) to minimize unrelated business income tax (UBIT) for tax-exempt investors and are developing procedures to monitor UBIT issues and avoid UBIT traps throughout the life of the fund. Funds are also looking for efficient structures to minimize foreign taxes and foreign tax withholdings for U.S. investors and to minimize U.S. taxes for both domestic and foreign investors. Funds also reported that they are looking for ways to ensure that the partners' relative capital accounts (after allocation of income and loss) are in accordance with the intended cash waterfall distributions, including efficiently designing partnership agreements and developing procedures for effective monitoring.

Yet another important concern for these funds is the investigation of ways to streamline processes and transform their businesses to make them technologically efficient and reduce costs. By maximizing the efficiency of fund processes and procedures, and thereby reducing costs, the yield to investors can be increased. Some of the biggest obstacles facing these organizations include a lack of communication between departments, currency, language, cultural, and time-zone differences, and lack of standardized procedures and processes. Advances in technology can enable the general partner to overcome many of these issues.

FINANCIAL AND PERFORMANCE REPORTING

The survey asked a series of questions addressing the reporting methodologies and practices of opportunistic real estate private equity funds. As expected, their accounting and underlying valuation practices are as varied as the funds themselves. Survey respondents identified what on the surface would appear to be three different (but basic) accounting and reporting methods. Eleven respondents (representing \$7.5 billion of equity) indicated that they report their financial statements using only historical cost accounting, and four respondents (representing \$4.8 billion of equity) said they report using income tax basis accounting principles. The remaining funds said they provide fair value financial statements. It should be noted that the fair value method of reporting is consistent with the generally accepted accounting principles (GAAP) used by private equity funds as described in the AICPA Audit and Accounting Guide for Audits of Investment Companies (Investment Company Guide).

With respect to those reporting on fair value, 14 respondents (representing $15.2 billion of equity) reported that they fully consolidate all controlled investments, and 10 respondents (representing $36.3 billion of equity) said they report their share of operating earnings and appreciation (depreciation) using the equity method of accounting. The other seven respondents (representing $8 billion of equity) said they report operating income and expenses and realized gains and losses only as cash is received (realized) from ventures, and otherwise report their pro rata share of unrealized changes in value.

There are several possible reasons for this diversity in reporting methods. The Investment Company Guide was not written with real estate private equity funds in mind and, accordingly, industry participants have had to adapt from practices of venture capital and buyout funds. While each of the aforementioned fair value methods results in differing presentations, the bottom line profit and loss results are the same. Similarly, our respondents reported using an assortment of methods in determining "fair value," which by definition is the amount at which the investment could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. Depending upon the subject asset and extent of its seasoning, some general partners (29 percent) reported performing discounted cash flow calculations to determine fair value. Others (52 percent) said they report increases in value upon the realization of certain market events, such as lease-up or the completion of improvements or renovations. Still others (24 percent) indicated they occasionally obtain third-party appraisals.

Market capitalization rates and the application of a multiple of earnings were also reported as value estimates methods utilized. Most funds said that declines in value are reported when events indicate that their investments' performance and potential have significantly deteriorated; in other words, as impairment has occurred. As this sector has grown, interest has heightened regarding the sector's varied reporting practices and methodologies.

Investors are seeking greater transparency in reported information, a greater ability to measure performance on an interim basis, and an ability to benchmark. Unfortunately, because of the complexity, diversity, and dynamic nature of the large number of the underlying investments held by opportunistic real estate private equity funds, there is no "one-size-fits-all" solution. Examples of fund investments include: private prison operating companies; raw land development; pools of non-performing loans; conversion of empty office properties into residences; private hotel companies; technology-related private operating companies; private home-builders; and preferred stock pieces of public companies.

General partners indicated that in overemphasizing the standardization of specific quantitative measurements, one runs the risk of not understanding these private equity vehicles at all. To a large extent, the valuation policies employed by the funds have been adopted from those long practiced by other alternative private equity investment funds. As mentioned earlier, private equity funds present their financial statements on a fair value basis as required by the Investment Company Guide. Underlying fund partnership agreements generally provide the general partners with the responsibility for determining the fair value of portfolio investments. Such valuations may or may not be subject to approval of a limited partner advisory committee or similar investment or valuation advisory group. Usually, their valuation policies recognize the degree of liquidity (or lack thereof) in fund investments in estimating value. Less-liquid private equity security investments generally presume cost as a proxy for value, except in instances where significant market events have occurred or when there has been an indication of a decline in value.

Opportunistic real estate fund general partners indicate that for opportunistic investments, estimating fair value at various times during the holding period is much more complex and subjective than valuing a stabilized operating property. For one thing, the ultimate realization of value is greatly dependent on the execution of a value-added business plan and exit strategy. Exit strategies often are unique to the capabilities and perspective of each fund's general partner, and its selection of an operating partner. Value creation is based on a number of variables, including: timing the markets correctly (including both the capital markets and local real estate markets); anticipating legislative changes; government privatization decisions; finding the right buyers for unique investment types; creatively selling a portfolio to those end-users who find the assets most valuable; the growth and related success of new real estate-aligned technology ventures; and understanding, supporting, and "betting" on emerging markets or a capital markets exit strategy.

The creation of value and valuation of these investments at most points during the holding period is extremely uncertain. As a result, many opportunistic real estate private equity funds state the fair value of their investment at or about at cost until a realization event occurs or is imminent. This is attributable in part to conservatism on the part of the general partners and a recognition of uncertainty. Some general partners informed us that where the creation of value is heavily dependent upon execution, they are reluctant to "take credit" for value before it is realized. The general partners worry that overestimating projected results could jeopardize their credibility with their investors.

OPPORTUNISTIC INVESTING

Some general partners indicated that there are other qualitative and quantitative communications with investors that could assist in monitoring the performance of their funds and underlying investments. They question whether there are truly negative implications of a conservative valuation philosophy for certain asset types within a fund that cannot be mitigated by enhanced disclosures. They point out that opportunistic real estate funds — like other alternative private equity funds — are limited-life investment vehicles in which value can only permanently inure to the general partners' carried interest after the realization of agreed-to preferred internal rates of returns (IRRs) for investors.

There is no doubt that there are inconsistencies in — and, in many instances, a limit to — the types of information being provided to investors. Much of the success of these private vehicles is dependent upon relationships, execution of strategies, and accumulation of knowledge that is sometimes deemed proprietary and often deemed a competitive advantage.

In the course of our work in this sector of the industry, we have observed numerous fund reports and reporting practices. Some of the "best practices" we have seen and that were communicated to us during the survey process include: quarterly and annual overviews of investment activity and fund performance; for each fund investment, quarterly and annual narratives of activity and performance against strategy; for each fund investment, quarterly and annual summaries of cash inflows and outflows and investment vital statistics, including condensed financial information; for each fund investment, quarterly and annually, the general partner's assessment of whether the investment is tracking on, below, or above the underwritten IRR, including a narrative description of why; and fund advisory committee approval of asset valuations.

Adoption of some or all of these practices would benefit both investors and the overall sector as it grapples with the issues of transparency and standardization. To further assist in this regard is the new year-ending December 31, 2001 Investment

Company Guide disclosure requirement of a net investment income ratio, an expense ratio, and a total return calculation (Financial Highlights) for private equity funds.

Given all the foregoing, it appears that comparability of performance between funds during their terms based solely on traditional return measurements is both insufficient and impracticable. Concerning the subject of performance measurement, the overwhelming majority of our survey respondents view IRR as the most appropriate performance measure. A few respondents went further, saying that a projected IRR that includes future value for residual would be a better proxy for interim measurements of performance and comparability.

Increasingly, methods for measuring performance are being guided by the Association for Investment and Management Research (AIMR). In accordance with AIMR guidelines, the only performance measure currently reported by private equity funds is IRR. Similarly, Venture Economics, the official database of the leading venture capital associations, provides for an annual IRR calculation using actual monthly cash inflows and outflows to investors and incorporating residual values reported in the annual financial statements in its benchmarking.

Notably, the total return calculation now required as a part of fund "Financial Highlights" is a time-weighted return (TWR). TWR is determined by calculating the rate of return between two or more periods and multiplying the results together, then taking the geometric mean of the results. It is generally considered a poor approximation of the IRR, and as Venture Economics points out, is a misnomer because the calculation does not consider the time value of money, but instead produces a return that does not penalize fund managers for timing decisions. The TWR calculation treats a dollar distributed today the same as a dollar distributed nine years ago. Time weighting was created to overcome instances where a manager had no control over the timing of cash into or out of their management, which is clearly not the case with real estate private equity funds.

Many survey respondents reported it was for these reasons that general partners do not calculate TWRs; those that do give the exercise little (if any) weight. For this reason, we would expect that the required Financial Highlights will be supplemented with other measures and disclosures.

TAX ISSUES

In their continued development, funds also face significant tax issues. Based on our survey and interviews with some respondents, we identified several key tax-related concerns facing opportunistic real estate private equity funds as they deal with the numerous challenges of meeting their yield targets. Generally, their tax goals are: to ensure there are no differences between the intended and actual cash distributions to investors or the general partner caused by distorted tax capital account; to minimize the general partner's current taxable income allocations; to minimize UBIT for tax-exempt investors, foreign taxes, and withholding on the fund's offshore investments, and U.S. tax liability for the taxable investors; to maximize the general partner's flexibility to structure investments for taxable investors; to coordinate tax planning and structuring with tax compliance functions; to arrange for state-of-the-art local partner tax deferral planning to facilitate property acquisition; to review internal general partner documentation regarding tax (and business) efficient incentives, benefits, and vesting within the general partner group; and effective internal clawback (and related breach remedy) provisions where such payments are required to be made by the general partner group to the fund.

To meet Internal Revenue Service (IRS) safe harbors and avoid, to the greatest extent possible, UBIT, nearly every fund makes its liquidating distributions in accordance with the final capital accounts of the partners. Thus, if upon liquidation there is a distortion in the partners' capital accounts caused by improperly allocated tax items (whether by mistake in structure or application, or as result of an IRS reallocation of tax items), distributions will not be made in the order originally negotiated in the tiered system for cash distributions (called the "cash waterfall" section) of the fund's partnership agreement.

To deal with this problem, the large majority of funds surveyed are adopting two approaches. They are considering instituting procedures that regularly test the partners' relative capital accounts (after allocating taxable income and loss) against the intended waterfall distributions. They are also adopting foolproof savings clauses in their partnership agreements that both satisfy the IRS safe harbors for tax allocations and ensure that tax allocations will produce correct economic capital accounts that will follow the intended cash waterfall distributions.

INCOME ALLOCATIONS AND DISTRIBUTIONS

A similar capital account problem results from the potential operation of the clawback in the 72 percent of responding funds that allow the general partner to receive interim distributions of "promote" before repaying to investors all of the investors' capital and unpaid cumulative return thereon. A "clawback" is the amount that the general partner must return to the fund for redistribution to investors if the fund does not perform as expected, and a promote is the percentage of earnings exceeding the general partner's percentage of capital contributions that the general partner receives should the fund perform as or better than expected.

A general partner's capital account is potentially distorted (too high) to the degree that they are allocated income attributable to promote distributions that are subject to clawback. To the extent the promote is deemed repayable under IRS rules, however, the promote payment is more akin to a loan than a distribution when it is received for tax purposes and no income should yet be allocated to the general partner. Consequently, a number of respondents indicated informally that they are reviewing taxable income allocations to general partners in order to determine whether income should instead continue to be allocated to the investors in the capital percentages (as opposed to allocating income to the general partner in a higher percentage to the extent it has received promote distributions).

The funds surveyed were divided on several timing and distribution issues: when the general partner receives its promote in relation to the return of investor capital and preferred return; when, and to what extent, the general partner is subject to clawback provisions; the method of handling the general partner's tax issues resulting from being allocated taxable income from operations or upon the sale of a property but receiving no actual cash because cash has to be paid to investors to satisfy investor IRR preferences; and how to handle interim promote funds. Most funds track contributions, distributions, and tax allocations on an investment-by-investment basis. This means the general partner is allowed to receive promote distributions from the sale of a fund investment after investors have received their capital (and promised return thereon) allocated to only that property, even if the investors' capital (and return) on other properties are still outstanding (Interim Promote Funds). In contrast, a few of the funds surveyed were "fully pooled," meaning that all of the investors' capital and unrepaid cumulative return must be paid before any distributions can be made to the general partner. One fund has a unique structure under which cash flow is distributed 90 percent to the limited partners and 10 percent to the general partner (without any preference for unpaid capital or cumulative returns) and upon the sale or refinancing, proceeds first repay investor capital (without a further preference for any cumulative return) and then are allocated 90 percent to the limited partners and 10 percent to the general partner. The balance of the funds were either "Interim Promote Funds" or "Fully Pooled Funds."

In addition, each fund that allowed for interim promote had at least one of the following clawback mechanisms to protect investors against situations in which, upon liquidation, the general partner could have received distributions in the promote percentage from some investments while the investors achieved less than a specified compounded return on their capital in other fund investments: the general partner is required to place a percentage of promote distributions in escrow (generally after-tax); the general partner is required to post a letter of credit for a portion of promote distributions; and other distributions to the general partner are reallocated to investors as necessary to satisfy the deficient return to investors on an aggregate basis through liquidation.

Concerning phantom income (i.e., when income is allocated, but no corresponding cash is distributed to the partners), 62 percent of the responding funds reported that their partnership agreements provide for relief for the general partner against their phantom income problems. In most cases, this involves a reallocation of preferential distributions away from investors and to the general partner as necessary to enable the general partner to pay its taxes on allocated promote income. Otherwise, the general partner may not receive enough distributions from the partnership to pay its taxes. All of these provisions treat these so-called "tax distributions" as an offset to future promote distributions to the general partner. Tax distributions have the effect of delaying the point at which the general partner can earn its promote on unsold properties, because to the extent money is distributed to pay the general partner's taxes, it cannot be used to repay unpaid investor capital or the accruing cumulative return thereon. As a result, a general partner is better off if it delays the time when it is allocated taxable income in its promote percentage than if it uses tax distributions to pay its taxes.

UBIT RISK

UBIT can result from the type of investment (e.g., condominium or home sales, direct ownership of hotels, interest computed on borrower net profits). But it also can result when leverage is used in acquiring or improving an equity or debt interest in real estate. UBIT from leveraged equity investments in real estate (as opposed to debt investments) can be avoided for pension plans and qualified educational institutions by complex tax allocation structuring (and certain related business limitations) that satisfy the IRS's so-called "fractions rule." Of the funds surveyed, 89 percent are allowed to have UBIT. A number of funds indicated informally that they obligate the general partner to use "reasonable efforts" to avoid UBIT for tax-exempt investors, but the general partner is allowed to incur UBIT if circumstances warrant (however, a few funds have actually guaranteed no UBIT to one or more investors). Some funds went further to protect the sponsor against disputes arising under the partnership agreement's reasonable efforts rule by clearly stating which investments are permitted to be acquired despite generating UBIT.

Most funds also require either attorney or accountant UBIT due diligence in the initial acquisition stage, and many have adopted ongoing UBIT monitoring programs (20 percent using internal employees only, 28 percent by attorneys or accountants, and 52 percent using a combination of internal and external resources). Perhaps surprisingly, many of the general partners do not involve the tax compliance accountants (tax return preparers) in all of the fund structuring, acquisition, and ongoing monitoring stages. Those who involve the tax compliance accountants at all of these stages do so to avoid a return position problem at tax return filing time that could have been solved when the documents were drafted or particular acquisitions were closed.

The potential for UBIT problems also arises under several other circumstances: when staged admissions are paired with payments to investors who were admitted earlier; when management fee discounts are not granted to all investors; when default buyout redemptions are permitted at a discount from fair market value; when the other partners receive an increased ownership; when some partners are required to ante up when one or more other partners default on their capital contributions (so-called squeeze downs); and, when clawback payments are received from the general partner. According to the documents provided or informal conversations, a number of general partners have either already provided special procedures for ensuring fractions rule compliance despite these issues or are in the process of doing so. Interestingly, only a few of the existing funds expressly authorize the general partner to structure so as to minimize the tax liability of taxable investors. In contrast, a number of general partners that had funds in formation reported they are adopting such provisions for both domestic and international investments on an ongoing basis in their new funds.

All of the funds surveyed report performing UBIT due diligence and monitoring internally. A number of funds have indicated informally that they also order supplementary external counsel and accountant reviews. Indeed, in an evolving cautionary trend, many funds have adopted multiple levels of review, checklists, and ongoing monitoring (both internally at the general partner level and with the outside professional firms) to protect against inadvertent UBIT traps. As noted, a number of general partners are increasingly involving their tax compliance professionals not only in the initial structuring of their funds but also in their ongoing business operations to ensure that tax judgment calls today do not create unintended results or issues later at tax return filing time.

The legal form or structure of the fund itself often can serve to eliminate UBIT, and one or more special entities are sometimes used to block the allocation of UBIT to a tax-exempt investor. Very few of the funds surveyed have actually used any UBIT blocker structures, and only a handful were fully aware of the wide variety of blocker structures that are available. A number of funds indicated informally that blockers are becoming particularly important in attracting private foundation and public charity investors, and for avoiding UBIT from sale/leaseback investments.

FOREIGN TAXES

Some of the funds surveyed are organized to invest exclusively in foreign properties, and a number of domestic U.S. funds may invest a portion (ranging between 10 percent and 30 percent) overseas without investor approval. The most popular locations include Western Europe and the Far East/Asia. A number of funds that invest overseas indicated informally that they have the authority to establish tax-efficient co-investment mechanisms and other structures that minimize any direct foreign taxes as well as foreign withholding taxes, and that enable foreigners to invest in the fund without doing business in the United States in a way that would subject them to U.S. taxes.

Foreign tax rules are in a constant state of flux as tax laws in every country continue to evolve in an effort to keep up with the sophisticated tax planning ideas and structures. In Japan, for example, the "TK" structure utilized by some funds is under review by Japanese tax authorities, and funds using this structure face the possibility of large tax assessments. The TK is a contractual agreement with a local Japanese proprietor that involves the use of funds provided by offshore entities, which in some cases pay no Japanese taxes. Fearing substantial exposure for unpaid taxes, some funds are exploring the use of the so-called Tokute Mokuteki Kaisha (TMK) structure, from which dividends from operations paid to investors are subject to a flat 20 percent withholding tax with the possibility of tax treaty reduction in appropriate cases. The sale profits, if the stock in the TMK is sold, are not subject to Japanese tax under certain treaties. Recently proposed legislation in Japan, if passed, would make the profit distributions from TK arrangements subject to a similar 20 percent withholding tax. If passed, this may create an alternative to the

TMK structure, which although beneficial from a tax perspective, is administratively difficult to utilize in practice.

OTHER ISSUES

A number of the general partners reported success in finding properties through advisors representing holders of real estate who are unable to sell because they face adverse tax consequences. One technique being used is a somewhat complicated partnership transaction between the real estate private equity fund and the property owner, which defers any tax liability for the owner, but permits the owner to monetize a substantial portion of the value of the property.

In response to our request for suggestions for future survey exploration, several general partners asked for industry data on: vesting within general partner entities (in both the promote share and asset management fee entities); benefit plans for employees, partners, and shareholders; succession planning at the general partner; clawback responsibility; key man insurance; and estate planning. Most of these general partners and other survey participants said they are in the process of examining (or plan to review) their own internal agreements concerning these business, tax, and accounting issues as part of their best practices review.

Yet another concern for funds is the ongoing need to streamline and standardize their businesses to remain competitive. Conversations with general partners and analysis of the survey data have made it clear that a number of circumstances are driving the funds to focus on improving and even re-engineering their infrastructure platforms (process, technology, and organization structure). Chief among the factors, of course, is the realization by general partners that opportunistic investing is an on-going business, not just an "opportunity" with a two-to-three-year window. But other factors are also at work. Funds are investing in a wider array of real estate using increasingly complex arrangements. At the same time, investors are calling for greater standardization in measures of performance. Also, general partners are trying to deliver more cost-effective returns by using software technology that was not available just a few years ago.

Of all the factors compelling funds to improve their business processes, a number of general partners have indicated that none has a greater impact than the globalization of the industry. For a global fund, manually intensive business processes with a spreadsheet and general ledger do not make the grade. The creation of value through the flow and sharing of information from the acquisition team to asset managers, finance and operations departments, and accounting and tax issues is complicated enough; it becomes even more so in a global environment. General partners must deal not only with currency, language, cultural, and time-zone differences; they must all deal with the range of government regulations and tax implications that exist from one country to the next, creating structuring and reporting issues that purely domestic funds do not face. Consequently, it is an environment that requires a well-defined organizational structure with clear roles and responsibilities as well as standardized procedures and processes that are supported by technology.

INFRASTRUCTURE

As businesses without boundaries, many survey respondents are finding it imperative that their processes, technology ,and responsibilities are well thought-out and defined, automated to the greatest extent possible, and integrated and understood throughout the entire global organization. In reaching these goals, funds have to surmount a number of challenges.

For example, survey respondents have indicated informally that there is often a disconnect in the flow of information between functions and departments, and it is a problem that is greatly magnified in global organizations. In closing a deal, it is more common than not that the most complex details of the transaction are not sufficiently or efficiently communicated to the back office, especially for accounting, reporting, and tax purposes, resulting in larger cycle times, greater costs, and the increased likelihood of compromised data flowing throughout the value chain. In many instances, the underwriting model is not updated for final deal terms, nor is it used as a management tool to monitor asset performance going forward.

The complexity of the structures and tax requirements results in significant documentation. But it is the management of these documents rather than the papers themselves that can greatly aid in knowledge sharing and the flow of information between time zones and global offices. Fortunately, there now are a number of technology tools available that will improve this important but often-overlooked business function.

International transactions are perplexing enough on their own, but when the fund structure itself becomes complex, perhaps as a result of multiple closings and currencies that, in effect, become a number of “funds” within a fund, the stress placed on the back office increases significantly. Generally, the more flexible the fund structure is for the general partner and investors, the more difficult and expensive it is to support.

Most global funds investing in Asia use middle-tier entity structures for tax purposes. From an operational perspective, however, these entities often are inadequate and place the fund at risk of not meeting some tax requirements. This is particularly important given the aforementioned challenges by Japanese taxing authorities. If approached correctly, middle-tier operations can provide real value to the back office and infrastructure. In addition to meeting substance requirements, they can provide back office support for Asian or European operations, and provide an internal central point for fund transfers and cash management.

BUSINESS TRANSFORMATION ISSUES

Most of the funds surveyed develop business plans, but their use as a management tool varies widely, as does the process deployed to develop them. For the most part, it is an arduous task, with few tools other than an Excel spreadsheet that is recreated each year. Consequently, the process usually takes anywhere from 90 to 150 days, but with little connection to the original pro forma or prior year's plan. The fund's budgeting plan, which should require a roll-up of the business plans, varies even more so from fund to fund. While most general partners go through the process, rarely is it used to manage the funds. The budgeting process also takes anywhere from 120 to 150 days, as well as a significant commitment of resources. We believe that for most funds the budgeting process needs improvement.

The transfer of funds is normally a rather routine operation. But in a global framework this relatively simple task faces its own set of unique challenges. For one thing, there is usually a multitude of parties involved, in crossing time zones. Ensuring an adequate audit trail and flow of funds through the various legal structures can also be challenging. If not handled properly, they risk compromising the benefits of the tax. In addition, funds operating globally need to deal with currency hedging issues, systems, and reporting to maximize return to investors, eliminate confusion, and avoid having a sound real estate investment turn into a money-losing proposition because of currency fluctuation.

Contact between headquarters, regional offices, and joint venture partners is frequently inefficient at best, and dangerous at worst. Some funds use the Internet to communicate. But they have no T1 or VPN lines to transmit confidential information, so basic security precautions are non-existent. Even when funds have the facility to communicate and transfer information between offices and partners, they tend to lack a standardized communications and reporting process. Many times, there is little or no regular schedule for reports, no specified format, no protocols.

And as a result, much of the work must be redone, reformatted, or manipulated at headquarters to fit the necessary information parameters.

If for no other reason than to eliminate duplicate entry of data, system integration is one aspect of the business process that can provide direct benefits. The goal is to obtain current and accurate information. For example, when a loan payment such as proceeds from the sale of an asset is received at the fund's banking institution, a good system will instantly update the fund's asset management database, which interfaces with the general ledger database so that up-to-the-minute financial and performance reports can be generated.

Unfortunately, the most basic type of integration across multiple systems does not appear to exist in the world of real estate private equity funds. The reason may be something as simple as coding references that differ from one system to another. But whatever the cause, our survey found that without any degree of commonality, the majority of funds are transferring data by e-mail, fax, or diskette. Repetitive data entry and a compromise in the integrity of that data is the result.

Another recurring challenge facing funds is the wide range of technological capabilities that exist at the various operational levels. This includes not only the in-place infrastructure in a foreign country, but also the analytical tools employed for financial modeling and sensitivity analysis at the home office.

The concept of document or content management is one with which nearly all funds are wrestling. The ability to scan, index, store, and quickly retrieve the content associated with a part of the business process is not one that even many of the businesses' leaders possess. Thus, getting to the point in which closing documents, operating systems, and loan servicing data is available for the entire portfolio seems a long way off. In addition, while most funds maintain some semblance of an investor relations database, few actually have adopted the most basic elements of customer relationship management. They must develop the ability to answer these essential questions: What information should be maintained about each individual investor? Does the same investor invest in multiple funds? What channel does the investor use to interact with the fund? What fund metrics have been communicated in the past and what metrics should be used in the future? Has the investor's position within the fund changed over time?

Many funds have asked which core financial and accounting systems are used by their colleagues and competitors. Our survey found that the MRI and Yardi Systems remain the industry leaders. Some funds use Peoplesoft, Timberline, Horizon, Platinum, Investran, or CODA. But with a continuing focus of tailored solutions for the real estate private equity and pension fund arena, both MRI and Yardi remain well entrenched.

Finally, in reviewing the data presented in the survey, several things become clear. For the most part, the major global funds are focusing on infrastructure and operations. They recognize that the complexities have grown and that the risks of a spreadsheet-based environment are simply too great. The funds making the greatest strides recognize that technology is not a silver bullet, but rather a tool to enhance operational efficiency and improve internal controls. They also recognize the interdependency of people, process, and technology in building their operations, and that often a process is not defined within a single department but crosses numerous functions, from sourcing and acquisition to accounting and investor reporting. To realize the benefits of change in the back office, changes are necessary in the front office, too.

Currently, the greatest opportunity for increased operational efficiency lies in the global operations and the connectivity of those operations to U.S.-based headquarters. This is also where the greatest risk exists. Fortunately, many funds recognize this as an area of vulnerability and are beginning to focus on upgrading their operating platforms and infrastructure. Unfortunately, most are doing so in a manner that is not leveraging off of lessons learned in the more mature U.S. market. Global offices are determining their own individual strategies without direction from the home office toward a global and uniform solution. Thus, disparate platforms are being created, platforms that, in many cases, do not meet the needs of either the local or headquarters offices. The result is a more costly, less efficient, and less seamless solution than is otherwise possible. The best-in-class funds are approaching their infrastructure needs from a truly global perspective, a position that leverages the lessons learned from the matured distressed asset market in the United States and the technology solutions now available.

CONCLUSION

In a little more than a decade, opportunistic real estate private equity funds have become a major component of the real estate capital markets in the United States and abroad. With this global expansion and the gradual maturation of this sector have come the types of operational issues and problems experienced by many industries. General partners are facing increased pressure to standardize performance reporting, create greater transparency in financial reporting, and develop consistent valuation methodologies for investments. General partners operating these funds have come to recognize some of the most critical issues and are considering ways to improve their reporting and operations. There are many areas where general partners may have an opportunity to drive cost savings, including adopting and integrating technology solutions, improving global communications, and identifying and implementing appropriate tax structures and strategies. The real estate private equity fund sector has come far in the last decade, but it still has a long way to go.

No attempt was made to verify the information supplied by the respondents. Ernst & Young does not take responsibility for the accuracy or reliability of this data.